

# Working Paper

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## **Can China Change Development Paradigm for the 21st Century?**

**Fiscal Policy Options for Hu Jintao and Wen  
Jiabao after Two Decades of Muddling through**

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# I. Introduction: “China Says Goodbye to Blind Pursuit of GDP Growth”

Over the past year, China has been abuzz with talk of a new development paradigm that was best epitomized by this headline in People’s Daily<sup>1</sup>: “China Says Goodbye to Blind Pursuit of GDP Growth”. Starting with the communiqué of the 16<sup>th</sup> Party Congress in September 2003, when the new administration of Hu Jintao and Wen Jiabao was announced, the call was sounded for emphasizing the *quality* of growth and downplaying the traditional stress on quantitative growth targets. This change was spelled out in more specific terms in Premier Wen Jiabao’s Report to the National People’s Congress on March 5, 2004, when he called for:<sup>2</sup>

- Reorienting China’s development strategy to one that emphasizes balanced, sustainable, and “people-centered” growth
- Strengthening social protection
- Solving fiscal problems of the rural sector
- Curbing corruption and government abuse, and
- Putting China on a timetable to achieve “*xiaokang shehui*” (well off society).

Following the National People’s Congress, the change in rhetoric has been striking. From government ministries to think tanks in Beijing, the talk is of a switch to a “scientific concept of development” that will be “people-centered” (*yiren weiben*), that rejects a narrow focus on GDP growth to emphasize social development, as well as a balanced, more inclusive growth. Premier Wen Jiabao, in particular, has called for redressing the current inequalities by “tilting” toward the rural sector through promulgating *sannong* policies with more favorable treatment of the agricultural sector, rural villages, and farmers – the “three agricultures”. In support of these policies, he has instructed the Ministry of Finance to come up with a plan to “extend public finance to the rural villages,” to improve the delivery of public services to the rural sector. The tenth five year plan (under preparation) is expected to include a set of objectively verifiable indicators for the achievement of the *xiaokang shehui* that will include socioeconomic indices such as educational attainment, access to clean water and health care, etc., that mimic closely “human development indicators” used by international organizations.

This seems a timely, long overdue adjustment of the development path China has taken since beginning its remarkable transition to a market economy some 25 years ago. This paper addresses the new paradigm and assesses China’s prospects for making the switch in development strategy, focusing especially on whether the government will be able to reverse the trend of growing inequality. This assessment will be done through the lens of fiscal policies, the primary instrument for the government in implementing the new paradigm.

## II. The “old” paradigm and the impetus for change

It would be unfair to characterize the “old” paradigm (circa 1978-2000) – the one intended to be replaced, as the “blind pursuit of GDP growth” implied by the People’s Daily headline cited above. However, it is undeniable that achieving economic growth was assigned top priority through the past two decades. The most concrete manifestation of this was the enshrinement of GDP growth at the top of performance indicators used in the cadre evaluation system at all levels of the administrative hierarchy (Whiting 2003). The old paradigm also tolerated a higher degree of inequality under the call of Deng Xiaoping, its chief

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<sup>1</sup> March 2004.

<sup>2</sup> Traditionally, the Premier appears at the annual National People’s Congress meetings in March to present a report on the work of the government. This report reviews the achievements of the past year and outlines the main undertakings for the coming year. This report is the occasion for presenting major new policies and changes in direction.

architect, at the outset of reform to “let some people (regions) get rich first.” The logic behind the call appeared to be that, if market reform brought with it rising inequality, it was the price to pay for faster growth, to lift the country out of the abject poverty that Maoist policies had brought.

Achievements of China’s liberalization and market transition are spectacular and well-known.<sup>3</sup> Since 1978, China has experienced a prolonged growth spurt that saw a nearly eight-fold increase in per capita GDP – a record unparalleled in world economic history.<sup>4</sup> What has been even more remarkable was the extraordinary rate at which China has joined the global economy. Starting out as an autarkic economy largely insulated from world trade, Chinese exports doubled every three years. By 2002 China had become the fifth largest trading nation in the world; in 2004 it was the third largest. In this process, China achieved impressive rates of productivity growth and improvement in global competitiveness; today it dominates world trade in a number of light manufactures including consumer electronics. In the 21<sup>st</sup> Century, China’s economic ascendancy has made it an “engine of growth” increasingly courted by world leaders. By IMF estimates, China accounted for nearly one-quarter of world economic growth in 2004, a remarkable feat given that the Chinese economy remains small compared to the major countries – it is just one-eighth the size of the US economy and less than 5 percent of the world GNP (World Development Report 2004).

Fueling this performance was the rapid structural transformation of the economy – some 25 percent of China’s labor force moved from low productivity agricultural sector jobs to higher productivity jobs in the industrial and service sectors. As productivity rose across-the-board, as many as 400 million people were lifted above the official poverty line, making this the most successful poverty alleviation program in world history.<sup>5</sup>

Time for a course correction?

Given these spectacular successes, it may seem surprising for the new, as yet untested administration of Hu Jintao and Wen Jiabao to call for a significant change in development strategy. The reasons are several-fold. First, while achieving this economic miracle, China also acquired a reputation as a country that has abandoned its socialist past and embraced a particularly virulent form of capitalism. The evidence includes a rapid rise in interpersonal income inequalities as measured by Gini coefficients, which rose from an estimated 0.28 in 1978 to 0.45 at the end of the 20<sup>th</sup> Century – a level that puts China in the same league as Latin American economies, and far worse than its East Asian neighbors.<sup>6</sup> A major cause is an urban-rural income gap that is among the biggest in the world. Having grown secularly since the mid-1980s, the ratio of average urban to rural income is now estimated to be more than three. The ever-growing divide between coastal and inland provinces also contributes to making China among the most unequal countries in the world. These large disparities are aggravated by the *hukou* system, a system of residency controls retained from the Maoist era, which imposes a caste-like divide between urban and rural populations. While rural-urban migration, prohibited for two decades during the 1960s and 1970s, has resumed and accelerated, rural migrants are denied access to many urban social services such as schooling, housing, health care and welfare provisions.

