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Distributional Consequences of Reforming Local Public Finance in China*

Albert Park, Scott Rozelle, Christine Wong and Changqing Ren

Central–local budgetary arrangements have undergone numerous changes since the 1960s as the Chinese government in its quest for modernization has sought to balance the needs of central control and local autonomy.¹ During the reform period, the falling tax share of GNP and a commitment to greater decentralization of the planning system led to major changes in the public finance system that have devolved expenditure responsibilities and financial authority to local governments.² Fiscal decentralization has been credited with hardening budget constraints for local publicly controlled enterprises and government agencies.³ New budgetary relations have instilled fiscal discipline, allowing local governments to disburse more expenditures only if they generated more revenues. These reforms have helped unleash the entrepreneurial spirit of local bureaucrats, fueling the rapid growth of rural industry.⁴

The fiscal reforms, however, have also triggered a number of less healthy trends. Heightened pressure on revenue-starved local governments may have led to over-investment in revenue-generating industrial enterprises, encouraged bureaucratic predation of enterprise resources and regional protectionism, and diverted attention away from long-term development strategies.⁵ Financial decentralization also can undermine the government's ability to redistribute public financial resources from prosperous to lagging regions in order to provide public goods and services equitably. Forcing revenue-scarce poor localities to be more fiscally self-reliant may have adverse consequences for their ability to provide basic services and pursue coherent investment strategies to further economic development.

Better understanding of the distributional consequences of fiscal reforms is of heightened importance given the increasing concern being

* This research is part of a collaborative project on "Resource Flows and Poverty in China" funded by the Ford Foundation in Beijing. Albert Park acknowledges fellowship support from Fulbright-Hays and the Committee for Scholarly Communication with China.

1. Michel Oksenberg and James Tong, "The evolution of central–provincial fiscal relations in China, 1971–1984: the formal system," *The China Quarterly*, No. 125 (1991), pp. 1–32.

2. Christine Wong, "People's Republic of China," in Pradumna B. Rana and Naved Hamid (eds.), *From Centrally Planned to Market Economies: The Asian Approach*, Vol. 2 (Hong Kong: Oxford University Press, forthcoming).

3. Yingyi Qian and Barry Weingast, "Beyond decentralization: market-preserving federalism with Chinese characteristics," mimeo, Stanford University, 1994.

4. Jean Oi, *Rural China Takes Off: Incentives for Reform* (Berkeley: University of California Press, 1996).

5. Christine Wong, "Fiscal reform and local industrialization: the problematic sequencing of reform in post-Mao China," *Modern China*, Vol. 18 (1992), pp. 197–227; Andrew Wedeman (ed.), *Chinese Economic Studies: Regional Protectionism*, Vol. 26, No. 5 (1993); Guobao Wu, "Goal conflict in poor areas: growth, budget solvency, and poverty alleviation," paper presented at a Discussion Forum on China's Poverty Policies sponsored by Ford Foundation, Beijing, October 1994.

expressed by Chinese leaders and citizens over the rising inequities accompanying China's rapid growth. Have the reforms hardened the budget constraints of local governments? Have distributional inequities increased? If so, how have poor counties coped with greater resource scarcity, and what have been the implications for development prospects and the provision of social services in poor regions?

Since most government revenues and expenditures in China are collected and spent by prefectural, county and township governments, answering these questions requires detailed analysis of patterns in sub-provincial finance. Almost all studies of China's fiscal reforms, however, have focused exclusively on the central-provincial division of fiscal responsibilities. In studies that have looked at subprovincial finance, most have centred on governments in rapidly growing regions where local budgets are predominantly running surpluses.⁶

This study examines changes during the reform period in the sub-provincial fiscal system of a poor province in north-west China, the consequences of these changes for the hardness of budget constraints and the distribution of public financial resources among local regions, and the implications for public spending and development strategies in poor regions. Shaanxi province serves as a good case study for understanding how reforms have affected the availability and distribution of public financial resources in regions facing ongoing resource scarcity. The province is one of the poorest in China, in 1992 ranking 28th out of 30 provinces in rural per capita income and 22nd in GNP per capita. In recent years, the province has consistently run fiscal deficits exceeding 20 per cent of expenditures.

This study draws on a unique set of county budgetary data and extensive interviews with finance bureau officials and local government leaders in poor counties to shed new light on the trends and consequences of reforms in local public finance in China. The study finds that China's fiscal reforms have led local governments to become increasingly self-reliant in meeting expenditure responsibilities, providing evidence that budget constraints have indeed hardened. This also has led to greater inequality in the provision of public goods and services, and created incentives for local governments to stress revenue mobilization at the expense of other distributional and growth objectives. Poor counties have become especially short of cash, accumulating large debts and becoming increasingly unable to pursue investment strategies to further economic development.

This article first examines the distributional consequences of reforms in

6. For example, see Oi, *Rural China Takes Off*, and Susan Whiting, *The Micro-Foundations of Institutional Change in Reform China: Property Rights and Revenue Extraction in the Rural Industrial Sector*, Ph.D. dissertation, University of Michigan, 1995. For more balanced treatment of rich and poor regions, see Christine Wong, "Financial local government: feasts, famines, and growing regional disparities in post-Mao China," mimeo, 1994; and Christine Wong, "Subprovincial finance in the People's Republic of China: a pilot study in Hebei province," a report for the Ministry of Finance under the Asian Development Bank TA for Supporting Policy Analysis, 1994.

local public finance, reviewing changes and trends in the different levels and forms of public finance. These include provincial and county (including township) budgets, alternative financing channels (China's Food for Work Programme), and non-budgetary revenues and expenditures that play a role in fiscal management. The article then scrutinizes more closely how poor, resource-scarce counties are coping with the need to be more financially self-reliant, and the consequences of these responses for expenditure and investment patterns.

Changing Patterns in Local Public Finance

The province. Many of the changes occurring in the distribution of public financial resources within the province result from the increasing pressure being placed on it as a whole to be more fiscally self-reliant. The agreement struck between Shaanxi province and the central government in 1980 divided revenues into three categories: local fixed revenues (*difang guding shouru*), income divided by a fixed percentage (*guding bili fencheng shouru*) and adjustment income retained by the province (*tiaojie shouru gui difang de bufen*).⁷ Expenditure responsibilities were also divided between provincial and central levels, with most investment, wages and services assigned to the province. The central government agreed to subsidize the anticipated shortfall between contracted expenditures and revenues, which were based on expected revenue and expenditure growth from 1979 base levels. The Centre made a strong *ex ante* pledge to refuse to grant additional funds *ex post* to make up for expenditure excesses, promising assistance only in the case of large natural disasters.

The 1980 agreement set the tone for increasing local self-reliance in public finance. The reforms were motivated by a commitment to greater decentralization of decision-making, the need to shed expenditure responsibilities given reduced central fiscal resources, and the desire of central leaders to secure the political support of provincial officials by increasing local autonomy.⁸ Policies were designed to encourage regional and local leaders to increase their efforts to promote economic growth and increase their revenue base. The principle was "the more you collect the more you spend, the less you collect the less you spend, rely on yourself to balance

7. See Wong, "Fiscal reform and local industrialization," for a general description. In Shaanxi, local fixed revenues, which were retained fully by the province, included income from local firms and administration, salt tax, agricultural and livestock tax, industrial commercial earnings tax, other industrial/commercial taxes, fines from late payment and underpayment of taxes, and other income. Income divided by a fixed percentage (80% to the central government and 20% to the province) consisted primarily of income from centrally owned firms managed by the local government (not including military firms, loss-making firms, and non-industrial/commercial firms). Land use taxes and profits-turned-taxes (*ligaishui*) were also split 80–20. Finally, adjustment revenue consisted of industrial and commercial taxes, 11.9% of which went to the central government.

8. Susan Shirk, *The Political Logic of Economic Reform in China* (Berkeley: University of California Press, 1993).

Table 1: Shaanxi Province Consolidated Revenues and Expenditures, 1980–92 (million *yuan* – nominal)

	(1)	(2)	(3)	(4)	(5)	(6)
			Revenue	Revenue shortfall to		Revenue to
Year	Revenues	Expenditures	shortfall	expenditures ratio	GNP	GNP ratio
				(3)/(2)		(1)/(5)
1980	1,581	1,828	247	0.14	9,521	0.17
1981	1,345	1,639	293	0.18	10,241	0.13
1982	1,356	1,730	374	0.22	11,230	0.12
1983	1,454	1,881	427	0.23	12,380	0.12
1984	1,531	2,275	743	0.33	14,979	0.10
1985	2,030	2,750	720	0.26	18,136	0.11
1986	2,409	3,559	1,150	0.32	20,683	0.12
1987	2,818	3,781	962	0.25	24,003	0.12
1988	3,388	4,458	1,070	0.24	30,200	0.11
1989	3,896	5,079	1,183	0.23	33,694	0.12
1990	4,440	5,712	1,272	0.22	37,485	0.12
1991	5,417	6,731	1,314	0.20	42,878	0.13
1992	5,095	6,527	1,431	0.22	49,445	0.10

Source:

Zhongguo tongjiju (State Statistical Bureau), *Shaanxisheng tongji nianjian* (Shaanxi Province Statistical Yearbook) (Beijing: State Statistical Press, 1989–93).

accounts” (*duoshou duozhi, xiaoshou xiaozhi, zilai pingheng*).⁹ The province, in turn, established revenue and expenditure contracts with prefectures and counties. It promised to provide counties with revenue shortfalls an annual fixed subsidy (*dinge butie*) at a level to remain unchanged for five years in nominal terms.

