

Intergovernmental fiscal reforms, expenditure assignment, and governance

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Introduction

The Tax Sharing System (TSS) Reform of 1994 brought China's intergovernmental fiscal system much closer to international practice. It also moved China out of the precarious fiscal situation of the mid-1990s, and general government revenues as a share of GDP as well as the center's share has increased rapidly. At the same time, the fiscal disparities in the system that prevailed at the time of introduction of the TSS, which were supposed to be gradually reduced by expansion of the equalizing "Transitory Systems Transfer," has persisted until now. This paper argues that the unequal distribution of resources is a major impediment to achievement of the goals of a Harmonious Society. However, a more equal distribution of resources alone is not enough, and should go hand in hand with better specification of expenditure responsibilities of the various levels of government, and stronger mechanisms for holding local governments accountable for those responsibilities.

China's fiscal system

China's fiscal situation has vastly improved over the last decade, and signs are that with the current tax structure revenues will continue to increase, provided tax administration keeps pace with the changing economy. General government revenues went up from below 10 percent of GDP (new GDP numbers) in the mid-1990s to almost 18 percent of GDP now. Some 2-2.5 percent of GDP social security contributions, which are included in government revenues in other countries, could be added to that, as well as extrabudgetary revenues of some 3 percent officially, and considerably more unofficially.

¹ This paper relies in part on the forthcoming World Bank (2006) report *Reforming Subnational Finance: Lessons from Northeast China* authored by Dana Weist, Roy Bahl, Ines Kudo, Magnus Lindelow, Mei Wang and Christine Wong.

Together with a sustainable deficit of some 2-3 percent of GDP, this would provide China with a fiscal envelope of some 25 percent of GDP, comparable to the lower income OECD countries, and higher than most East Asian countries, including East Asian Newly Industrialized Economies (NICs). Indeed, excluding redistributive functions through social security and non-contributory transfers that take up more than half of government spending in advanced OECD countries, China's government size is already comparable in terms of share in GDP with those advanced OECD countries.²

China is much more decentralized than OECD countries and middle income countries, particularly on the spending side (Table 1). In part, the sheer size of the country explains this degree of decentralization, but the structure of government and some unusual expenditure assignments also give rise to this pattern of spending. Functions such as social security, justice, and even the production of national statistics are largely decentralized in China, whereas they are central functions in most other countries.

Table 1: Share of Subnational Governments in Total Government

	Developing Countries	OECD Countries	Transition Countries	China
Sub-national share of Government Tax Revenues	9.27	19.13	16.59	40
Sub-national share of Government Expenditure	13.78	32.41	26.12	73

Among the sub-national levels of government, sub-provincial levels spend more than 50 percent of overall government expenditures (Table 2).