Since the 1990s, there have been increasing signs of social tension, fanned by the emergence of a muckraking press. Demonstrations and protests have become commonplace throughout the country: police statistics show the number of public protests reached nearly 60,000 in 2003, an increase of 15 percent from 2002 and eight times the number a decade ago.<sup>7</sup> They range from pensioners, laid-off workers and teachers marching on city hall to complain about defaults on payment of salaries and benefits, to farmers protesting against rising fees and levies (Bernstein and Lu 2003), to citizens protesting against unlawful/unreasonable evictions in the name of urban development, to violence that just explodes

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<sup>3</sup> For an overview of China’s economic achievements through the first twenty years of transition, see World Bank (1997).

<sup>4</sup> In recent world economic history, Japan and South Korea underwent growth spurts of similar magnitudes, but China has maintained the growth spurt for longer duration and at higher rates.

<sup>5</sup> World Bank (2001).

<sup>6</sup> See, for example, Li Shi, “Empirical Analysis on Rising Income Inequality in China at the Beginning of the New Millennium”, paper presented at the International Symposium on Income Distribution during the Economic Transition, Shanghai Academy of Social Sciences, January 2005; and Wang Shaoguang, “A framework for the study of inequality,” a background paper for the Human Development Report 2005: China.

<sup>7</sup> Joseph Kahn, “China’s ‘Haves’ Stir the ‘Have Nots’ to Violence”, The New York Times, December 31, 2004.

on perceived injustices, etc. Social surveys conducted in recent years consistently find increasing concerns about income inequalities, official corruption and economic security. Two recent books on the plight of the farmers, *China along the Yellow River* (2000) and *Investigations of China's Farmers* (2004), created a stir among urban residents and brought popular outcries for corrective action. The environmental degradation in many parts of the country – chemical run-offs ruining rivers and contaminating ground water supplies, large cities choking from polluted air, etc., have also brought increasing calls to re-examine the strategy of pursuing growth at all costs. Finally, leadership successions are opportunities for the introduction of bold policy initiatives, as the new leaders try to prove their worthiness and put their marks on the country's direction, undoubtedly this is partly the motivation of Hu Jintao and Wen Jiabao as well.

### III. Fiscal policies: China's decentralized system and the growth of inequalities in late 20<sup>th</sup> Century

The new development paradigm calls for more government assistance to the poor – people, regions, and sectors. The focus on the “all-around building of a well-off society” (xiaokang shehui) will require a significant reallocation of government resources, away from the traditional “hardware” of productive investments to more investment in “software” – education, health, social welfare, and the environment. To assess the prospects for the successful implementation of the paradigm, in this section we turn to fiscal policies, especially the intergovernmental fiscal system.

To understand the central role played by the intergovernment fiscal system in shaping distributional outcomes in China, we start with some stylized facts. First, China is the most decentralized country in the world by expenditure shares: the central government accounts for only 30 percent of total budgetary expenditures. The rest are distributed across the four levels of subnational government (see Annex A for the structure of government). Some comparative data are presented in Table 1 to show China to be far more decentralized than other countries.

**Table 1: China's Decentralization in Comparative Perspective**

	Sub-National Expenditure (% National Expenditure)
China 2003	70
Developing Countries 1990s	14
Transition Countries 1990s	26
OECD Countries 1990s	32
Other large countries (1990s):	
Germany	40
India	46
Japan	61
Pakistan	29
Russia	38
USA	46

Source: adapted from Mountfield and Wong (2005), and Bahl (2002).

The reason for the central government share to be so small is because in China, many costly public services are financed by subnational governments. Among the most notable are that cities and counties have sole responsibility for pension pooling, unemployment insurance, and social welfare programs such as the minimal living stipends scheme. Counties, districts and townships together account for 70 percent of public expenditures on education, including all basic education in the rural sector. they also account

for 55-60 percent of public subsidies to the health sector (World Bank 2002).

Table 2 shows that China is also unusual in assigning many responsibilities to the lower levels of government, below the province.

Table 2. Expenditure Assignments in Selected Comparator Countries

	Defense	Foreign Affairs	Environment and natural resources	Unempl. Insur.	Industry and agric.	Education	Health	Social welfare	Police	Highways
China	F	F	F,S,L	L	F,S,L	L	L	L	L	F,S,L
Vietnam (2004)	F	F	F, S, L	..	F, S, L	S, L	S, L	F, S, L	F	F, S, L
India (1)	F	F	F,S	F,S	F,S	F,S	S	F,S	S	F
India (2)	F	F	F,S	F,S	F,S	F,S,L	S,L	F,S	S	F
Japan (1)	F	F	..	..	L	F,L	F,L	F,L	L	..
Japan (2)	F	F	..	..	..	L	F,L	F,L	F,L	L
Malaysia (2)	F	F	L	..	F,S	F	F,S	F,S	F	F
(assignment of constitutional powers)										
Canada	F	F	F,S	F	C	S	S(F)	F,S	F,S	S
United States	F,S	F	F,S	F,S	S	S,F	S(F)	F,S	F,S	F,S
Switzerland	F	F	C	C	F,S	C,F,S	S,C	F,C	S	FS
Australia	F,S	F	F,S	C	S,C	F,S	F,S	C	S,F	F,S
Germany	F	F,S	C	C	C	C,S	C,F,S	C	C,S	C
Austria	F	F	F,S	F	F	F,S	C,F,S	C	F,S	F,S

Source: adapted from Mountfield and Wong (2005), Table 2.

Key: 1 = responsibility; 2 = provision; F = federal/national; S = state/province; L = local; C = concurrent

China is virtually unique in assigning pension pooling, social welfare and unemployment insurance to local governments. In other countries, because of their ballooning costs and potentially large requirements for fiscal subsidies, social security is almost always provided by the central (or federal) government, except in a few former Soviet republics.<sup>8</sup> Safety net mechanisms are almost always jointly financed by the national government because these large, cyclical expenditures are difficult for local budgets to accommodate especially as they run counter to economic cycles (i.e. with expenditures rising during economic downturns, when tax receipts are falling). Responsibilities for basic education and public health are similarly often shared with the provincial and central governments because of their costliness, important spillover effects, and concerns for maintaining minimum standards of provision.

These unusual expenditure assignments in China are the unreformed legacies from the planned economy. During the 1950s-1970s, in China the central government was responsible for national defense, economic development (capital spending, R&D, industrial policy, universities and research institutes), and administration of national institutions such as the judicial system. Local governments had responsibilities for delivering day-to-day public administration and social services such as education (except universities), public safety, health care, housing, and other local/urban services. Social security (pensions) was mostly the responsibility of state-owned enterprises.<sup>9</sup> These assignments were unproblematic because they were financed by the central budget through revenue-sharing arrangements.

