

THE EVOLUTION OF CHINESE FISCAL DECENTRALIZATION AND THE IMPACTS OF TAX REFORM IN 1994

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Abstract

During the last two decades, fiscal decentralization has been a critical component of economic reform in China. The decentralization includes a series of fiscal arrangements, which not only involved the devolution of government authority from the central government to the lower-tier governments, but also introduced fiscal incentives for the local governments. The implementation of new tax system in 1994 affected incentives of local governments, and it created some new problems in the inter-governmental relations in China. The focus of this paper is mainly on the following three issues: (1) How has the relationship between the central government and the local governments been changed? (2) What are the incentives for the local governments in the decentralization? (3) What are the effects of this new tax arrangement? The goal of the paper is only to give a brief summary of the fiscal decentralization in China.

Key words: China; Fiscal decentralization; Tax reform; Intergovernmental relationship

JEL classification: H71, H72, H77, O23

I. Introduction

During the last two decades, fiscal decentralization has been a critical component of economic reform in China. The process of decentralization consisted of two periods. The first period started at the end of the 1970's, and finished at the end of 1993, with the feature of so called "fiscal contracting system"; and the second one began in the beginning of 1994, which was marked with the implementation of the new tax reform. Although the goal of the new tax reform is to strengthen the controlling capability of the central government, the trend of fiscal

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decentralization is still continued.

The focus of this paper is mainly on the following three issues: (1) How has the relationship between the central government and the local governments been changed? (2) What are the incentives for the local governments in the decentralization? (3) How have these incentives been changed by the implementation of the new tax system in 1994? The goal of the paper is only to give a brief summary of the fiscal decentralization in China.

The paper is arranged as follows. In Section 2, the dynamic picture of decentralization would be described, and fiscal incentives for the local governments should be carefully examined in Section 3, where the feature of fasting growth of "extra-budget-revenue" and "off-budget-revenue" would be discussed. The contents and the effects of the new tax system in 1994 and its impacts would be analyzed in Section 4. Our conclusion will follow in the final section.

II. *The Evolution of Inter-Governmental Relationship*

The centralized fiscal system was incompatible with the market-oriented reform embarked in the beginning of 1979. Like other reforms, fiscal reform started as an experiment. In 1977, Jiangsu province was chosen to implement a new fiscal arrangement, which is called "eating from separate kitchens" (*fenzao chifan*). This system represents a dramatic departure from the previous system "unified revenue collection and unified spending" (*tongshou tongzhi*).

In 1978, the central government enacted fiscal arrangement under the name "relating expenditure with revenue, dividing extra revenue with fixed share" in 10 provinces of China. Under this arrangement, (i) the local governments' expenditures depended on their own revenues; (ii) almost all of fiscal revenues were collected by the local governments, then the total revenues were divided between the central and the local governments according with some pre-determined share which was fixed within three years; (iii) if there were some extra revenues beyond the previous year, then the local governments would be eligible to share them with somewhat preferred ratio. It is clear that there were strong incentives for the local governments to collect revenue in this arrangement.

The new fiscal system in 1980 is called "fiscal contracting system". Under this system, various responsibilities assigned to different levels of governments were closely related with the ownership of state-owned-enterprises (SOEs). The spending for the investment in central-government-owned-enterprises was clearly included in the expenditure of central government, while the local governments were responsible for providing cash flow for both fixed investment and non-fixed investment of local-government-owned-enterprises. Therefore, the decentralization implies the instinct connection between the local governments and local state-owned-enterprises.

The "fiscal contracting system" was continued until 1985 when the central government determined to replace the state enterprises' profit remittances with income taxes. For this reason, the new fiscal arrangement is called "changing profit remittance into taxes". In fact, the tax reform in 1985 was a prelude of the more comprehensive tax reform in 1994, the intention of the central government in these two tax reforms are the same: that is, to change the declining trend of the central government revenue in the whole fiscal revenue.