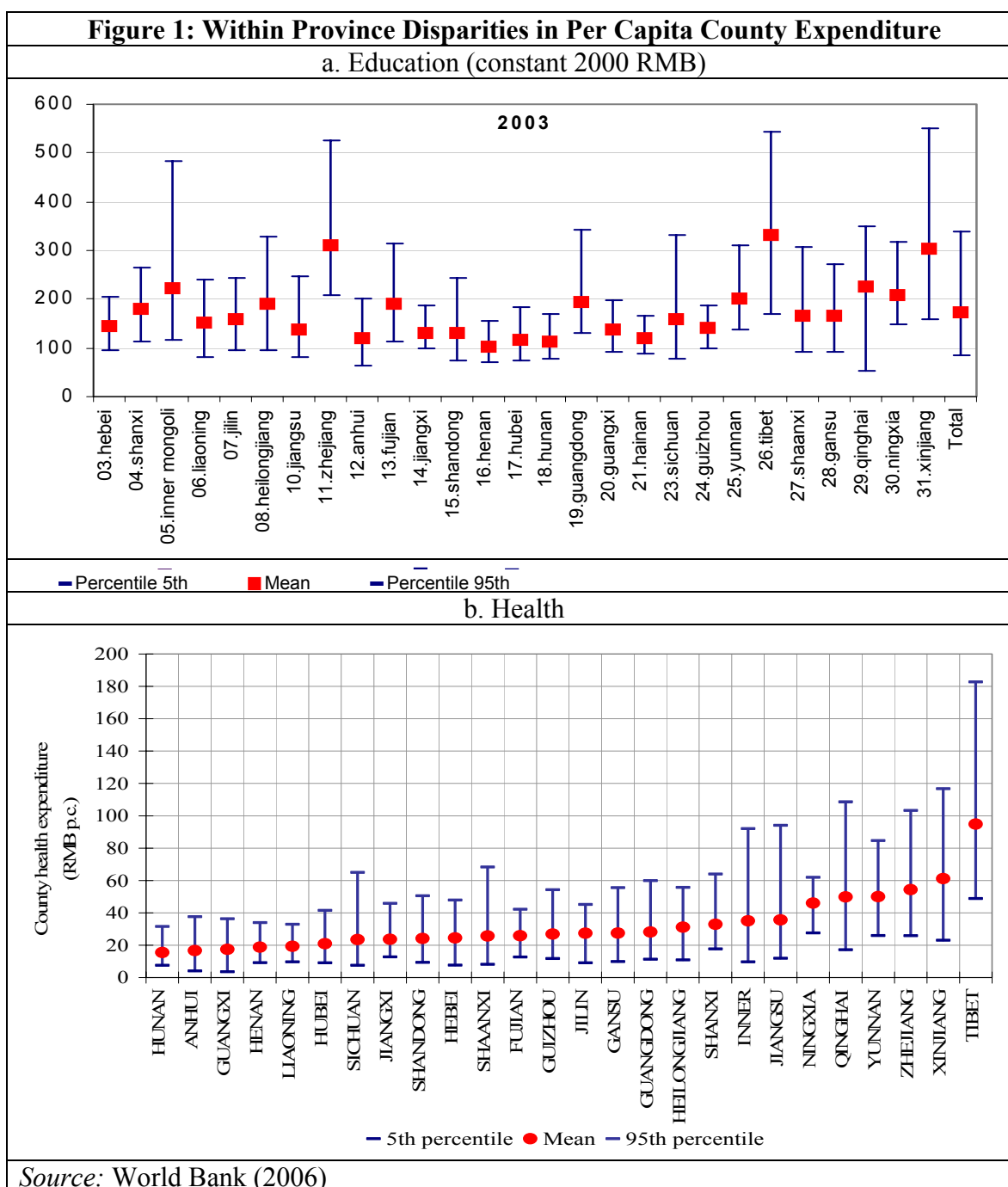
² China's Flow of Fund accounts 1996-2002 show that Taxes net of non-contributory transfers—the amount available for government consumption and investment was some 18 percent of GDP in 2002. This is comparable to Germany (18.6), France (18.3), the United States (17.9), and Japan (17.5). Thanks to Francois Bourguignon for the OECD data, which were taken from the OECD National Accounts for 1994.

Table 2. Changing Shares of Revenues and Expenditures: Percent Distributions by Level of Government							
Revenues	1993	1999	2003		1993	1999	2003
Central Government	22%	51%	55%	}	35%	61%	66%
Provinces	13%	10%	12%				
Prefectures/Municipalities	34%	17%	16%	}	66%	39%	34%
Counties + Townships	32%	21%	17%				
Expenditures							
Central Government	28%	31%	30%	}	45%	51%	49%
Provinces	17%	19%	19%				
Prefectures/Municipalities	23%	21%	21%	}	54%	49%	51%
Counties + Townships	31%	28%	30%				
Source: World Bank (2006)							

Fiscal disparities among subnational governments are larger in China than in most OECD countries. These disparities have emerged alongside a growing disparity in economic strength among the provinces. From 1990 to 2003, the ratio of per capita GDP of the richest to poorest province grew from 7.3 to 13. In China, the richest province has more than 8 times the per capita spending than the poorest province. In the US, the poorest state has about 65 percent of the revenues of the average state, and in Germany, any state falling below 95 percent of the average level gets subsidized through the “*Finanzausgleich*” (and any receiving more than 110 percent gets taxed). In Brazil, the richest state has 2.3 times the revenues per capita of the poorest state (World Bank, 2002). Some countries for which data exist have higher fiscal disparities than China, though. In Russia, disparities are larger: the richest of the 89 regions has revenues per capita some 40 times higher than the poorest (Martinez-Vazquez et al, 1998). After transfers the richest province in the Philippines has 28 times more revenues per capita than the poorest one, while the same numbers for Indonesia and Viet Nam are 10, and 22 respectively.³

Inequalities in spending are much larger at the sub-provincial level. The richest county, the level that is most important for service delivery, has about 48 times the level of per capita spending than the poorest county (World Bank 2006). In Indonesia, the richest district government has thirty times the expenditure per capita of the poorest one (Hofman and Cordeiro, 2005). These disparities in aggregate spending levels also show up in functional categories such as health and education where variation among counties and among provinces is large (Figure 1)

³ It should be noted that these countries’ regions are much smaller than the average province in China and indications are that the smaller the sub-national entity in a country, the larger the measured inequality.