#### Decentralization by default rather than design

Through the twenty-five years of transition to a market economy, the expenditure assignment *rules* have remained largely intact, while *expenditure shares* have shifted significantly to local governments. The rules remain that subnational governments are mainly responsible for public administration and “local social

<sup>8</sup> In the early 1990s in Brazil the states and municipalities were allowed to opt out of the national social security scheme, and many established their own scheme. The poor design and management of these local schemes have led to the creation of contingent liabilities on local governments that amount to as much as 500 percent of GDP. Yvonne Sin presentation at the World Bank, March 17, 2005.

<sup>9</sup> Unemployment was not recognized as a problem and no provision was made for it.

needs”, while the central government focuses on issues of national scope. However, several changes occurred to raise the subnational share of expenditures:<sup>10</sup>

1. Under the planned economy, a large portion of central spending went to capital investments and providing financing for state-owned enterprises. By the mid-1980s, the financing for state-owned enterprises had been transferred from the budget to the banking system, as were the bulk of capital investments. These reduced central spending relatively.
2. Responsibilities for capital investments in support of local economic development were decentralized to local governments.
3. Social expenditures that had been borne by state-owned enterprises – including housing, pensions, education and health care, were gradually transferred to local governments.
4. Retrenchment in the state-owned enterprise sector led safety net expenditures to rise rapidly – unemployment stipends, early retirements and increased pension payouts.
5. Rapid wage increases during the transition have raised the cost of labor-intensive services such as public administration, education, health and other social services, affecting disproportionately subnational expenditures.
6. Local government expenditures also rose with the rising standards of provision for education, health care, etc., due to national policy as well as popular demand.
7. Urbanization, increased mobility of population, and the growing diversity of economic entities brought increased costs of infrastructural and other urban services including public safety, judicial and procuratorial services, most of which are local responsibilities.

Even without a revision of functional assignments, these changes combined to raise the subnational share of total budgetary expenditures from 45 percent in 1980 to 70 percent by the 1990s. In the meantime, though, revenue-sharing rules were being changed repeatedly by the central government in response to macroeconomic pressures and attempts to stimulate revenue mobilization, and the link between local revenues and expenditure needs was weakened and then severed. As a result, local governments were shifted from performing deconcentrated functions of the central government to financing these functions.

#### Changes in revenue sharing rules

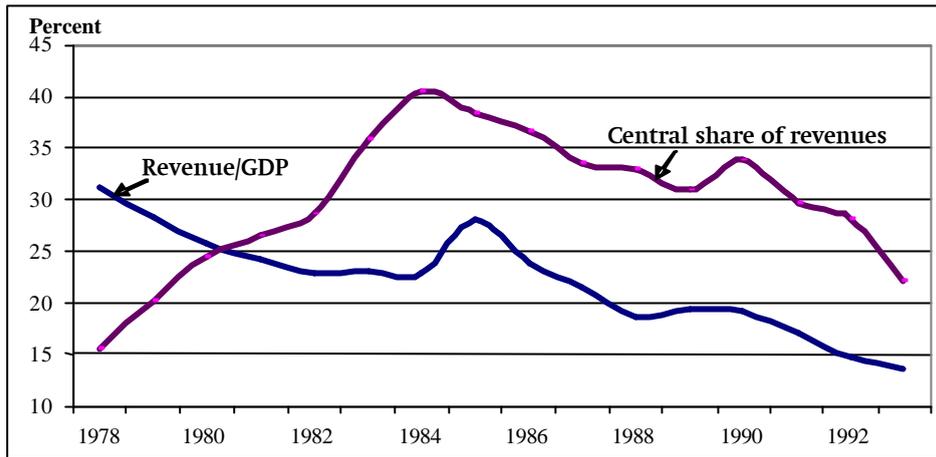
Under the planned economy, all revenues belonged to the central government, but were collected by local governments and remitted upward. Revenue sharing with local governments was *ex post*, negotiated annually, and adjusted to finance local government functions. Market reforms brought a rapid and dramatic erosion in the traditional tax base of the planned economy – state-owned enterprise profits, and revenue collection declined steeply. Central revenues were especially hard-hit as local governments in rich regions often shielded local enterprises from taxation to avoid sharing revenues with central government.<sup>11</sup> The results can be seen in Figure A, where budget revenues fell from more than 30 percent of GDP to less than 15 percent during 1978 – 1993. At the same time, the central government’s share of revenues was also declining as revenue assignments adjusted to the rising expenditure needs at the local levels.

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<sup>10</sup> See Wong (1991) for a discussion of these effects on increasing local government fiscal burdens, most of which had occurred during the 1980s.

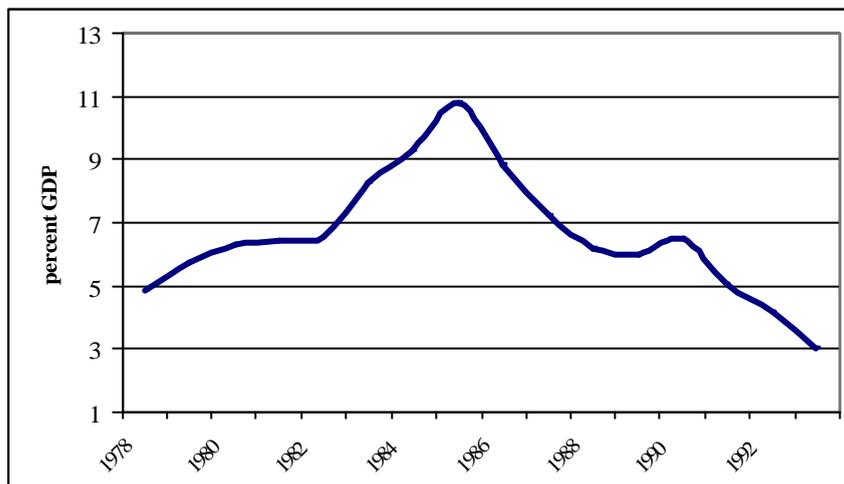
<sup>11</sup> For example, under the planned economy Shanghai remitted more than 80 percent of its revenues to the central government. This high “tax” on Shanghai revenues created incentives for collusion between the municipal government and its subordinate enterprises and the potential for informally sharing the “saved revenues” within Shanghai. For analyses of this evolution, see Oksenberg and Tong (1991), and Wong (1991, 1992).