In 1985, a new agreement between the Centre and the province was reached, setting an annual nominal fixed subsidy of 276 million *yuan* based on target revenues of 1.24 billion *yuan* and target expenditures of 1.52 billion *yuan*. This subsidy was supposed to be fixed for five years, but was adjusted downward to 120 million *yuan* for the period 1988 to 1991 as part of a new fixed subsidy agreement accompanying yet another major reform in 1988.¹⁰ In 1985, the province also entered into new five-year fixed-subsidy contracts with deficit counties. In 1990, these contract amounts were extended indefinitely without change, though in individual cases fixed subsidies have been adjusted.

The 276 million *yuan* fixed subsidy accounts for only about one-third of the 720 million *yuan* total provincial revenue shortfall in 1985 (Table 1),¹¹ the remainder of which was financed by earmarked and other

9. Shaanxi caizheng sishinian, 1950–1990 (*Forty Years of Shaanxi Financial Statistics, 1950–1990*) (Xian: Shaanxi Finance Bureau, 1992), p. 428.

10. Christine Wong, Christopher Heady and Wing Woo, *Fiscal Management and Economic Reform in the People's Republic of China* (Hong Kong: Oxford University Press, 1995), p. 92.

11. Revenue shortfall is defined as the gap between collected revenues and approved expenditures.

Table 2: Shaanxi Province Consolidated Revenue Shortfall and National Subsidies, 1985–90 (million *yuan* – nominal)

<i>Year</i>	<i>Revenue shortfall</i>	<i>Fixed subsidies</i>	<i>Earmarked subsidies</i>	<i>Total subsidies</i>	<i>Ratio of subsidy to revenue shortfall</i>
1985	720	270	560	830	1.15
1986	1,150	270	750	1,020	0.89
1987	962	270	740	1,010	1.05
1988	1,070	120	720	840	0.78
1989	1,183	120	680	800	0.68
1990	1,272	120	760	880	0.69

Source:

Christine Wong, Christopher Heady and Wing Woo, *Fiscal Management and Economic Reform in the People's Republic of China* (Hong Kong: Oxford University Press, 1995).

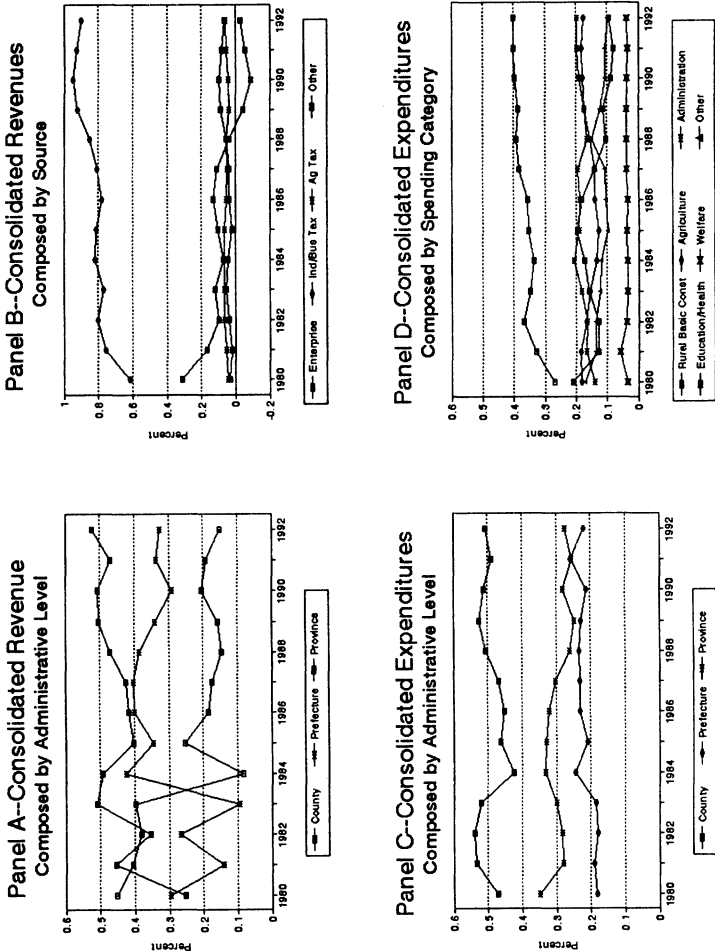
subsidies or borrowing. As the nominal revenue shortfall increased through the late 1980s and early 1990s, the share financed by fixed subsidies fell. The 120 million *yuan* fixed subsidy in 1988 only covered 10 per cent of the provincial revenue shortfall. Earmarked subsidies did not make up for the fall in fixed subsidies which began in 1988, resulting in sizeable deficits that had to be financed from other sources (Table 2). Meanwhile, revenue collection did not keep up with overall growth. Increasing pressure to reduce revenue shortfalls was evidenced by the fact that after rising steadily in the early 1980s, revenue shortfall measured in real terms has fallen continuously since 1986, even when economic growth stagnated in 1989 and 1990.¹²

Reforms in the fiscal system can be seen in changes in the composition of provincial *consolidated* revenues and expenditures (Figure 1).¹³ The share of revenues coming from industrial and commercial taxes has increased to over 90 per cent, while that from enterprise profits has actually become negative because of government subsidization of loss-making enterprises (Panel B). This pattern is due to the introduction of income taxes on state-owned enterprises, which converted profit remittance to tax remittance. The importance of agricultural taxes remains small throughout. On the expenditure side, the share of funds devoted to spending categories with a large wage-bill component has increased overall while rural infrastructure investment has fallen since

12. Table 1, column 3, shows that the nominal revenue shortfall rose after 1986. However, in real terms revenue shortfall fell monotonically after 1986. Throughout the article, the provincial wage index is chosen as the price deflator since wages are the largest component of fiscal expenditures.

13. Consolidated is defined to include all budgetary revenues and expenditures of lower level units (including townships but not villages). In 1992, the revenues earned by the province itself (own revenues), for example, account for 15% of provincial consolidated revenues. In this article discussion of county revenues and expenditures always includes township budgets, so the term consolidated is dropped.

Figure 1: Consolidated Revenues and Expenditures by Administrative Level, Source and Spending Category in Shaanxi, 1980–92.



Source: Zhongguo tongjiju (State Statistical Bureau) *Shaanxi tongji nianjian* (Shaanxi Statistical Yearbook) (Beijing: China Statistical Press, 1990–93).

1985 (Panel D).¹⁴ This is in line with national trends and is an anticipated feature of budgets facing increasing revenue scarcity.¹⁵ Central-provincial relations have increasingly left poor provinces to fend for themselves while letting surplus provinces keep a greater share of locally generated revenues.¹⁶ Shaanxi, a very poor province, has been under increasing pressure to become more fiscally self-reliant, with inevitable consequences for how the province relates to subprovincial governments and the extent to which it can mobilize resources to equalize the distribution of public financial resources.

Counties. In Shaanxi, where the rate of urbanization is relatively low, the county is the most important administrative level for collecting revenues, making local investments and providing basic public services.¹⁷ County governments have collected the largest proportion of consolidated revenues and disbursed the largest share of consolidated expenditures (Figure 1, Panels A and C).¹⁸ These shares have risen since the mid-1980s as would be expected with increasing decentralization. Given China's industry-centred tax structure, it is not surprising that in a poor, rural province like Shaanxi, 67 of the 93 counties suffer from revenue shortfalls and are dependent on transfers to finance a portion of their expenditures. The remaining counties have negotiated revenue-sharing arrangements with the province similar to those that govern fiscal relations between the province and the central government.

14. Since 1985, the share of spending on health/education and agricultural services has increased, and the share of administration expenditures initially fell and then has risen since 1988.

15. M. Gallagher and O.M. Ogbu, "Public expenditures, resource use and social services in Sub-Saharan Africa," Africa Region Technical Department (Washington, D.C.: World Bank, 1989), cited in Ferroni, Marco, and Ravi Kanbur, *Poverty-Conscious Restructuring of Public Expenditure, Social Dimensions of Adjustment in Sub-Saharan Africa*, Working Paper No. 9 (Washington, D.C.: World Bank, 1990). Nationally, the share of administrative expenses in total expenditures grew from 3.9% in 1979 to 8.7% in 1991, and expenditures on culture, health, science and health grew 14.7% per year. During the same period, the capital investment share fell from 30% to 7.5% of expenditures (Wong, Heady and Woo, *Fiscal Management and Economic Reform*).