The large vertical and horizontal fiscal imbalances put much demands on the transfer system, which should not only provide adequate resources to the various levels of government, but should also reduce the large disparities. The current transfer system is dominated by the “Tax Rebates” that can best be understood as a form of revenue sharing, and numerous earmarked grants, which together make up over 60 percent of total grants. The general equalization grant (the “transitional systems transfer”) has been growing in recent years, but still makes up only 10 percent of all transfers to the regions

Vertical imbalances in China are, as noted, large, but by itself that does not imply that on aggregate, insufficient resources are transferred to subnational levels. Indeed, without a better specification of the role and functions of various levels of government, it is hard to determine whether subnational governments receive sufficient resources for their functions (see below). At the same time, there are signs that the budgetary resources available to local governments are insufficient to cover their perceived functions. For one, there is growing subnational government indebtedness. Even though local governments are formally only allowed to borrow with State Council approval, this can be, and is, easily circumvented, and many local governments are thought to be in arrears on their debt. On aggregate, local government debt is estimated to be as high as 14percent of GDP.⁴ This local government debt is one sign that the allocated budgetary resources are not sufficient to discharge local government responsibilities.

Another sign of this is the considerable amounts of extrabudgetary resources, which have become critical to the finances of public service units. Although consolidation has taken place since the mid-1990s when extrabudgetary funds peaked, budgetary units throughout the government system still generate considerable non-tax revenues, which are by and large used for service provision.⁵

The disparities in expenditure per capita cited above already suggest that the transfer system has limited impact on the horizontal imbalances. Indeed, the transfer system as a whole is not equalizing in the sense that per capita transfers to the provinces continue to show a positive correlation with per capita income (World Bank 2006). Even if the tax return transfers are taken out, the remaining discretionary transfers show a similar positive correlation with per capita income (Persson and Erikson, 2006), which suggests that other considerations than equalization dominate the transfer system.

Intergovernmental Fiscal Reforms for a Harmonious Society

The Chinese intergovernmental fiscal system is clearly evolving. The Tax Sharing System Reform of 1994 has been very successful in reversing the downward trend in government revenues and the central share in government revenues. As a result, the size of the public sector has grown, but so has the fiscal imbalance among the central, provincial and local governments. Expenditure assignments to sub-provincial governments are inappropriate in some cases and expenditure responsibility is unclear. Disparities between rich and poor places are large, and the present system of transfers does not sufficiently equalize these disparities.

Ongoing reforms such as completing the Tax Sharing System reform below provincial levels, the rural tax reform, changes in expenditure assignment, the “three rewards and one subsidy” program, budget management and treasury reform are introducing

⁴Half of that is owed to the center, and the 14 percent of GDP should therefore not all be seen as additional general government debt

⁵ It is largely because of the extrabudgetary funds that the government sector in the National Accounts is some 5 percentage point larger than in the fiscal accounts.

fundamental changes that affect virtually all aspects of the intergovernmental fiscal system. However, because these reforms are implemented in piece-meal ways, they often introduce complications that have had unintended effects. For example, policy calls for addressing the fiscal problems of the county and township levels, but reform measures such as the rural fee reform and the abolition of the agricultural tax reduce revenues, and policies such as the teacher salary increases push up cost burdens to those levels of local government. Compensatory transfers from central government only partially cover the lost revenue or increased costs. Other levels of government are meant to contribute to this compensation as well, but implementation is often only partial.