Figure A. The “two ratios”



The resultant squeeze on central resources is shown in Figure B, where the net result of the trends in overall revenues and the central share meant that resources under central government allocation fell from the mid-1980s, to only 3 percent of GDP at the nadir.

Figure B. Resources under central budgetary allocation



To stop the hemorrhage on central resources, the government retreated in 1988 to a system of fiscal contracts in an attempt to revive revenue collection – by offering better incentives to local governments to boost revenues, as well as ensure stable receipts at the center. The contracts stipulated a lump-sum remittance (or subsidy) for each province, to increase annually by an agreed rate, with all the rest accruing to the province. In return, provinces accepted responsibility for meeting their expenditure needs from retained revenues. This change de-linked revenue sharing from expenditure needs and put subnational governments on a self-financing basis for the first time – a *de facto* devolution of responsibilities.

#### Recentralization of revenues: the Tax Sharing System reform in 1994

Fiscal contracts did not solve the central government’s financial problems, though, as revenues continued to decline due to continuing problems of SOE profitability and persistent credibility problems of the central government. Moreover, as the generous terms of the contracts gave local governments a disproportionate share of new revenues, the central share of revenues continued to fall, to just over 20



## The broken intergovernmental system and the growth of inequalities

Through the 1980s and 1990s, the coherence of the intergovernmental fiscal system was steadily chipped away by the piecemeal, incremental changes that occurred. While the Soviet-type system that was in use had been conducive neither to efficiency nor growth, it had built-in mechanisms for adjusting revenues assignments and transfers to expenditure needs. During the 1980s, amidst the steep fiscal decline, attention was focused on how to resuscitate revenue collection. Reforms on the intergovernmental system were designed to stimulate tax effort by local governments, and virtually no attention was paid to issues of expenditure assignments. Equally little attention was paid to transfers, which were increasingly driven by dwindling central resources (Wong 1997). By changing only one component of the intergovernmental system – revenue assignments, and delinking them from expenditure needs, the reforms have left local governments saddled with unusually heavy and unsustainable expenditure assignments, especially at low levels of government.

By the mid-1990s, local governments were self-financed, with no supporting system of transfers to ensure minimum standards of service provision across regions. As economic growth also became more concentrated in coastal regions during the 1990s, income disparities accelerated, and the fiscal system provided no palliative. The outcome was a sharp rise in interregional disparities in fiscal spending – Table 3 shows a significant worsening of the distribution in both economic and fiscal resources through the 1990s.

**Table 3. Fiscal and Economic Concentration in Rich and Poor Provinces**

	1990	1998
<i>Five richest provinces<sup>a</sup></i>		
Percentage of GDP	22.8	25.1
Percentage of population	12.7	12.2
Percentage of revenue collections	26.0	23
Percentage of government expenditures	19.8	18.5
<i>Five poorest provinces<sup>b</sup></i>		
Percentage of GDP	12.7	11.7
Percentage of population	18.9	18.7
Percentage of revenue collections	12.3	9.8
Percentage of government expenditures	14.0	8.6
<sup>a</sup> Shanghai, Beijing, Tianjin, Guangdong and Zhejiang.		
<sup>b</sup> Guizhou, Gansu, Sha'anxi, Jiangxi and Henan. Tibet and Hainan are excluded because of special circumstances and data availability.		
Source: World Bank (2002), Table 2.6.		

With the built-in adjustment mechanisms eliminated in the 1980s, but the government slow to reform the system of transfers, many local governments have been unable to perform their assigned functions especially in poorer regions (World Bank 2002). There were reports of deterioration in public services provided in the inland provinces. For example, Heberer (2001) reports that in the Liangshan Yi Autonomous Prefecture in Sichuan Province, fiscal problems led to the elimination of free medical care and epidemic prevention programs, free films and cultural activities by the mid-1990s. Many clinics and health stations closed. Epidemic diseases thought to have been wiped out reappeared. In 1996, only 40 percent of Yi children attended school, a figure that dropped to 10 percent in the poorer villages. Through the 1990s, financial pressures on local governments continued to intensify as national campaigns imposed rising standards of provision for education (the nine years of universal compulsory education), rural roads, etc. When funding was unavailable in the poor regions, local governments turned increasingly to imposing fees, levies and user charges to finance the cascade of unfunded mandates from higher levels.

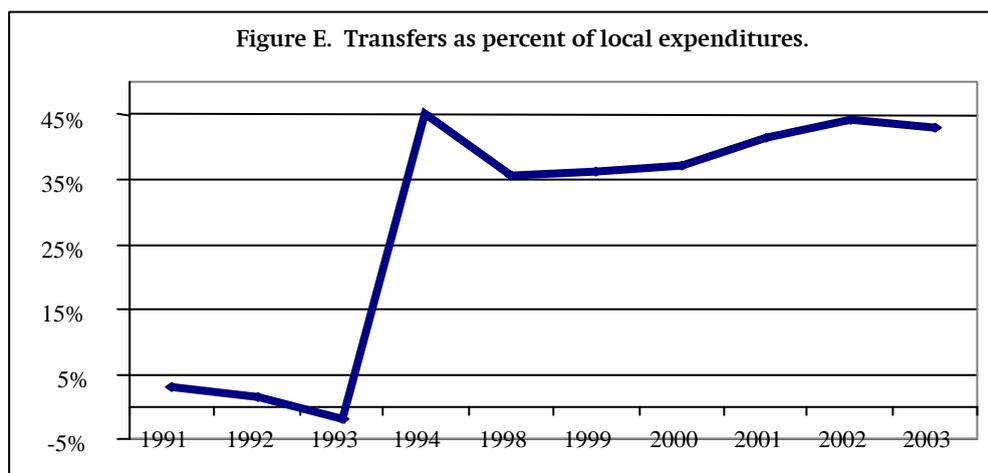
The outcomes of this intergovernmental fiscal system are highly regressive. Citizens in rich localities enjoy more and better quality public services while citizens in poor localities not only have access to fewer services of lower quality but have to bear a proportionally higher share of the costs through user charges. By leaving so many costly but important responsibilities at the local level and providing little support to

their financing, the national government essentially abrogated its social responsibility to the poor regions. In effect, with the TSS reform, the government had turned its back on the poor. This decentralization by default can be seen as part of the strategy of “muddling through” – by devolving responsibilities to lower levels, defaults on government obligations can be hidden or blamed on local conditions.