But, in practice, the effect of the tax reform in 1985 was weakened by decentralization

TABLE 1. TOTAL REVENUE AND EXPENDITURE OF CENTRAL AND LOCAL GOVERNMENTS
(1978-1998, 10 million yuan RMB)

year	Total revenue ^a	Revenue collected by central government	Revenue collected by local governments	Ratio of revenue to GDP (%)	Ratio of central revenue in total revenue (%)	Total expenditures ^a	Central government	Local government	Ratio of central expenditure in the total expenditure (%)
1978	1132.26	175.77	956.49	31.2	15.5	1122.09	532.12	589.97	47.5
1979	1146.38	231.34	915.04	28.4	20.2	1281.79	655.08	626.71	51.1
1980	1159.93	284.45	875.48	25.7	24.5	1228.83	666.81	562.02	54.3
1981	1175.79	311.07	864.72	24.2	26.5	1138.41	625.65	512.76	55.0
1982	1212.33	346.84	865.49	22.9	28.6	1229.98	651.81	578.17	53.0
1983	1366.95	490.01	876.94	23.0	35.8	1409.52	759.60	649.92	53.9
1984	1642.86	665.47	977.39	22.9	40.5	1701.02	893.33	807.69	52.5
1985	2004.82	769.63	1235.19	22.4	38.4	2004.25	795.25	1209.00	39.7
1986	2122.01	778.42	1343.59	20.8	36.7	2204.91	836.36	1368.55	38.0
1987	2199.35	736.29	1463.06	18.4	33.5	2262.18	845.63	1416.55	37.4
1988	2357.24	774.76	1582.48	15.8	32.9	2491.21	845.04	1646.17	34.0
1989	2664.90	822.52	1842.38	15.8	30.9	2823.78	888.77	1935.01	31.5
1990	2937.10	992.42	1944.68	15.8	33.8	3083.59	1004.47	2079.12	32.6
1991	3149.48	938.25	2211.23	14.6	29.8	3386.62	1090.81	2295.81	32.2
1992	3483.37	979.51	2503.86	13.1	28.1	3742.20	1170.44	2571.76	31.3
1993	4348.95	957.51	3391.44	12.6	22.0	4642.30	1312.06	3330.24	28.3
1994	5218.10	2906.50	2311.60	11.2	55.7	5792.62	1754.43	4038.19	30.3
1995	6242.20	3256.62	2985.92	10.7	52.2	6823.72	1995.39	4828.33	29.2
1996	7407.99	3661.07	3746.92	10.9	49.4	7937.55	2151.27	5786.28	27.1
1997	8651.14	4226.92	4424.22	11.6	48.9	9233.56	2532.50	6701.06	27.4
1998	9875.95	4892.00	4983.95	12.4	49.5	10798.2	3125.60	7672.58	28.9

Source: *Statistical Year Book* (1999).

a. Revenue in the table does not include revenue from domestic and foreign borrowings, and expenditure does not include the payment of the principal and interest of domestic and foreign debts and the expenditure for capital construction using foreign loans.

process. When the tax reform was started, two provinces, Guandong and Fujian, had actually got the permission to keep the "fiscal contracting system" as before. The reasons for the failure of the tax reform in 1985 were two: first, the SOEs were generally dissatisfied with the income tax, managers of the SOEs prefer to accept the fixed profit remittance to the governments; and secondly, at that time, most SOEs were profitable, and the local governments could share the profits with the SOEs to develop local economy. It was the joint interest between the SOEs and local governments that deter the implement of the tax reform in 1985. China formally returned to the fiscal contracting system in 1987, which was continued until the end of 1993 when the second round of tax reform was implemented.

The period of 1987-93 was characterized by a variety of fiscal contracting experiments in China, it was in this period that the share of formal government budget revenue in the GDP declined consistently. In the last three years of the 1980's, that share was about 15% of GDP, and it was decreased to 12% (Table 1) in 1993. The share of revenue collected by the central

TABLE 2. DWINDLING SHARE OF SOES AND ITS CONTRIBUTION TO TAX REVENUE
(1985-1998, 100 million yuan RMB)