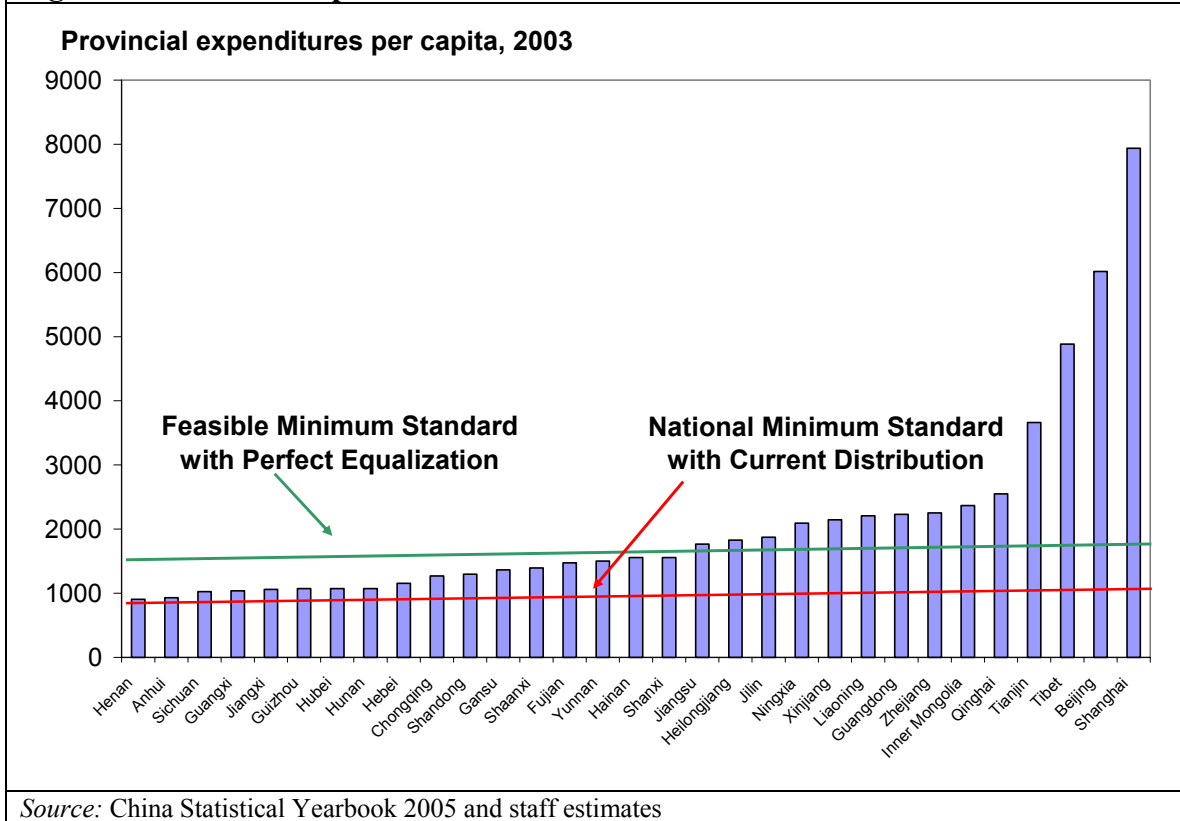
A rebalancing of the fiscal system is essential. This can be accomplished through some combination of expenditure reassignments, productivity improvements, new independent sources of revenue for local governments, a restructuring of intergovernmental transfers, and establishing a framework for responsible borrowing. Correcting the dysfunctionalities in the existing intergovernmental fiscal system will likely also have a positive effect on the financing and delivery of local education and health services.

The key challenge for China's fiscal system in supporting the Harmonious Society remains the high fiscal inequality. This fiscal inequality is a problem for China as a whole, not just the poor regions: from the perspective of the central government, the fiscal system should provide for a minimum standard of public goods for all Chinese, but the highly unequal distribution of resources means that China as a whole can only afford very low standards that are increasingly out of line with the country's status on the international scene. The rich regions have arguably *excess* revenues, which they are free to spend on pet projects like Olympics and World Exhibitions, but from a national point of view such spending means that Gansu is not capable of sending kids to school for 9 years of basic education.

To illustrate, on current policies, the poorest region on a per capita basis (Henan province) only spent RMB900 per capita for consolidated provincial government in 2004. The richest (Shanghai) spent RMB 8000. If China would seek minimum standards of public service for the country as a whole, this can only cost as much as the poorest region can afford (Figure 2, the bottom line), so RMB900. If more equalization were to take place, those minimum standards could be raised. With perfect equalization on a per capita basis,⁶ i.e. all provincial resources are pooled, and allocated on a per capita basis to the provinces, the average per capita spending level could be almost RMB1600, and so the national minimum standard could be almost twice as high.