16. Spending by provincial governments as a share of revenues jumped in the mid-1980s to reach 104% in 1986 (from 67% in 1982), implying a diminished ability of the central government to redistribute surplus funds. Since 1986, provincial remittance rates have fallen from 33.6 to 22.2% in 1991 (Wong, Heady and Woo, *Fiscal Management and Economic Reform*). According to Roy Bahl and Christine Wallich, "Intergovernmental fiscal relations in China," Policy Research Working Paper No. 863 (Washington, D.C.: World Bank, 1992), per capita expenditures of richer provinces are higher and growing faster than poorer provinces.

17. The prefecture also plays an important role in the financial system since the reforms. Examination of prefectural revenue, expenditure and deficit patterns shows that while there is some equalizing redistribution of resources among prefectures in Shaanxi, a heavy urban bias in financial resource allocation is evidenced by the much higher expenditure per capita enjoyed by residents in urban municipalities and counties with prefectural capitals than in rural counties.

18. In other words, there are three types of expenditures made by the province: direct spending on its own fiscal matters; disbursement to prefectures to be spent by the prefectures themselves (prefectural own expenditures); and disbursements that move to the county for expenditure at that level (county expenditures). Figure 1, Panel C shows that of the *total* of these three types of spending (consolidated expenditures), the county spends the largest share.

To examine the trends in county finance a data set is used that includes all counties (*xian*) and county-level municipalities (*xianji shi*) in the province. These 93 county units account for 87 per cent of the provincial population in 1992.¹⁹ Revenue collection and spending by township governments are subsumed in the county data.²⁰ Counties are divided between “poor” and “non-poor.” Status as poor is in accordance with official national and provincial government designations based on per capita income thresholds in 1985, with special consideration given to minority and old revolutionary base areas.²¹ By these criteria, of the 93 counties in the province, 46 are poor and 47 are non-poor. Poor counties are divided into northern and southern counties (numbering 20 and 26, respectively).²² Northern Shaanxi was the site of the Communist base after the Long March, and receives about 50 million *yuan* each year in special targeted development capital from the national government (about 7 *yuan* per capita). Preferential treatment of northern poor counties shows up clearly in their high expenditures and revenue shortfall per capita (Table 3). Despite consistently lower per capita incomes and revenues to 1989, per capita expenditures have been much higher in northern poor counties than in southern poor counties. These expenditure rates even exceed by a wide margin per capita spending in non-poor counties.

County revenues per capita for both poor and non-poor counties exhibit irregular patterns of growth in the early 1980s before growing steadily until the early 1990s (Table 3 and Figure 2, Panel A). Focusing on the period of sustained revenue growth from 1985 to 1991, real revenue per capita grew 48 per cent in non-poor counties, 56 per cent in southern poor counties, and 152 per cent in northern poor counties. Two possible explanations for the unexpected result that revenue growth has been greater in poor regions are the greater pressure on poor counties to earn revenues for own-expenditure needs as transfers have declined, and greater market liberalization and growth in poor areas.²³

During the same period, the growth in real rural income per capita in non-poor, poor southern and poor northern counties were 14, 26 and 18 per cent. This indicates that revenue collection efforts have increased

19. Hereafter, *counties* refers to both counties and county-level municipalities. Urban districts are excluded because of the significant differences in public finance in urban and rural areas.

20. Data on township revenues and expenditures are reported separately for the years 1986–89 in Table 7 and discussed in a later part of the article. Township revenues consist primarily of TVE taxes, agricultural taxes, and, beginning in 1991, special agricultural product taxes. Townships, in turn, have responsibilities to meet fixed expenditures for local agricultural infrastructure construction, education and health services, and welfare.

21. Office of the Leading Group for Economic Development in Poor Areas Under the State Council, *Outlines of Economic Development in China's Poor Areas* (Beijing: Agricultural Publishing House, 1989).

22. Here, counties in Yanan and Yulin prefectures are defined as northern counties. Southern counties refer to the 26 non-northern poor counties (i.e., those in Shaanxi's eight other prefectures).

23. Albert Park, Scott Rozelle and Fang Cai, “China's grain policy reforms: implications for equity, stabilization, and efficiency,” *China Economic Review*, Vol. 5, No. 1 (1994), pp. 15–34.

Table 3: County Revenue Expenditures, Revenue Shortfall and Income Per Capita in Shaanxi Province, 1980–92^a

Year	All counties ^b						Non-poor counties						Poor counties in southern Shaanxi						Poor counties in northern Shaanxi					
	Revenue			Revenue			Revenue			Revenue			Revenue			Revenue			Revenue			Revenue		
	Expenditure	shortfall	Income	Expenditure	shortfall	Income	Expenditure	shortfall	Income	Expenditure	shortfall	Income	Expenditure	shortfall	Income	Expenditure	shortfall	Income	Expenditure	shortfall	Income	Expenditure	shortfall	Income
1980	13.9	31.5	17.6	64	15.3	27.9	12.7	70	10.9	32.0	21.1	57	15.6	45.6	31.0	54								
1981	18.8	32.9	14.2	59	23.6	30.7	7.2	66	12.5	32.1	19.6	46	12.4	43.6	31.2	57								
1982	16.1	32.9	16.8	85	17.4	29.1	11.7	98	15.1	33.7	18.6	70	12.5	46.6	34.1	69								
1983	20.8	31.9	11.1	128	26.2	26.8	0.7	146	13.6	34.7	21.1	112	13.2	47.3	34.2	89								
1984	17.6	26.1	8.5	158	21.7	25.1	3.5	181	13.4	24.7	11.3	128	10.3	33.4	23.1	126								
1985	15.4	29.4	13.9	188	20.5	27.1	6.5	221	9.8	28.3	18.4	148	6.5	41.1	34.6	136								
1986	16.3	31.6	15.3	205	21.2	29.7	8.5	250	10.5	30.1	19.6	150	8.8	42.5	33.7	141								
1987	18.2	31.7	13.5	211	23.9	30.5	6.6	258	11.5	29.3	17.7	160	9.4	41.2	31.8	127								
1988	20.5	32.8	12.3	209	26.9	33.2	6.3	247	12.6	27.8	15.2	161	11.5	41.7	30.2	158								
1989	22.3	34.2	12.0	194	29.0	34.9	6.0	227	13.6	29.1	15.5	156	13.7	41.9	28.2	139								
1990	22.9	33.5	10.6	210	29.5	34.0	4.5	242	14.3	28.9	14.6	172	14.7	40.8	26.1	160								
1991	24.0	34.6	10.6	219	30.4	35.3	4.9	251	15.3	30.2	14.8	187	16.4	40.7	24.3	160								
1992	22.2	30.8	8.6	—	27.9	30.6	2.6	—	14.5	27.9	13.5	—	15.8	37.3	21.5	—								

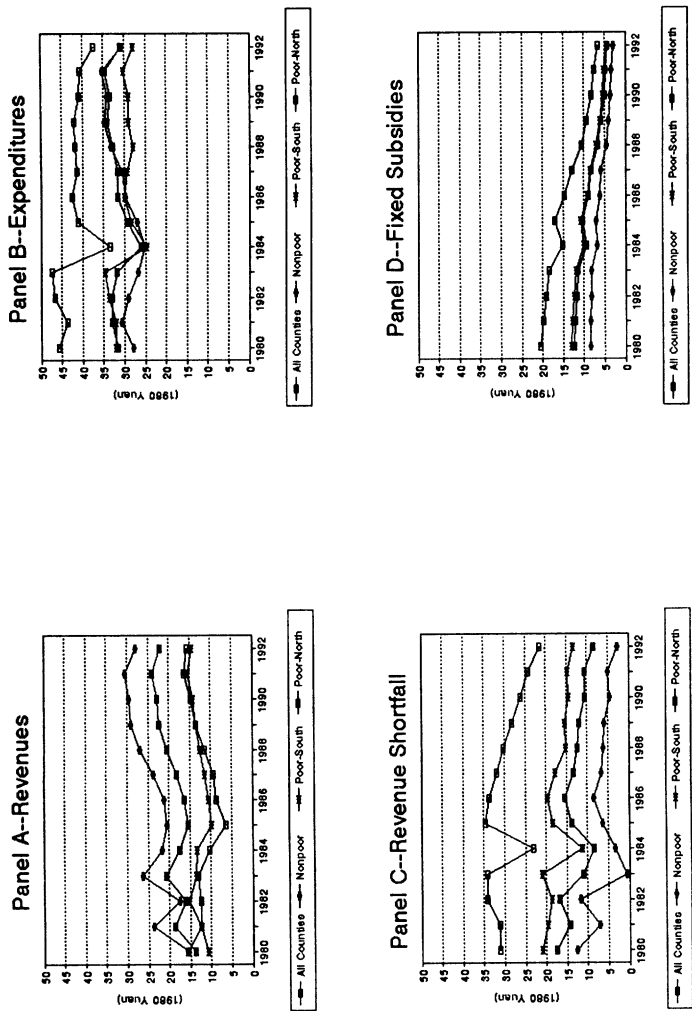
Notes:

^aAll figures are in 1980 yuan, deflated by the Shaanxi government wages index published in 1981–93.^bOf the total 93 counties, 47 are non-poor, 26 are southern poor counties and 20 are northern poor counties.