Year	Total tax revenue	Industrial and commercial taxes	Income tax of state-owned-enterprises (SOEs)	Subsidies to loss-making enterprises ^a	Net revenue contribution by the income tax of SOEs	Share of industrial and commercial taxes of SOEs in total industrial and commercial taxes	Share of value of SOEs in total industrial output (%)
						(%) ^b	
(1)	(2)	(3)	(4)	(5)	(6) = (4) + (5)	(7)	(8)
1985	2042.79	1097.47	595.84	-507.02	88.82		64.9
1986	2090.73	1202.19	595.40	-324.78	270.62		62.3
1987	2140.36	1282.47	563.20	-376.43	186.77		59.7
1988	2390.47	1485.72	570.93	-446.46	124.47		56.8
1989	2727.40	1760.49	583.59	-598.88	-15.29		56.1
1990	2821.86	1858.99	604.12	-578.88	25.24		54.6
1991	2990.17	1981.11	627.59	-510.24	117.35		56.2
1992	3296.91	2244.21	624.77	-444.94	179.83		51.5
1993	4255.30	3194.49	582.91	-411.29	171.62		47.0
1994	5126.88	3914.22	609.75	-366.22	243.53	63.7	37.3
1995	6038.04	4589.68	759.38	-327.77	431.61	60.9	34.0
1996	6909.82	5270.04	822.33	-337.40	484.93	58.6	28.5
1997	8234.04	6553.89	794.43	-368.49	425.94	56.5	25.5
1998	9262.80	7625.42	743.93	-333.49	410.44		28.5

Source: *Statistical Year Book* (1999).

a. Subsidies are treated as the negative revenue here.

b. This data comes from Liu, Zhong-Lee (1998).

government in the whole budget revenue decreased to 22% in the same year (Table 1). The worry of "losing control" had significantly affected the central government's decision-making, consequently, the new tax reform was introduced in 1994.

It is shown in Table 1 that the ratio of government budget revenue in GDP has been declining consistently during the last two decades. In the first decade (1978-1987), the driving force hidden behind the decline trend of the relative share of government revenue in GDP is the reform on the incentive mechanism for the state-owned-enterprises. According to the calculation by Liu Zhong-Lee (the former minister of finance of China) (1998), from 1979 to 1980, the government agreed to establish "remained profit fund", "bonus fund" and "welfare fund", in which about 21.5 billion yuan (RMB) of the profit of state-owned-enterprises were retained at the firms that accounts for about 5% of total GDP in that period. And, from 1981 to 1985, the total amount of profit or tax reduction permitted by the policy of "allowing return debt before taxes" is about 65 billion yuan (RMB), which accounts for 2% of GDP in the same period. And, from 1986 to 1988, the central government increased the depreciation rate for the SOEs which, accompanied by "returning debt before taxes" and other policies, resulted in a big cut in the revenue (the amount is about 139 billion yuan RMB). Thus, in total, the share of the revenue in GDP was reduced by more than 10 percent.

In contrast to that in the first decade, the fundamental reason for the declining size of the revenue in GDP in the second decade is that the basis of the traditional government budget

revenue was shrinking, i.e., the state-owned enterprises failed into very difficult situation. It is shown in Table 2 that the contribution of the income tax of state-owned enterprises, after netting of the “subsidies to loss-making enterprises”, was limited. In the middle of the 1980’s, the share of net income tax by SOEs in total tax revenue was about 8% or 9%, while at the end of the 1990’s, it declined to 4% or 5%. As more and more SOEs failed into money-loss-making situation, their contributions to the income tax became zero or negative.

Another problem is the “divergence” between the industrial structure and the structure of industrial and commercial taxes. As it is presented in column (7) and (8) of Table 2, in the later half of the 1990’s, the relative size of SOEs in total industrial output has shrunk to around 25%, while its contribution to total industrial and commercial tax revenue was still about 60%. Since the industrial and commercial taxes were the most important tax in China (it accounts for more than 80% of total tax revenue), and, since this tax was imposed on the value of output, if the tax rate were equal for all of the firms, then even if the relative size of SOEs in GDP shrank, the ratio of the tax revenue in GDP would not decline, because the government could get more from the faster growing non-state-owned economy.¹ The dwindling share of revenue in GDP means that the average tax rate on the non-state-owned enterprises must be below that on the SOEs.

There is a lot of evidence to support our argument. When it was imposed in 1984, the designed average rate of the industrial and commercial tax was 11% of total turn-over value, while the actual average rate was 10.3% in the same year. Under the new tax system since 1994, the actual average rate of the turn-over tax is about 7.3%. According to a sample investigation in 1995 (which cover 80,000 enterprises), the tax rate on the SOEs was 7.4%, while it was only 3.6% on collective firms, and 3.3% on private enterprises [Liu, Zhong-Lee (1998)]. With the combination of faster growing and large share of non-state economy in China and the lower tax rate on it, the SOEs, which is the tax revenue basis in the traditional system, is unable to keep a high ratio of government revenue in the GDP. In order to regain the higher ratio of both the fiscal revenue in the GDP and the ratio of the central government’s revenue in total fiscal revenue, the new round of tax reform was introduced in 1994.