⁶ Note that such an extent of equalization may not be desirable from the perspective of incentives for revenue mobilization, nor may an equal per capita amount necessarily equalize expenditure needs.

Figure 2: Provincial expenditures and central minimum standards.



Thus, achieve the Harmonious Society for *all*, a major reallocation of fiscal resources will need to take place. This is politically very difficult, as well as technically challenging, but in the end it will be necessary.

First, China would need to devote an increasing amount of resources to equalizing grants—in exchange for higher performance standards for the receiving regions (see below). A better definition of fiscal needs in the regions, including a much more detailed assignment of obligatory functions across all levels of government, and over time establishment of affordable minimum standards will be required for this. In addition, a better definition of revenue capacity, including extrabudgetary funds, would be needed to better define the grants system.

Second, China should consider options for devolving more revenue sources that benefit poor regions. An excellent opportunity here is natural resource taxation, which in China are assigned to the regional governments.⁷ Many of China's scarce resources (water, energy, land) are located in the poor regions, whereas most of the consumers of the resources are located in the rich regions. Taxing these scarce resources more by means of

⁷ This by itself could be problematic, although many countries around the world have similar arrangements. See Hofman and Manuelyan, 1994, for a comparison of China's and international practice.

higher resource taxes would therefore not only be good for a more efficient use of those resources, but also help in reducing some of the current fiscal disparities.

Third, China could consider cutting transfers to the rich regions in tandem with *increasing* the tax base for subnational governments. This is good for reasons of accountability, and would free up fiscal resources for more transfers to the poorer regions. A well-designed property tax to replace the existing real estate and land taxes (and the many extrabudgetary fees and charges put on land transactions) would be an excellent source of revenue for urban areas, and one that could promote more efficient land use at the same time. Other options for local tax bases include motor vehicle taxes and a surcharge on the personal income tax.

Fourth, central government should get involved in sub-provincial distribution of resources. As noted, sub-provincial inequalities are even larger than inter-provincial inequalities, and the center could, as a minimum, set limits on the disparities among sub-provincial governments. China could go further, and consider defining revenue assignments for each level of governments, and expanding the central treasury system such that the transfer system can target the county level directly, and thereby making equalization a truly central task.

Expenditure Assignment and Accountability.

Since reforms in the intergovernmental fiscal system started in 1980, the emphasis has been on the revenue side and the transfer system. Indeed, the budget law, which is the basis for the current intergovernmental fiscal arrangements, only provides a broad division of labor between central and local governments, and does not touch upon sub-provincial responsibilities, which is left to provincial governments, and considerable variation exists. Sector laws often give only token attention to the issue of functional assignment and its fiscal consequences. In contrast, other decentralized countries define the responsibilities in much more detail, either in the constitution (South Africa, Germany), in a special law on local government (Philippines, Indonesia) or in sectoral laws.

The absence of a clear assignment of responsibility is problematic in a number of ways:

- It could lead to overlapping responsibilities, to unfunded mandates on local government, or to the underprovision of essential public services
- It leaves expenditure needs of the various levels of governments undefined. Without it, it is hard to define an effective intergovernmental fiscal system, as it is unclear as to what level of spending a local government is to undertake to implement national policies.
- It undermines accountability of local governments, as neither their constituents, nor supervising governments are in the clear what to expect in terms of service delivery from that level of government.

The international literature emphasizes that clarity of function is more important than exactly which level does what. The economic literature prescribes that a function should

be assigned to that level of government that best matches benefits and costs of that function, whereas the “subsidiarity principle” would lead to assignment of a function to the lowest possible level. These considerations, however, still leave much scope for interpretation, and in practice there is considerable variety in the assignment of functions among countries.

For some functions, China’s assignment of functions is out of line with what theory would prescribe and with what other countries practice. Thus, China could consider *centralizing* some of the responsibilities for government services, or at least of centralizing the financing of those services, for equity reasons as well as efficiency as well. In particular, income-maintenance responsibility (pensions, disability, and unemployment insurance) would seem an inappropriate assignment for sub-provincial governments. In most countries, this is a central government responsibility. In a large country like China, it may be reasonable to assign this function to the provinces, but prefectural and county responsibility for this function, as is presently the case, is likely not viable in the long run. The reassignment of these functions should be accompanied by a reassignment of revenues.