Sources:

Shaanxi Province Statistical Yearbook 1989–93; Shaanxi caizhengting (Shaanxi Finance Bureau), *Shaanxi caizheng sishinian, 1950–1990* (Forty Years of Shaanxi Fiscal Statistics, 1950–1990) (Xian: Shaanxi Statistical Press, 1991).

Figure 2: County Per Capita Revenues, Expenditures, Deficits and Fixed Subsidies in Shaanxi Province, 1980–92.



Source:

Shaanxi caizhengting (Shaanxi Finance Bureau), *Shaanxi caizheng sishinian (Forty Years of Shaanxi Finance)* (Xian: Shaanxi Finance Bureau, 1992), and Zhongguo tongjiju (State Statistical Bureau) *Shaanxisheng tongji nianjian (Shaanxi Province Statistical Yearbook)* (Beijing: State Statistical Bureau Press, 1992 and 1993).

considerably across the board, but especially in poor counties. This pattern of more rapid revenue increases in poor areas has also been observed for 25 poor counties nation-wide and for poorer provinces.²⁴ Bahl and Wallich also show that poor provinces exert greater tax effort when measured against tax capacity determined on the basis of income and urbanization. By this measure, Shaanxi ranks 12th among 30 provinces in tax effort. The seemingly strong incentives for poor areas to increase revenue collection suggest that budget constraints are perceived to be hard. If local governments perceived that subsidies would automatically compensate for revenue shortfalls or decrease if revenues increased, there would be little incentive for high tax effort.

To determine which sectors are most important in generating county revenues, county revenue per capita is regressed for each year on gross output value of six component sectors of social output value (normalized by population) – agriculture, county industrial enterprises, township industrial enterprises, village industrial enterprises, other industry and other sectors (transportation, construction and commerce). County enterprise industrial output remains a consistently important source of revenue throughout (Figure 3). The positive coefficient means that increased output value from county enterprises leads to higher revenue collection. In the early 1980s, township industrial output also was a robust determinant of tax revenues, but by 1990, the coefficient fell to zero. The coefficient on village industrial output rose to become positive in the early 1990s. The falling contribution of township enterprises can be explained by either lower profitability and/or lower effective tax rates. Greater township fiscal independence since 1985 may have increased incentives for township governments to under-report profits and therefore reduce tax collection in order to direct funds into extrabudgetary channels. Competition among regions to attract investment in township enterprises also may have increased tax concessions and reduced profitability.²⁵ In contrast, village industries may suffer less from local government predation because they are smaller and more numerous. They also may be more efficient than township enterprises in poor areas where pressure to raise revenue has been greater.²⁶

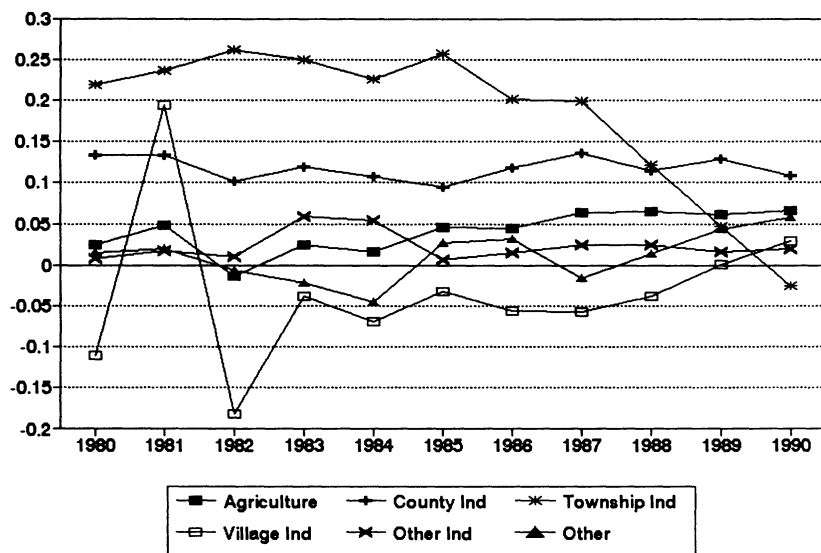
Although revenues per capita have risen over time, expenditures per capita were nearly the same in 1992 as they were in 1980 (Figure 2, Panels A and B). Non-poor counties, however, registered greater gains

24. Xingqing Ye, "Bianyuan didai zhengfu shouzhixingwei fenxi" ("Analysis of government revenues and expenditures in remote regions"), *Jingji kaifa luntan (The Tribune of Economic Development)*, March 1991; Bahl and Wallich, "Intergovernmental fiscal relations in China."

25. Barry Naughton, "Implications of the state monopoly over industry and its relaxation," *Modern China*, Vol. 18, No. 1 (1992), pp. 14–41.

26. Village leaders have fewer fiscal expenditure responsibilities than township leaders. Greater revenue scarcity and the fewer number of taxable TVEs may have led township leaders in poor areas to be more predatory than in richer regions, resulting in greater relative profitability of village industry; see Hehui Jin and Zhixiong Du, "Productivity of China's rural industry: growth rates and regional disparity," paper presented for a National Workshop on Rural Industrialization in Post-Reform China sponsored by the International Labour Organization, Beijing, October 1993.

Figure 3: Coefficients of Regression of County Revenues Per Capita on Different Sources of County Per Capita Output Value for Shaanxi Province, 1980–92.



Source:

Results based on data from Ministry of Agriculture, County database, Chinese Academy of Agricultural Sciences, Beijing, 1981–91.

than poor ones. In poor counties, expenditure levels in the late 1980s and early 1990s were well below those of the early 1980s.²⁷ For non-poor counties, expenditures per capita grew steadily from 1984 to 1991. In the early 1980s, in fact, county expenditures per capita in poor counties were well above expenditures in non-poor counties. But by 1987, per capita expenditures in non-poor counties had surpassed those in southern poor counties, and by the early 1990s the gap with northern poor counties had narrowed considerably. After the across-the-board drop in expenditures that occurred in 1992, real per capita county government expenditures in Shaanxi had fallen to their 1980 starting level despite sizeable real growth in output value and incomes.

These contrasting trends in county-level revenues and expenditures imply that local government revenue shortfalls have shrunk over time (Figure 2, Panel C). The reductions have occurred in both poor and non-poor counties. Government revenue shortfalls per capita fell by 5.9, 6.1 and 12.2 *yuan* per person, respectively, in non-poor, poor southern and poor northern counties from 1986 to 1992. The share of expenditures financed by transfers for all counties in the province dropped steadily from 56 per cent in 1980 to 28 per cent in 1992. In the consolidated provincial budget, this revenue shortfall to expenditure ratio initially increased during the early reform period, peaking at 33 per cent in 1984 before declining to as low as 20 per cent in 1991 (Table 1,

27. Though not as low as in 1984 when expenditures per capita plummeted.

column 4). This implies that while transfers from the provincial and prefectural governments to county governments remain positive (that is, counties spend more than they take in), such transfers have decreased since the early 1980s.

County revenue shortfalls are not completely financed by fiscal transfers from higher level governments. As explained above, the province provides a fixed subsidy every year to each deficit county, and counties also receive earmarked subsidies to be spent for approved purposes. The amount of this subsidy can vary from year to year depending on the quality of proposed projects, claims to subsidies, overall revenue availability, and the nature of prefectural and provincial development plans. While overall county revenue shortfalls have diminished over time, the share of revenue shortfalls financed by fixed subsidies (which are more reliable from a county administrator's point of view) has also fallen steadily (Figure 4, Panel A). In fact, counties in Shaanxi have been told that fixed subsidies will be abolished altogether after 1997. Since these subsidies have been more redistributive than earmarked subsidies, their elimination could have significant implications for equity in the provision of public investment and services.