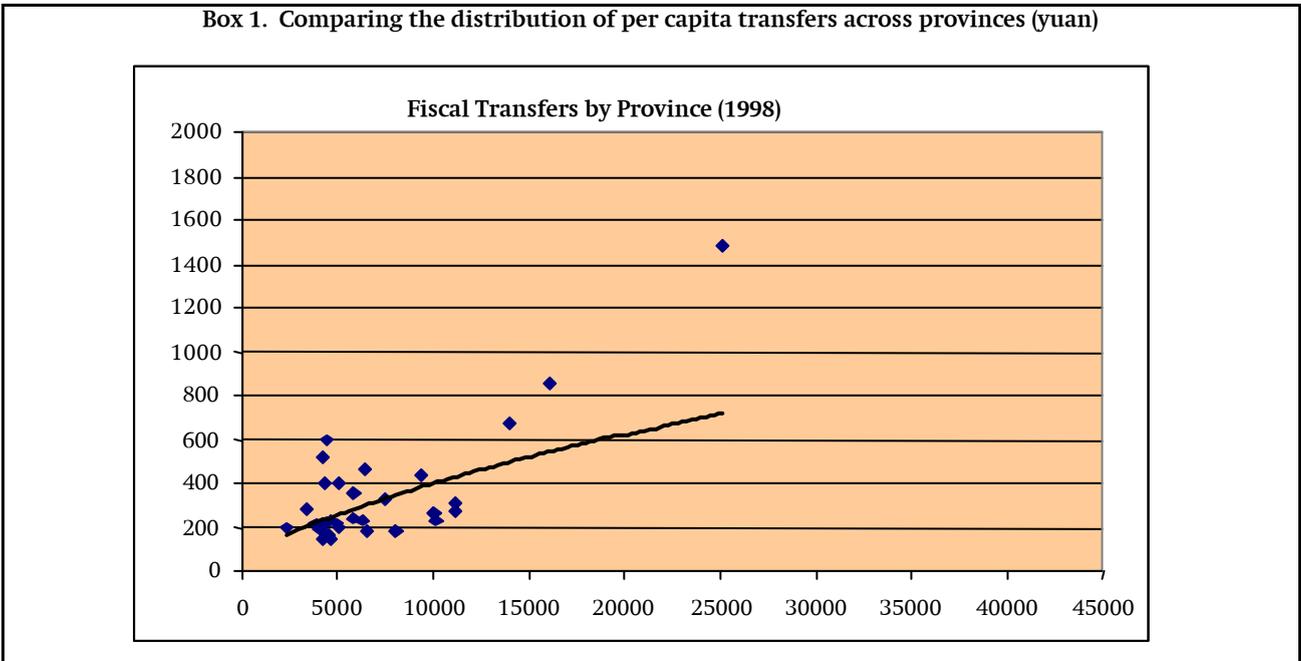
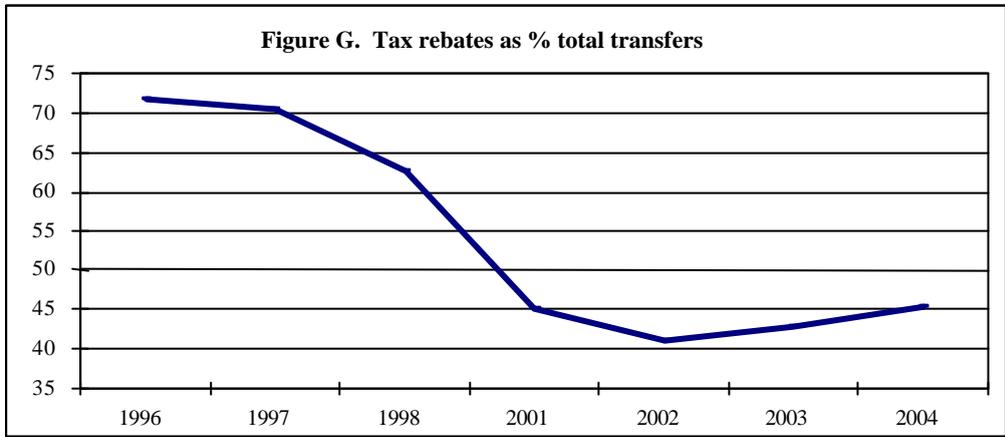
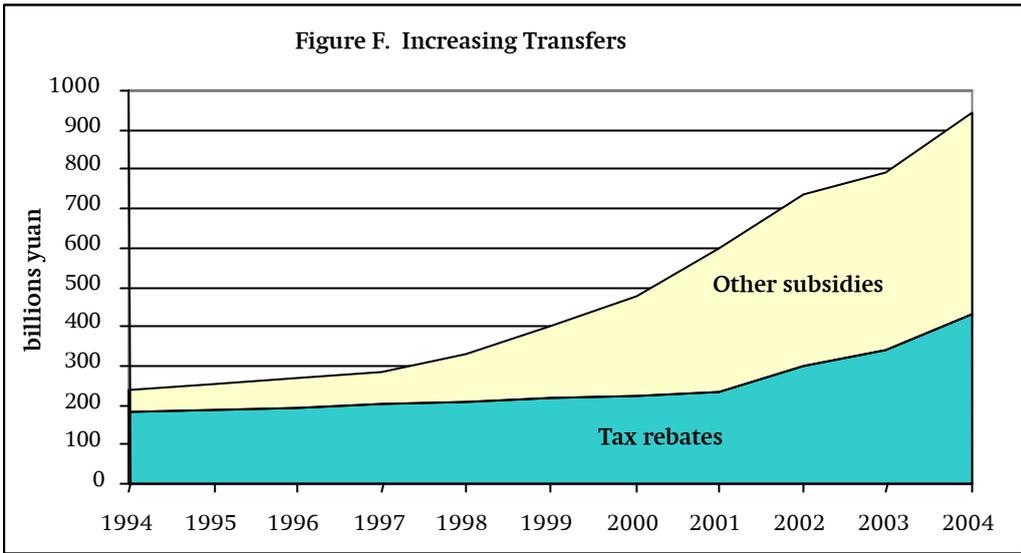
But the costs were increasingly evident, as the intergovernmental system became a bottleneck to national policy implementation. With local funding problems limiting services, the national government has been unable to deliver on some priority programs such as universal basic education – China is still unable to provide nine years of free education to all children that was targeted for Year 2000. In spite of repeated pledges by the State Council to increase investment in human development, budgetary spending on education remained stagnant at about 2-2.5 percent of GDP during 1978-1999, half the level called for in the 1985 Education Law, and well below the levels of spending in neighboring East Asian economies. Similarly, in health care, public spending is low, also less than 2 percent of GDP.