For most functions it is more important to clarify rather than to reassign. In that context, first order of business for China is to establish more clearly the nature of local government. While China is a unitary country, and local governments are in principle an agent of the central government, *de facto* there is a high degree of autonomy for subnational governments. This may well be desirable in a large country such as China, but at the same time, determining the boundaries of autonomy would from a fiscal perspective be desirable. In particular, the continued role of many sub-national governments in the production of basically private, tradable goods remains an issue. In many unitary countries, the central government determines by law what type of activities local governments can be engaged in through a *positive list* of functions (“an “*ultra vires*” definition of local governments). But even if local government is granted a wide range of autonomy (“general competence”), central government could consider specifying at least those functions that a local government *must* perform, *obligatory functions*, lest fiscal resources be used for tasks that are not considered national priorities.

Detailed empirical evaluation of the fiscal implications of expenditure assignment and reassignment is needed. In doing this analysis, it will be necessary to work out the fiscal implications (and necessary remedial policies) for the next five to ten years if no restructuring takes place. This is a bigger issue than just expenditure assignment. The financing of this shift in responsibility would likely include a reassignment of some revenue sources and reallocation of transfers as well.

The gradual expansion of the experiment to establish three levels of (budgetary) government rather than the current five offers an important opportunity to clarify expenditure responsibility. Functions will need to be reassigned from either the township level or the prefectural level to county/municipal level or province level, which is a massive task, and one fraught with considerable risk to service delivery as well as budget

discipline, if not done together with a careful mapping of responsibilities and expenditure needs.

Enforcing accountability

Even if responsibility over functions is clarified, China still faces considerable challenges with enforcing accountability. This is of considerable concern, because without accountability there are limits to what the intergovernmental fiscal system can achieve in terms of efficiency and redistribution. Specifically, if there is limited accountability for results, more equalization of spending to poorer provinces could well lead to higher waste of resources rather than better service delivery for the poorer part of the population, and achieving the goals of the Harmonious Society may be only partial.

Given the high degree of decentralization in China, a key issue is accountability of local governments to central government. Key in this accountability is the evaluation criteria for local officials. Up until recently, evaluation criteria for local officials were heavily focused on achieving investment and growth. These are not that hard to measure, and the accountability system has evidently worked reasonably well. But the shift in focus to a “harmonious society” reflects the fact that China has reached a stage of development in which the people and the central government are putting more weight on non-growth outcomes, such as health status of the population, educational attainment, energy efficiency, and quality of the natural environment. It is inevitably going to be harder for the central government to know if the local government is doing a good job meeting these multiple objectives and to use that information in staffing and financing decisions.

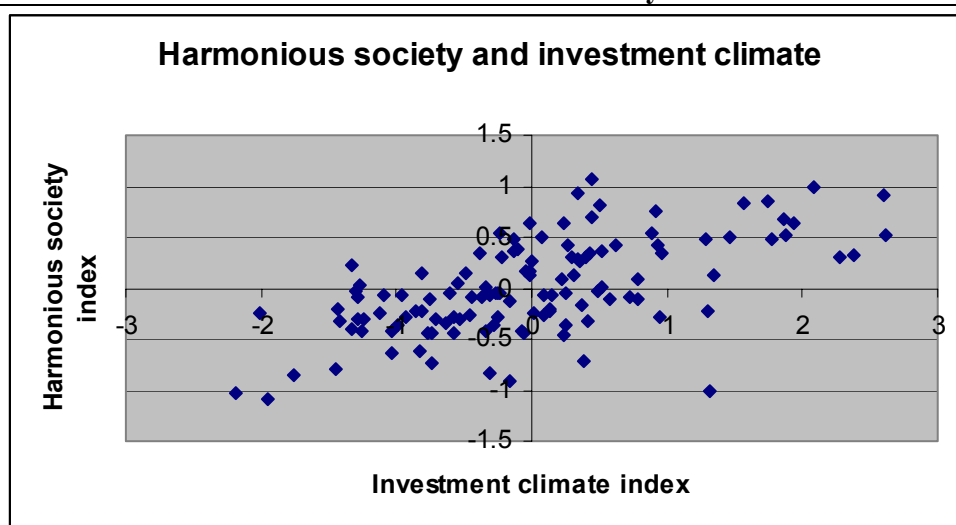
There are complementary directions in which China can try to improve accountability of local officials to the center. First, China has quite a few transfers ear-marked to specific issues: for example, transfers for rural education. In many countries some or all of the transfer would be conditional on meeting certain performance criteria. The criteria could be as simple as number of students who complete the school year; or they could be a more sophisticated measure of what the government really wants to support: for example, having a certain percentage of exiting students pass a standardized exam. There are a number of areas of public policy where performance-based grants can be an effective tool of redistribution and accountability. A system of broad categorical block grants for the main functions in which the center takes an interest (health, education, rural infrastructure) with equalizing properties, and conditional on performance could also be a good intermediate steps—better than the multitude of ad-hoc earmarked grants with conflicting objectives in place today, but short of a single unconditional equalizing grant that requires a better specified system of expenditure responsibilities.