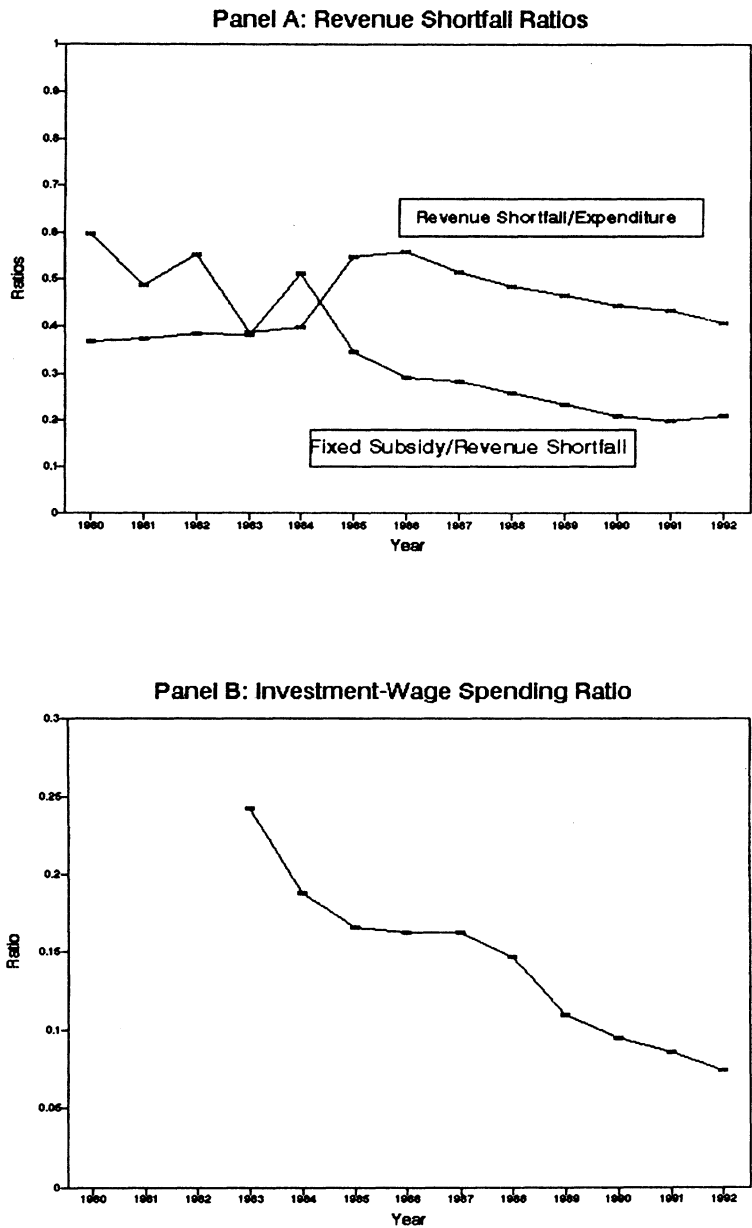
Given this story of increasing self-reliance in local public finance, an increasing connection between local revenue generation and local expenditures would be expected. The partial correlation between expenditures and revenue per capita has increased over time, exceeding 0.5 in every year from 1987, and peaking in 1992 at 0.71 (Table 4, column 1). Partial correlations between expenditures and income per capita and between revenues and income per capita also reach higher levels in the late 1980s and early 1990s, hinting at greater inequality in public spending across counties even within the same region.²⁸ Revenue remains more highly correlated with income than expenditures, however, providing evidence of continued redistribution. Such redistribution is achieved by varying the amount of grants and subsidies for deficit counties and the sharing rates for collected revenue for surplus counties. But overall, the county budgetary data provides strong evidence of declining redistribution of financial resources from richer to poorer counties.

Increasing variation in expenditure and revenue levels provides further evidence of increasing disparities since the mid-1980s. After erratic movement during the reforms in the early 1980s, the coefficient of variation for county expenditures per capita has risen monotonically since its trough in 1986 (following the financial reforms in 1985) to reach 49.3 by 1992 (Table 4, column 4). The coefficient of variation for revenues per capita has also risen over time, reaching 86.4 in 1992 (Table 4, column 5).

Food for work and alternative financing channels. Alternative financing channels through government agencies may in part be offsetting trends towards greater inequality in the generation and allocation of

28. Partial correlations use prefectural dummy variables to control for across-region effects.

Figure 4: Revenue Shortfall and Investment Ratios from Shangluo Prefecture’s Consolidated Budget, 1983–92.



public funds. In Shaanxi, targeted investment spending in poor areas funded by the national government’s Food for Work Programme (FFW – *yigong daizhen*) in recent years has provided a significant share of the development capital made available to poor areas for construction of

Table 4: Correlation Among Per Capita Expenditures, Revenues and Income and Coefficients of Variation for County Revenues and Expenditures in Shaanxi Province, 1980–92

Year	Correlation coefficients			Coefficients of variation	
	(1) Expenditures to revenues	(2) Expenditures to income	(3) Revenues to income	(4) Expenditures per capita	(5) Revenues per capita
1980	0.18	− 0.04	0.45	40.9	59.9
1981	0.18	− 0.03	− 0.05	52.4	72.5
1982	0.52	− 0.01	0.04	44.5	61.3
1983	0.09	0.10	0.32	44.7	67.0
1984	0.28	0.06	0.15	41.5	73.9
1985	0.30	0.02	0.44	41.2	65.1
1986	0.35	− 0.07	0.41	39.1	62.1
1987	0.50	0.09	0.35	40.9	66.8
1988	0.59	0.11	0.43	42.2	77.2
1989	0.63	0.23	0.53	45.3	79.4
1990	0.51	0.13	0.48	46.3	83.8
1991	0.61	0.20	0.50	45.0	83.4
1992	0.71	—	—	49.3	86.4

Source:

Columns 1–3: *Shaanxi Province Statistical Yearbook*, 1989–93; columns 4 and 5: *ibid.* and *Forty Years of Shaanxi Fiscal Statistics, 1950–1990*.

roads, drinking water projects and agricultural infrastructure such as terraces and irrigation. The programme is organized around multi-year projects administered by the provincial planning commission (*jiwei*). Projects are funded only after careful appraisals by the provincial FFW staff. These rules limit the role of the FFW projects as a way poor areas can meet unexpected revenue shortfalls or expenditure overruns. FFW investments bypass county finance bureaus by providing resources directly to relevant county agencies (such as the Transportation and Soil and Water Conservation Bureaus). Resources are provided in kind from state marketing agencies, or coupons are issued that are redeemable through state banks. By policy, resources supplied by the national government should be matched by provincial, prefectural and county governments. In practice, local contributions are often limited or non-existent because of revenue scarcity.

After a three-year experiment in 1984–86 followed by two years of no projects, funding for FFW projects in Shaanxi has picked up dramatically since 1989 (Table 5). In 1992, national FFW resources provided 100 million *yuan* to the province compared to 441 million *yuan* in provincial

Table 5: Rural Infrastructure Investment in Shaanxi Province, 1984–94
(million *yuan* – real 1985 *yuan*)

<i>Year</i>	<i>Food for Work programme</i>	<i>Rural basic construction</i>
1984	67	330
1985	67	419
1986	67	457
1987	0	365
1988	0	318
1989	3	390
1990	28	334
1991	108	334
1992	100	441
1993	180	—
1994	230	—

Source:

Shaanxi Province Statistical Yearbook, 1989–93, and authors' interviews at the Provincial Planning Commission.

consolidated rural infrastructure investment. The value of FFW projects more than doubled by 1994, and the national government has announced further expansion of the programme as part of a new campaign to eliminate absolute poverty by the year 2000. The scope of projects has also widened, expanding from roads and drinking water to rural investments of all types. Only poor regions are eligible for FFW projects (including poor townships in non-poor counties), but within poor areas, projects are selected on merit and typically reflect developmental rather than distributional goals.²⁹ Thus, while these targeted investment funds may increase resources made available to poor regions, they do not soften budget constraints by compensating for fiscal deficits.

One reason the FFW programme has been praised and targeted for expansion is that because it bypasses local finance bureaus, relatively few funds have been diverted by local governments for other uses, a common occurrence for many earmarked budgetary items including those targeted at rural infrastructure investment (discussed below). The programme thus represents an institutional response to the government's inability to implement contingent grants through conventional channels. There is concern that expanding the scope of FFW will make it more difficult to monitor and increase the incentives for local governments to think of ways to divert the funds. Creating multiple channels for funding local agencies also hurts the transparency of the fiscal system and effectively reduces the planning authority of local governments.

29. Ling Zhu and Zhongyi Jiang, "Public works and poverty alleviation," paper presented at a Discussion Forum on China's Poverty Policies sponsored by Ford Foundation, Beijing, October 1994.

Table 6: Extra-budgetary Revenues and Expenditures in Shaanxi Province, 1986–90 (million yuan)

Year	Revenues	Expenditures	Share of consolidated budget	
			Revenues	Expenditures
1986	194.1	197.3	0.81	0.55
1987	261.8	246.7	0.93	0.65
1988	324.9	290.3	0.96	0.65
1989	261.2	359.4	0.67	0.71
1990	380.7	392.7	0.86	0.69

Source:

Zhongguo caizhengbu (China Finance Ministry), *Zhongguo caizhen tongji, 1950–1991* (Chinese Financial Statistics, 1950–1991) (Beijing: Science Press, 1992).

Non-budgetary finance: extra-budgetary and self-raised funds. Extra-budgetary funds (EBF) consist of enterprise retained profits and depreciation funds, and a variety of surcharges and users' fees collected by local governments and administrative agencies. These funds are "off-budget" and are generally discretionary funds to be spent by the enterprises and local governments to which they accrue, usually on capital construction projects.³⁰ EBF revenues and expenditures are legally defined and must be accounted for by officials through China's fiscal reporting system. Their importance has grown rapidly during the 1970s and 1980s.³¹ In 1990, EBF comprised 15.6 per cent of China's GNP in comparison to 20 per cent for budgetary revenues, and extra-budgetary revenues and expenditures in Shaanxi were equal to 86 and 69 per cent of provincial consolidated revenues and expenditures (Table 6).