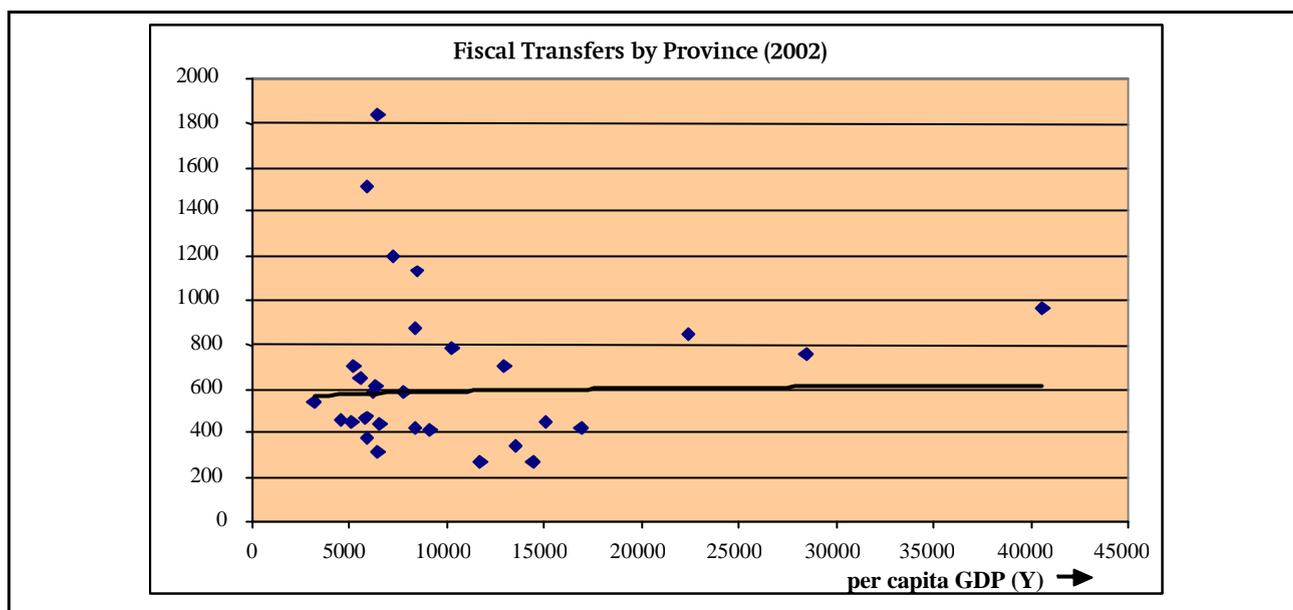
#### IV. Can the inequalities be reversed?

By recentralizing revenues but leaving expenditure assignments unchanged, the TSS had created a huge vertical fiscal gap that had to be filled by transfers. At present subnational governments depend on transfers to fund nearly half of their expenditures (Figure E). Reversing the inequalities would seem to require only tinkering with the design of transfers.



In fact, attempts to improve equalization had already begun under the Zhu Rongji administration. Since around 1998, a number of new programs have been introduced that had the effect of “tilting” toward the poorer regions. This began with the fiscal stimulus program introduced in 1998 to counter the effects of the Asian Financial Crisis with deficit spending. The program injected 100 billion yuan into capital spending, mostly on infrastructural investments, and the decision was taken to “tilt” them toward promoting economic growth in inland provinces. The Western Regional Development Initiative introduced in 1999 was explicitly targeted at the poorer western provinces. In addition, there has been a proliferation of ad hoc, earmarked grants also slanted toward poorer regions (Figure F). Because of the increase in other subsidies, tax rebates have declined steeply as a share of transfers (Figure G). Given the extremely disequalizing nature of tax rebates, these changes should have improved equalization.





This is confirmed by the figures in Box 1. However, while Box 1 shows that transfers may have stopped being disequalizing, it does not show transfers having a clearly equalizing effect. Moreover, Table 4 presents a picture of very large fiscal disparities across provinces: in 2002 per capita budgetary expenditures were 5307 yuan in Shanghai, the richest provincial level unit, and just 655 yuan in Guizhou, the poorest one. The range of 8.1 to 1 from the richest to the poorest is large by international standards. These inter-provincial disparities were aggravated by the TSS reform in 1994, but have moderated since 1998. Given that very large differences remain, the size of the equalization effort required is huge.

Table 4. Provincial disparities in per capita budgetary expenditures \*

	1990	1992	1994	1996	1998	2000	2002
Highest (1)	609	737	1452	2415	3211	3708	5307
Lowest (2)	104	127	157	278	347	470	655
Ratio of (1)/(2)	5.9	5.8	9.3	8.7	9.2	7.9	8.1
average (unweighted)	242	285	416	603	795	1027	1502
Coeff. of variation	0.54	0.53	0.64	0.74	0.76	0.72	0.69

\* excluding Tibet.