A second and complementary approach is a more general benchmarking of the quality of government in different locations. The World Bank is involved in an interesting example of this right now. We have worked with the National Statistical Bureau to carry out an investment climate survey covering 12,400 firms in 120 Chinese cities. Many of the questions get at the issue of local governance and how it affects the climate for investment: for example, how much time firms have to spend dealing with the

government bureaucracy, whether they have to pay bribes to get loans from the state-owned banks, how long it takes to clear goods through customs. In general, cities in China vary enormously in these areas, and cities with better local government receive more foreign investment, more local private investment, and more growth.

An innovation in this round of investment climate surveys is that we also collected data at the city level on social issues such as the unemployment rate, education expenditure per capita, and medical insurance coverage, as well as on environmental issues such as clean air days per year, percent of water treated, and green space per capita. We find a very clear pattern in which cities with better investment climate also tend to have better social and environmental conditions (Figure 3). To some extent these measures provide a scorecard on local governance. I do not think that there is a unique, scientific way to create such a scorecard. But efforts to measure and publicize the quality of governance in different cities stimulate a healthy debate and puts competitive pressure on cities to provide better services. Indeed, such benchmarks are likely to influence investors in their choice of location, which in turn would stimulate cities to improve their investment climate. For the central government, looking at these kinds of benchmarks can help identify locations where governance is quite poor and which need specific reform measures before any large increase in transfers are likely to bear fruit.

Figure 3: Investment Climate and Harmonious Society



Source: Author's estimate based on 120 cities investment climate survey 2005

A similar benchmarking exercise is under way for public services. The World Bank, together with the DRC and Tsinghua University is sponsoring a pilot household survey in 5 cities to determine people's perception of public services in their city, a variation of the "citizen's scorecards" that has gained popularity in countries such as India, Indonesia, and the Philippines. Although people are less mobile than capital in China, and perception based surveys need careful interpretation, the central government could decide to take these and similar indications of household satisfaction with their public services into account in allocation decisions and/or promotion of local officials.

A third option for better accountability is citizens' participation in decision making on budgets. China has already started several experiments in this regard citizen's budgets and community driven development. The China Development Foundation is experimenting with participation in budget processes in several local governments in China, whereas the Leading group for Poverty Reduction has just started an experiment in community driven development in 60 villages across the country in which villagers themselves rather than the government decide on how to use village grants funded from the county and central budget.

Finally, more fiscal transparency at all levels of government would improve accountability over service delivery as well. More information as to how the budget is spent would allow People's Congresses at all levels to better discharge their oversight function. More information in the public domain would allow better policy analysis and evaluation by the rich field of research institutes and universities that China possesses. The upcoming revision of the budget law is in this respect an opportunity to anchor more transparency in fiscal and intergovernmental fiscal matters in law.

Conclusion

China has in principle sufficient fiscal resources to afford the level and type of spending that would be commensurate with a Harmonious Society. But to achieve this spending a major redistribution of resources will be needed, not just among provinces, but also below the province. This reallocation of resources can only be done gradually, and would need to go hand in hand with a better specification of roles and functions of the various levels of government, and stronger mechanisms for accountability to ensure that poorer local governments use their higher level of resources well.

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