While the amount is substantial, Wong points out that most of these funds are controlled by increasingly autonomous state enterprises and administrative agencies and so are not available to local governments.³² In 1990, enterprises, administrative agencies and local governments controlled 76, 21, and 2 per cent of EBF in China.³³ Extra-budgetary funds accruing to administrative agencies are often from commercial ventures such as restaurants, hotels and stores, and are resources over which local governments have limited claims. Beginning in 1994, retained earnings by enterprises were no longer officially classified as

30. In 1983, two 10% profit taxes for energy and communications construction and urban construction were established as sources of extra-budgetary revenue. Local finance departments are officially required to report all extra-budgetary revenues, though widespread under-reporting is likely.

31. Oksenberg and Tong, "The evolution of central-provincial fiscal relations."

32. Wong, "People's Republic of China."

33. Wong, Heady and Woo, *Fiscal Management and Economic Reform*.

Table 7: Township Revenues and Expenditures in Shaanxi Province, 1986–89

	Year	Amount (million yuan)	Share of consolidated revenue expenditure	Proportion of Revenue/expenditure from:		
				Budgetary	Extra- budgetary	Self- raise funds
Revenues	1986	42.2	0.18	35.5	0.5	6.2
	1987	48.0	0.17	44.0	0.4	3.5
	1988	67.0	0.20	56.8	5.9	4.4
	1989	83.5	0.21	75.0	1.6	6.9
Expenditures	1986	41.3	0.12	35.5	0.3	5.5
	1987	5.07	0.13	47.0	0.2	3.5
	1988	65.0	0.15	59.9	0.6	4.4
	1989	77.7	0.15	70.4	1.0	6.3

Source:

Forty Years of Shaanxi Fiscal Statistics, 1950–1990.

extra-budgetary funds.³⁴ The fiscal component of EBF is thus quite small, increasing within budget revenues and expenditures by only 3.7 and 2.4 per cent respectively.³⁵ In Shaanxi, the share of EBF in revenues and expenditures of township governments is extremely small (Table 7). Still, if local governments can successfully pressure enterprises and administrative agencies to use these discretionary funds to provide social services such as education and health services to their employees, the funds should be included in a fair appraisal of local provision of public goods and services.

Unfortunately, data do not permit a detailed assessment of the distribution of extra-budgetary revenues and expenditures across regions in Shaanxi. However, since EBF relies heavily on industrial output, the distribution of these expenditures is likely to be highly skewed to more prosperous industrializing regions.³⁶ They are almost certain to be more unequally distributed than county expenditures that benefit from planned transfers and targeted funding programmes. As expected, interviews with officials from poor counties found that extra-budgetary funds did not significantly mitigate difficulties in meeting local expenditure responsibilities. The size of EBF in poor counties is too small to be an important revenue source, and too much under the control of autonomous units to be helpful to officials.

Another important source of funds for local governments (especially

34. Wong, "Financing local government."

35. Wong, Heady and Woo, *Fiscal Management and Economic Reform*.

36. Wong, "Subprovincial finance in the People's Republic of China."

township governments) is self-raised funds (*zichou zijin*), an amalgam of user fees and levies similar to extra-budgetary funds levied by local governments. Self-raised funds are similar to EBF but differ in the degree of control and monitoring exercised by upper level auditing agents. They include fees not explicitly categorized by state policy to be budgetary or extra-budgetary, and apply especially to township and village level fees. These more flexible funds are often used for purposes such as education, cadre wages, electricity and water service. Sun and Gang describe these funds as extra-system funds (*zhiduwai zijin*) in contrast to within-system funds (*zhidunei zijin*), which include both within budget and extra-budgetary funds. They report that in a number of counties investigated throughout China, the amount of self-raised or extra-system funds considerably exceeds the amount of extra-budgetary funds.³⁷ Nation-wide, in 1993, the shares of township government revenues from budgetary revenues, extra-budgetary funds and self-raised funds were 74, 6.5 and 20 per cent, respectively.³⁸ For townships in Shaanxi, self-raised funds accounted for about 7 per cent of total township revenues in 1989, far exceeding extra-budgetary funds (Table 7).

Just as with extra-budgetary funds, it is likely that self-raised funds amplify rather than dampen regional disparities. Self-raised funds that come from local enterprises will be more plentiful in richer, industrialized regions. Spending on local services and projects funded by direct levies on the beneficiaries of that spending does not equalize resource distribution across regions, and, in fact, is often regressive since flat fees are a higher share of the income of the poor. That the percentage of township finance accounted for by non-budgetary sources in Shaanxi is less than half that of the national average is a strong indication that non-budgetary finance is likely to exacerbate the inequitable distributional consequences of reforms in local public finance.

Fiscal Crisis in Poor Counties

Financing fiscal net deficits. County revenue shortfalls are not always fully financed by fixed subsidies, earmarked subsidies and other assistance from above. In many cases, even after receiving these transfers, a deficit still remains (hereafter referred to as a net deficit). This is especially true when counties fail to meet revenue targets or must make unexpected outlays. In recent years, however, net deficits have become a persistent rather than transitory phenomenon in poor counties. By 1994, up to one half of counties in China had encountered difficulties making timely wage payments.³⁹ In several poor counties visited in 1993 and

37. Tanzhen Sun and Gang Zhu, "Woguo xiangzhen zhiduwai caizheng fenxi" ("Analysis of extra-system township finance in China"), *Jingji yanjiu* (Economic Research), No. 9 (1993).

38. Wong, Heady and Woo, *Fiscal Management and Economic Reform*.

39. Remarks by Duan Yingbi, Vice-Director, Financial and Economic Committee of the State Council, at a seminar on food problems in China held at Beijing Agricultural University on 19 October 1994.

1994, wage payments for government workers, including teachers, had been suspended for up to five months.

Counties can appeal to upper level governments for special subsidies, or even an upward adjustment of fixed subsidies. Such an adjustment has been made for some visited counties and is not uncommon if a persuasive case can be made for why the net deficit was unavoidable, or if public spending is necessary for maintaining social stability. As transferable funds grow increasingly scarce, however, this negotiation has become more difficult for deficit counties.

Net deficits can be financed in a number of ways. Counties can generate extra revenues by selling urban resident permits (*hukou*); borrow funds originally earmarked for other uses, such as family-planning funds, education investments, grain bureau subsidies and agricultural investments; borrow other idle capital held by state enterprises and agencies; or borrow from banks. The latter occurs even though direct borrowing from state banks to cover budget deficits is illegal in China. The relative importance of financing options varied among visited counties, but in many cases accumulated debt to finance successive years of net deficits has reached extremely high levels.⁴⁰

The extent to which poorer counties have become revenue-starved is reflected by the need in recent years to accumulate hidden deficits in addition to acknowledged net deficits. Hidden deficits are budgetary funds officially recorded as having been allocated to designated spending categories, but which in fact are diverted (or "borrowed") to pay for more pressing needs (that is wages). One county had accumulated hidden deficits at year-end 1993 of 7.6 million *yuan* (in addition to the accumulated net deficits of 5.3 million *yuan*). These were financed by deferring payments to the following expense categories: 2.8 million *yuan* for health care reimbursements, 1.9 million *yuan* for bonus payments, 1.3 million *yuan* for cadre business expenses, 0.7 million *yuan* for housing for retired officials, 0.7 million *yuan* for family-planning operation expenses, 0.2 million *yuan* for wages, and 0.1 million *yuan* for books and subscriptions. Often the government simply refuses to make payments to units and employees for such reimbursable expenses. In many cases, expenses incurred years ago have yet to be reimbursed, with little prospect for early repayment. The existence of hidden deficits means that financial statistics systematically underestimate the amount of fiscal debt. Fund diversion occurring at local levels also makes it likely that reported non-wage expenditure figures overstate actual outlays.

40. Budget officials in one northern county reported that borrowing to cover the net deficit in 1992 was 1.25 million *yuan* (8% of the total government deficit) and had almost entirely been financed by loans from the Agricultural Bank. The county had run up a cumulative debt of 7.75 million *yuan* from 1984 to 1992. In contrast, a poor southern county accumulated debts of 16.69 million *yuan* from 1985 to 1992 (in 1992 alone borrowing to cover the net deficit reached 6.8 million *yuan*, about one-third of the total deficit), but did not borrow any money from banks. Rather, funds had been borrowed (*jiekuan*) from about 30 different administrative units within the county. This borrowing included 1.5 million *yuan* in education fees collected by the Education Committee and 0.3 million *yuan* from the Forestry Bureau originally meant to finance afforestation programmes.