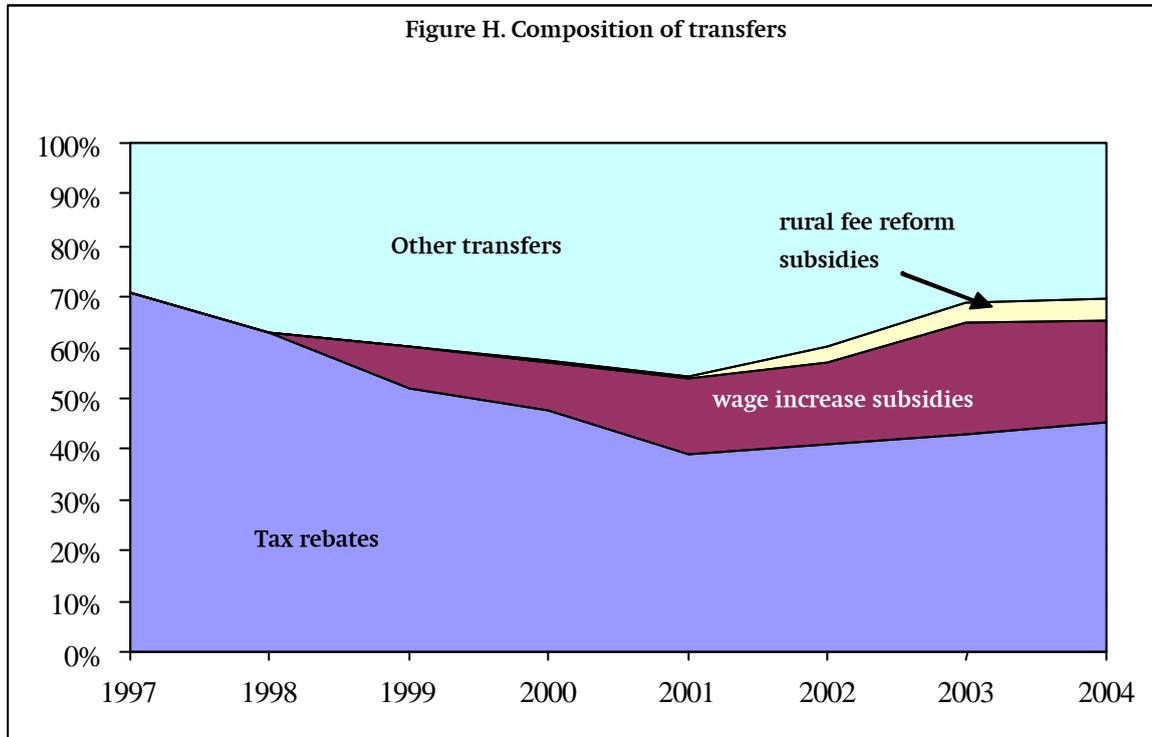
Source: Chinese Fiscal Statistical Yearbooks.

A closer look at the composition of transfers in the tables and figures below exposes some major problems for implementing “balanced growth”, and especially for Wen Jiabao’s laudable program to “tilt” toward the rural sector.

First, starting from the current situation where tax rebates remain more than 40 percent of the total (Table 5), the amount of change necessary just to neutralize their disequalizing effect is far too huge to be politically feasible, and would face enormous resistance from the rich provinces. Moreover, even though revenues have recovered significantly, the government’s tax capacity remains weak at around 20 percent of GDP. The central government still allocates only about 10 percent – a relatively low figure for a large and diversified country that faces many large expenditure needs in continuing SOE reform, recapitalization of the banking sector, pension reform, etc.

Table 5. The size of central transfers

	2003	2004
Total (billions yuan)	793.7	941
Tax Rebates	340.4	427.7



Second, it shows the limits on the central government's allocative power. Figure H shows the fastest growing component of transfers to be the "wage increase subsidies": introduced in 1998, it has grown to absorb 20 percent of total transfers, or 36.5 percent of transfers outside of tax rebates (Table 6). These are transfers given to most provinces to offset the cost of wage increases for public employees. Under China's nationally unified civil service pay system, centrally mandated pay increases raise the cost of government throughout the administrative hierarchy; since 1998 there have been six rounds, and the level of wages and salaries have more than doubled. Since wages and salaries are a large and often major component of local government spending, these pay raises caused havoc with local budgets, and the central government has been forced to help local governments cover these increased costs.

Table 6. The growing share of wage increase subsidies in central transfers

(unit: billions yuan)	1999	2000	2001	2002	2003	2004
Wage increase subsidies	34.3	45.1	89.2	118	175.5	187.3
As share of total transfers	8.4%	9.7%	14.8%	16.0%	20.0%	19.9%
As share of transfers net of tax rebates	17.4%	18.3%	24.2%	27.1%	32.7%	36.5%

Sources: Budget speeches and speeches on government work reports at the National People's Congress, and author interviews.

Within "other subsidies", another large component that has grown rapidly comprises subsidies to bail out local social security schemes, and subsidies to fill funding gaps for living stipends for laid off workers and urban minimum living stipends (Table 7).

Table 7. Social security and welfare subsidies.

(billions yuan)	Subsidies to local social security schemes	Subsidies for laid off SOE worker stipends	Urban minimum living stipends
1998	15.0	7.6	0
1999	34.4	9.0	0
2000	n.a.	13.3	0
2001	34.9	12.7	2.3
2002	51.2	n.a.	4.6

Source: budget speeches, *Labor and Social Security Yearbook 2002*, p. 552.

Both the wage increase subsidies and subsidies to social security and welfare programs are transfers aimed at bailing out local governments: meeting payroll, and keeping social security and unemployment schemes from defaulting. They are expenditures needed to put out fires in specific areas to preserve social calm. The extent to which these expenditures are constraining central government allocative discretion can be seen in the following: In 2001 social security bailouts plus the wage increase subsidies together absorbed RMB187.4 billion from the central budget, which accounted for nearly one-third of all central transfers and more than 60 percent of transfers net of tax rebates. In 2002 central expenditures on these items jumped to some RMB400 billion, absorbing virtually *all* of the central government transfers to local governments outside of tax rebates and “system subsidies”, leaving little room for new programs.<sup>15</sup>

In other words, the central government has been forced to subsidize local expenditures in these areas because of the “wrong” assignment of responsibilities and a contradiction in the intergovernmental fiscal system – a nationally unified civil service pay scale clashing with decentralized finance. While these subsidies have some equalization effect – they have gone mostly to inland provinces,<sup>16</sup> they are all urban, and are not best targeted on the poorest regions or populations. By comparison, the subsidies for rural fee reform are tiny (equal to only 4 percent of total transfers in 2004).

Moreover, the piecemeal changes to the intergovernmental system have created many distortions, so that local governments are extremely inefficient, and increased transfers from the central will not translated straightforwardly into better services at the periphery. The single biggest distortion is that of civil service wages. Rudimentary budgeting practices that allocate subsidies on a per staff basis continue to encourage adding staff despite national campaigns calling for downsizing the civil service. This is especially since over the years, it became clear that the Ministry of Finance intervenes whenever necessary to preserve social stability, and will go to great lengths to prevent wage arrears from getting out of hand. In essence, civil servants are free goods to local governments. Second, the nationally unified civil service wage scale translates into salaries that are very high relative to local incomes in poor regions. This gap has grown as civil service wages have more than doubled since 1998. The result is that local governments, especially at the county and township levels, are adding staff at accelerating rates, and “selling” civil service positions is commonplace (Burns 2003). In many localities the provision of services to residents continues to lag as personnel costs are squeezing out non-personnel recurrent expenses, despite increased funding from higher levels. In one rural county, for example, the new Center for Disease Control built with post-SARs subsidies has no funds to pay for gasoline for the Center’s two vehicles but it has added new staff.