The question of legality surrounding direct borrowing from local banks by local finance bureaus is probably less important than whether local government officials in practice can influence lending decisions more generally. If they can, it is always possible to launder loans through state enterprises or other government units to channel funds to the finance bureau indirectly. The crucial determinant, then, of whether local governments have an incentive to reduce deficits is the extent to which budget constraints are hard, both in the fiscal and financial (banking) systems. Some argue that fiscal decentralization and monetary centralization have significantly hardened budget constraints facing local governments in China, with positive effects on the efficiency of resource allocation.⁴¹ That budget constraints have hardened in a credible fashion seems consistent with falling county revenue shortfalls per capita over time in Shaanxi and accounts of suspended wage payments, fund diversion and accumulation of hidden deficits. Revenue scarcity at all levels, especially in poor provinces, the nation-wide credit squeeze in 1993 and continued efforts to commercialize banking operations all have helped harden budget constraints further.

Effect of budget pressures on public expenditure patterns. While fiscal decentralization may improve enterprise performance by helping to harden budget constraints for essentially government-owned firms, it can have deleterious effects on the social efficiency of the provision of critical public goods such as infrastructure construction and education and health services, especially when populations are relatively immobile as in China. One would not expect linkage between expenditure and revenue amounts to lead to optimal distribution of government investment and services. Rather, increasing fiscal self-sufficiency and the pressure to eliminate deficits may result in under-investment in public goods in poor areas and increase the incentives for local governments to maximize revenues rather than social welfare.⁴²

The former phenomenon is hinted at in the borrowing and diversion of funds from education, health and agricultural investments described earlier. Most local governments put first priority on meeting their wage bills, which constitute the vast majority of expenditures.⁴³ In the consolidated expenditures for the province as a whole, most of the education/health, administration and agriculture expenditures go towards wage and bonus payments. The common experience of many countries outside China is that contractions in public expenditures lead to a decline in the efficiency of resource use because of deterioration of previous capital

41. Yingyi Qian and Weingast, "Beyond decentralization"; and Yingyi Qian and Gerard Roland, "Regional decentralization and the soft budget constraint: the case of China," mimeo, Stanford University, 1994.

42. Guobao Wu, "Goal conflict in poor areas".

43. *Ibid.*

Table 8: Government Expenditure Shares in Shangluo Prefecture, Shaanxi Province, 1983-92

	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992
<i>Investment</i>	18.6	14.1	12.6	11.8	11.3	11.5	8.8	7.8	7.1	6.4
Of which:										
Urban construction	4.1	5.0	8.2	13.3	12.5	12.8	19.8	20.1	15.9	16.9
Firm improvement	26.9	26.6	5.4	12.6	22.6	13.8	2.6	0.3	2.3	3.2
Technological improvement	1.0	1.5	1.3	5.5	3.1	1.9	1.6	1.2	1.7	1.2
Rural production	65.6	66.9	85.0	68.6	61.5	57.6	66.5	67.3	66.6	66.2
Targeted poverty investment	0.0	0.0	0.0	0.0	0.0	11.3	9.5	11.2	12.1	12.5
Other	2.3	0.0	0.1	0.0	0.2	2.5	0.0	0.0	1.3	0.0
<i>Employment</i>	76.8	75.3	76.3	72.5	69.7	77.9	80.0	81.9	83.2	86.0
Of which:										
Agriculture	12.5	11.1	9.3	9.0	10.1	10.1	9.6	9.6	9.5	9.0
Industry, transport, trade	3.4	3.0	3.9	3.4	4.5	3.6	3.8	3.2	3.3	2.7
Education, sanitation, culture, science	54.7	52.1	56.1	53.7	51.8	52.5	51.7	50.1	49.3	49.2
Administration	25.5	30.5	26.7	28.3	27.9	22.2	22.3	24.0	24.6	26.3
Other	3.9	3.4	4.0	5.6	5.7	11.5	12.6	13.0	13.2	12.8
<i>Welfare</i>	4.3	6.5	6.0	6.3	8.5	4.8	5.3	4.3	4.1	4.0
Of which:										
Youth employment funds	4.7	9.1	2.1	4.1	1.2	1.5	2.0	2.7	6.6	3.7
Welfare and disaster relief	95.3	90.9	97.9	95.9	98.8	98.5	98.0	97.3	93.4	96.3
<i>Subsidy</i>	0.0	0.0	1.3	7.0	6.1	4.6	4.8	4.5	2.1	1.6
<i>Other</i>	0.3	4.1	3.8	2.4	4.4	1.2	1.2	1.6	2.5	2.0

Source:
Shangluo tongjiju (Shangluo Prefecture Statistical Bureau), *Shangluo tongji nianjian, 1985, 1993* (Shangluo Prefecture Statistical Yearbook, 1985 and 1993) (Shangluo Municipality, Shaanxi Province: Shangluo Prefectural Finance Bureau Press, 1986 and 1994).

Table 9: Shangzhou Shi (County Level Municipality) Budget Expenditures, 1985 and 1993

	1993			1985	
	Amount (million yuan)	Percentage of total	Percentage of plan	Amount (million yuan)	Percentage of total
Expenditures	48.47	—	119	18.63	—
By spending category:					
Agricultural investment	0.47	1.0	31	1.61	8.6
Urban construction	0.72	1.5	73	0.17	0.9
Operating expenses	29.82	61.5		9.16	49.2
Agriculture	3.62	7.5	108	0.94	5.0
Industry, transport	0.47	1.0	189	0.21	1.1
Education, health, sanitation	20.49	42.3	101	7.43	39.9
Security and police	2.57	5.3	128		
Other	2.67	5.5	152	0.58	3.1
Administration	10.67	22.0	161	3.57	19.2
Social welfare	1.96	4.0	91	1.92	10.3
Other	4.82	9.9		2.20	11.8
By use:					
Direct expenditure on					
personnel	30.76	63.5		9.20	49.4
Wages	12.37	25.5		4.85	26.0
Subsidies	8.44	17.4		1.99	10.7
Benefits	2.04	4.2		1.07	5.7
Retirement	2.88	5.9		0.41	2.2
<i>Cha e buzhu</i> ^a	1.57	3.2		0.86	4.6
Special 1993 wage subsidy	2.10	4.3			
Other	1.38	2.8		0.03	0.1
Office expenses	3.83	7.9		1.28	6.9
Operation expenses	3.06	6.3		0.88	4.7
Equipment	0.50	1.0		0.36	1.9
Maintenance and repair	1.23	2.5		1.38	7.4
Other	9.10	18.8		5.53	29.7

Note:

^a*Cha e buzhu* is the wage subsidy to units that are partially self-supporting (e.g. hospital, clinics, theatres).

Source:

Authors' interviews in Shangzhou County Finance Bureau, October 1994.

investments, as spending on non-wage recurrent expenditures, such as maintenance expenses, falls.⁴⁴

The composition of government expenditures provides evidence of the effect of tightening budgets (Tables 8 and 9). Per capita expenditures in

44. Gallagher and Ogbu, "Public expenditures, resource use, and social services."

Shangluo prefecture, one of Shaanxi's poorest, fell from 38 *yuan* in 1983 to 31 *yuan* in 1990,⁴⁵ a period when expenditures per capita for all counties in Shaanxi were relatively stagnant (Table 3). Expenditures are divided into five categories: investment, wage-based (operating expenses for government and administrative units), welfare, subsidies and miscellaneous (Table 8). The investment share of the budget fell consistently from 19 per cent in 1983 to 6 per cent in 1992, while that of wage-based expenditures increased from 77 per cent in 1983 to 86 per cent by 1992 after dropping to 70 per cent in 1987 (mainly due to the higher share of grain subsidies accompanying decentralization of grain management).⁴⁶ The most important investment category, rural productive investment, fell to just 4 per cent of expenditures in 1992 compared to 10 per cent for the provincial consolidated expenditures. Falling investment shares are not an artefact of crises in one or two counties but are true for all counties in the prefecture. The ratio of investment to wage-based spending fell continuously throughout the period from 1983 to 1992 (Figure 4, Panel B). The same phenomenon is found in northern Shaanxi, where in one visited county the share of government expenditures devoted to rural productive investment fell from 20 per cent in 1980 to just 2 per cent in 1992.

The wage-based expenditure categories described above actually include other expenses such as office costs, operating expenses, equipment purchase, and maintenance and repair. Table 9 disaggregates these expenditures more precisely for the 1993 and 1985 budgets of Shangzhou municipality, a poor county-level municipality in southern Shaanxi. Direct expenditures on personnel accounted for only 49.4 per cent of the budget in 1985, but by 1993 had grown to 63.5 per cent. Meanwhile expenditures for equipment and maintenance/repair fell from 1.9 and 7.4 per cent in 1985 to 1.0 and 2.5 per cent in 1993. Such trends raise concerns that in addition to reductions in public investments, budgetary pressures reduce the effectiveness of government services as employees lack necessary equipment and operating funds, a story consonant with accounts of agriculture and forestry extension agents with no funds to run training classes or set up model sites, and teachers who lack adequate teaching facilities and materials. Actual expenditures also can be compared to planned expenditures in 1993 (Table 9). All wage-based expenditures (operating expenses and administration) surpassed planned amounts; expenditures for rural infrastructure construction, urban con-

45. In 1980 *yuan* (deflated by provincial government wage index). Expenditures per capita recovered to 35 *yuan* in 1992.

46. The fall in investment is less dramatic if firm improvement investments are excluded (falling from about 13% in 1983). These investments were systematically shifted from budget to enterprise accounts and so overstate the drop in actual investment. Similar reports of the increased importance in wages are found in Xingqing Ye, "Analysis of government revenues and expenditures" for 25 poor counties and in Wong, Heady and Woo, *Fiscal Management and Economic Reform*, for Gansu, where 80% of expenditures went to personnel costs. Though not as dramatic, the national trend has also been falling for spending on capital construction, though it is being partly offset by increasing availability of EBF. Part of the reason for this trend is that government employment has grown at a high rate, even exceeding that of the urban labour force. Administrative personnel in China grew from 20 to 29 million people from 1978 to 1990, an increase of 45% or 3.1% per annum (*ibid.*).

struction and social welfare fell short of targets. Rural investment, in particular, reached only 31 per cent of planned expenditures, accounting for only 1 per cent of expenditures compared to 8.6 per cent in 1985.

The impact of fiscal reforms on the ability of local governments in poor areas to make productive investments in infrastructure and social service provision (beyond wage payments) has important implications for economic development prospects in poor regions and for widening economic inequality and social stability. Some of the apparent fall in investment in poor counties is compensated for by increased spending through other channels, especially the Food for Work programme. While local investments can also be made through provincial and prefectural spending, these amounts tend to be modest. Data from several visited counties on investment levels from all sources for key investment categories (such as education, road construction, soil and water conservation including terracing, and afforestation) reveal imperfect but consistent declines in investment funding by the late 1980s and early 1990s when compared with the mid-1980s. It also appears that in some cases the introduction of the FFW programme has considerably revived investment in basic infrastructure. However, availability of FFW funds may make it more likely that county budget bureaus will reduce their own budgetary commitment to similar projects, although the funds themselves, because they do not pass through the budget bureau, are less fungible and less easily diverted to other uses.

Deficit counties have also begun to think of ways to reduce their wage obligations and to increase revenues. In one northern county, wage payments in 1993 were suspended because the designated funds were used instead to pay as-yet unpaid bonuses for 1992. To cope with the fiscal crisis, the county implemented a rotating employment scheme in which half of all government office workers were laid off at half pay with the understanding that if they wished to return the following year, the other employees would then take their turn being laid-off, with this alternating system continuing indefinitely. The hope was that laid-off employees would find new jobs and not return, but most came back. In other counties, staff have been laid off outright. A more common result of the frequent reorganizations of local government personnel, however, is that workers are shuffled around but not let go. Some government bureaus, especially grain bureaus, have been renamed as companies with the pay of workers linked to profit-earning. Many government bureaus and agencies have been urged to think of ways to generate revenue. As elsewhere in China, many have released workers to pursue entrepreneurial activities that have little or nothing to do with their agency's public mission, such as opening restaurants and hotels, or engaging in procurement and trade of a wide array of commodities. There is a *de facto* wide-scale privatization of government activity occurring at local levels that has received remarkably scant attention.⁴⁷

47. Scott Rozelle, Albert Park and Jikun Huang, "Dilemmas of reforming state-market relations in rural China," mimeo, Stanford University, 1995.

Many such reforms are painful but necessary as local governments shed outdated functions inappropriate for China's new market-oriented economy. But there should also be a countervailing concern that, in the rush to earn revenues, important public good functions that need to be filled by local government are being neglected. For example, agricultural research and extension staff whose programme funding is cut and whose salaries remain low are unlikely to be effective in disseminating new technology.⁴⁸ Grain bureaus bent on profitable trade cannot afford to fulfil policy functions of price stabilization and grain relief provision.⁴⁹ Of even greater concern is that the rush to increase local budget revenues will compromise the government's role as a social planner. "Local state corporatism," while taking advantage of the ability of local bureaucrats to co-ordinate local economic ventures, can also lead to support and protection of state and collective industries despite lower economic and social returns.⁵⁰ Such inefficiencies can spill over to other sectors as well. In one county visited by the authors, over one-third of county revenues came from a tax on tobacco. Even villages unsuited to tobacco production were given mandatory planting quotas, and farmers willing to shoulder the quota burden were rewarded with land allocations or other considerations by village leaders.

Conclusions

Evidence from Shaanxi suggests that reforms in local public finance in China have increased local self-reliance in government public finance, hardened the budget constraints of local governments and reduced redistribution of government financial resources. Many changes within the province reflect new realities in central-provincial fiscal relations that have reduced the Centre's ability to subsidize provincial deficits in a time of overall resource scarcity. Growing differences in budgetary expenditures among rich and poor regions have been mitigated somewhat by funding through alternative financing channels (FFW programme), but have undoubtedly been exacerbated by differences in extra-budgetary and self-raised funds. Overall, inequity in the availability of public financial resources within Shaanxi appears to have widened. In poor counties, the fiscal crisis has become acute. While hardening budget constraints have forced local governments to streamline operations and make tough allocation decisions, scarcity of financial resources is compromising the ability of local governments in poor counties to make public investments and provide basic social services.

This study strongly supports the contention that budget constraints have hardened at the local level as evidenced by increasing fiscal

48. Carl Pray, Scott Rozelle and Jikun Huang, "Assessing reforms in China's agricultural research system," mimeo, Rutgers University, 1994.

49. Rozelle, Park and Jikun Huang, "Dilemmas of reforming state-market relations."

50. Oi, *Rural China Takes Off*.

self-reliance and the deficit-coping behaviour of local governments in poor areas. The work of Oi, Qian and Weingast, and others suggests that fiscal decentralization has improved the incentives facing local bureaucrats to expand local industry while instilling financial discipline in local enterprises. This may be true in prosperous regions generating financial surpluses, but in poor regions suffering from acute shortages of fiscal resources, local leaders desperate to raise fiscal revenues to meet government wage obligations and other recurrent expenditure needs must compromise development objectives and divert funds away from basic services and investments.

Increased pressure to raise revenues is more likely in this context to lead to biases in government policies and resource allocation decisions that are distortionary and inimical to promoting economic development.⁵¹ For example, investment in poor counties has been shown to be biased towards industry even when agricultural investments better serve growth and distributional goals.⁵² The strong desire to augment revenues also has led to a panoply of *ad hoc* non-budgetary fees and levies that reduce transparency, are often regressive and may act as a disincentive to firm managers.

The current state of inter-governmental fiscal relations has been described as "a state of crisis, with a high level of dissatisfaction and distrust on all sides."⁵³ It is characterized by deficient public spending services at all levels.⁵⁴ Much of the problem stems from the lack of buoyancy in a tax system overly dependent on industrial enterprises whose extractable surpluses have fallen with price and tax reforms, more competitive markets, and increased regional competition to attract investment through tax breaks and other favourable treatment.⁵⁵ Unfortunately, the system of revenue-entitled expenditures designed to address these problems does not provide an effective mechanism for meeting equity objectives. Over time, this has proven to be an increasing source of dissatisfaction.⁵⁶

The dissatisfaction with the distributional and efficiency costs of the current fiscal system resembles the situation in the mid-1970s when the Chinese government sought to decouple expenditures from revenues after a lump-sum transfer scheme had resulted in regional imbalances and cries

51. This is consistent with the concerns about over-investment expressed in Wong, "Fiscal reform and local industrialization."

52. Guobao Wu, "Goal conflict in poor areas"; Scott Rozelle, Albert Park and Changqing Ren, "Assessing the effectiveness of poverty alleviation investments in China," mimeo, Stanford University, 1994; Xingqing Ye, "Analysis of government revenues and expenditures."

53. Wong, Heady and Woo, *Fiscal Management and Economic Reform*, p. 127.

54. Bahl and Wallich, "Intergovernmental fiscal relations."

55. Naughton, "Implications of the state monopoly."

56. Ramgopal Argawala, "China: reforming intergovernmental fiscal relations," World Bank Discussion Paper No. 178 (Washington, D.C.: World Bank, 1992).

for change from poorer provinces.⁵⁷ Recognizing these problems, the new fiscal reforms implemented in 1994 attempt to increase the share of revenues controlled by the Centre, presumably increasing the government's ability to allocate equalizing grants to poorer provinces. However, it maintains a revenue-sharing system to provide credible incentives for revenue mobilization now deemed indispensable.⁵⁸ The extent to which the new system can be effectively implemented remains to be seen. What is clear is that the Chinese government must address the current financial difficulties facing many counties that prevent effective governance and cloud economic development prospects.

57. Oksenberg and Tong, "The evolution of central-provincial fiscal relations."

58. Jean Oi, "Fiscal flows and institutional incentives for economic growth in China," paper presented at the Taxation, Resources, and Economic Development Conference, "Local and Intergovernmental Finance in Transitional Economies," Lincoln Institute of Land Policy, Cambridge, MA, 15-16 October 1993.