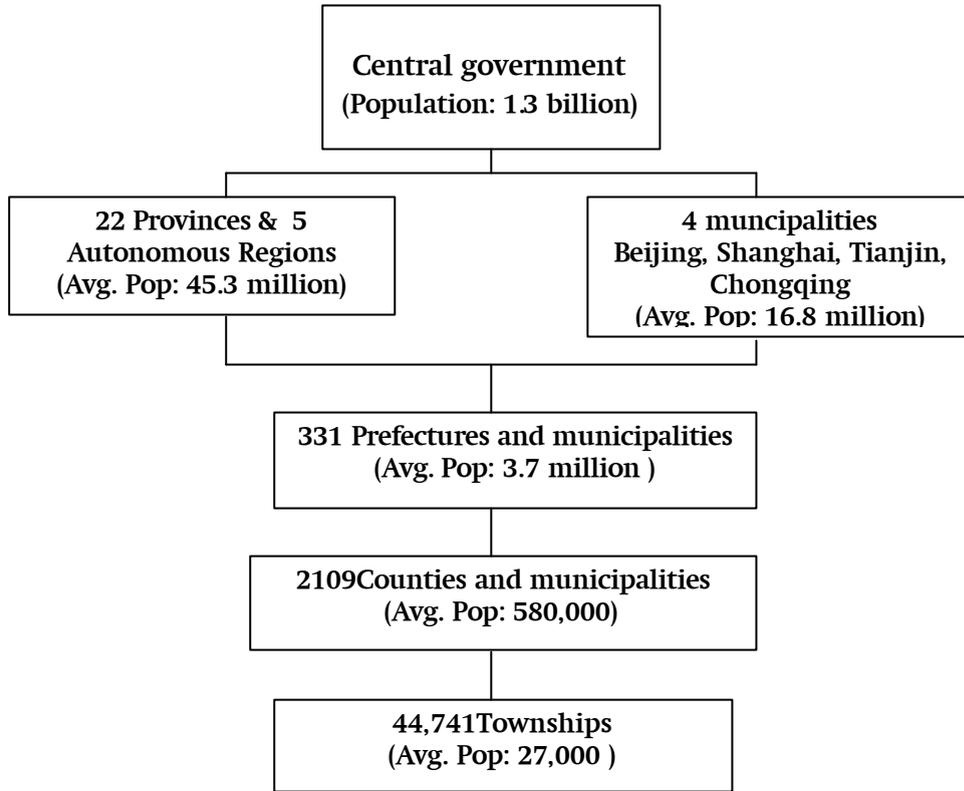
This examination of the pattern of transfers in recent years leads to a sobering prognosis: there will unlikely be enough money for subsidies for an inclusive development strategy without a fundamental reform of the intergovernmental fiscal system that begins by revising expenditure assignments to take providing basic education, basic health provisions, social safety net as *national*

<sup>15</sup> Zhu Rongji, “Report on the Work of Government” March 2003. These calculations are based on figures of RMB175.5 billion in transfers to offset civil service wage increases in the central and Western provinces, and RMB177.7 billion in transfers to subsidize local payouts of SOE laid off worker living stipends, unemployment stipends, and minimum living stipend support. No figures were reported for subsidies to local social security schemes, but if we assume that they were RMB51.2 billion as budgeted, these transfers totaled RMB404 billion, compared to the reported total of RMB402 billion (Zhu Rongji 2003).

<sup>16</sup> The wage increase subsidies are given only to inland provinces. Coastal provinces are mostly expected to absorb these costs from own resources.

*responsibilities*. The funding for this will have to be raised from revising revenue assignments. Finally, the whole framework for transfers will have to be revised to move away from earmarked subsidies to rely more on general transfers and revenue assignments. To improve the efficiency of local government, they should be given more decisionmaking autonomy, but only if mechanisms can be installed to hold them accountable for performance, either to local citizens or to higher level authorities. But even these will not be effective without a broader reform of public institutions, including public administration. To effect a significant reversal of inequalities that reaches the people, then, China needs a fundamental reform of the public sector to improve incentives and mechanisms throughout the administrative hierarchy. This is a daunting task, and the process will be protracted and difficult.

Annex A. Structure of Government in China (2003)



## Annex B. Revenue Assignments under the Tax Sharing System

### I. Taxes exclusively assigned to the Central Government

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

### II. Taxes shared between the central and local governments

1. Value-added tax (75 percent central, 25 percent provincial)
2. Natural resource taxes (coal, gas, oil, and other minerals if the enterprises are fully Chinese owned.)
3. Construction tax on the cost of construction of buildings that are outside the plan and financed from retained earnings
4. Salt tax
5. Industrial and commercial tax, and income tax levied on foreign and joint venture enterprises.
6. Security and exchange tax (50 percent central, 50 percent provincial) – added in late 1990s
7. Income tax of all enterprises – added in 2002 and shared at 50-50 in the first year, and 60 percent central, 40 percent local thereafter.
8. Personal income taxes – added in 2002, with the same arrangement as enterprise income tax.

### III. Taxes exclusively assigned to local governments

1. Business (gross receipts) tax falling on sectors not covered by VAT (transportation and communications, construction, finance and insurance, post and telecommunications, culture and sports, entertainment, hotels and restaurants, and other)
2. Rural market (stall rental) trading tax
3. The urban maintenance and construction tax (a surcharge on the tax liability of enterprises for business tax, consumption tax, and VAT)
4. The urban land use tax
5. Vehicle and vessel utilization tax
6. Thirty percent of the product and VAT revenues collected from enterprises owned by the Ministry of Industry, Ministry of Power, SINOPEC, and the China nonferrous metals companies
7. Value-added tax on land
8. Education surtax
9. Entertainment and slaughter taxes
10. Property tax
11. Surtax on collective enterprises
12. Resources tax
13. Fixed asset investment tax (discontinued in 1999)
14. Fines for delinquent taxes.

Source: adapted from World Bank (2002) Table 4.1.

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