III. *The Incentives of Local Governments in Fiscal Decentralization*

In the fiscal decentralization process, the local governments not only had the authority over local expenditures, more importantly, they are also offered some incentives to build up their local economies and the revenue bases. The basic incentive schemes consisted of three elements: the rate of the marginal revenue of the local government, the extra-budget revenue, and the off-budget fiscal sources (the fees).

1. **Marginal Revenue Rate of Local Governments**

There were various marginal revenue rates for different regions (provinces or cities), and even

¹ Let the share of the SOEs in GDP be x , and the share of non-state-owned economy be y ($=1-x$), and let the tax rate be t (if the t is equally for any industry firm), then change rate of the total industrial and commercial tax revenue would be $t(dx+dy)=0$, i.e., the ratio of tax revenue in GDP should not be changed.

if for the same region, the marginal revenue rate had been subjected to changes in the different periods. Table 3 presents a general review of these rates for all regions in China in 1993, which represents the incentive mechanism under the fiscal contracting system. There are five types of fiscal contracting system.

(1) *Fixed Rate of the Revenue Retained by Local Governments*. Under this contract, the local governments had actually achieved right to gain marginal revenue at a constant rate. There

TABLE 3. MARGINAL REVENUE RATES FOR LOCAL GOVERNMENTS (1993)

Provinces (cities)	Fixed rate of revenue remained by local government in the aggregate revenue (%)	Fixed rate for remained revenue and target of revenue growth		Fixed remittance up to the central government (100 million yuan RMB)	Fixed amount of remittance and its target of growth		Fixed subsidies (100 million yuan RMB)
		Fixed margial revenue rate (%) (1987 as base year)	Target of revenue growth (%)		Fixed amount of remittance (100 million yuan)	Target of growth (%)	
Shanxi	87.6						
Anhui	77.5						
Henan		80.0	5.0				
Hebei		70.0	4.5				
Beijing		50.0	4.0				
Harbin		45.0	5.0				
Jiangsu		41.0	5.0				
ningbo		27.9	5.3				
Shanghai				105.0			
Heilongjiang				3.0			
Shandong				2.0			
Guangdong					14.1	9.0	
Hunan					8.0	7.0	
Inner-mongolia							18.4
Xinjiang							15.3
Tibet							9.0
Guizhou							7.4
Yunnan							6.7
Qinghai							6.6
Guangxi							6.1
Ningxia							5.3
Hainan							1.4
Gansu							1.3
Shanxi							1.2
Jilin							1.1
Fujian							0.5
Jiangxi							0.5

Source: Jiakang (1999).

were only two provinces (Shanxi and Anhui) which were offered with this policy.

(2) *Fixed Rate for Retained Revenue and Target of Revenue Growth*. With this contract, the marginal revenue rates were constant too; but, the local government could share the total revenue only after she had fulfilled the pre-determined target for the revenue growth. The target rate of the growth varied between 4.5% and 5.3%.

(3) *Fixed Remittance up to the Central Government*. This is exactly a higher power incentive contract. After some amount of revenue was remitted to the central government, the local government could keep 100% of the rest revenue at its own control. Shanghai, Shandong and Guangdong (all on the east coast) were offered with this scheme.

(4) *Fixed Remittance with Target of Revenue Growth*. This is basically the same as category (3) except for the constraint of targeted revenue growth.

(5) *Fixed Subsidies*. This is the same as category (3) if we replace the remittance with subsidy. Hence, the local governments within this contract category actually got 100% rate of marginal revenue.

Therefore, in fact, under fiscal contracting system, there were 19 provinces (out of 30 provinces) in China had actually obtained the 100% rate of their marginal revenue, and 8 provinces or cities got relatively higher marginal revenue rates (normally above 50%).

2. Evolution of the Concept of “Extra-Budget” Revenue and Its Implications

The concept of “extra-budget revenue” is very subtle in China, because the change of its definition means some great change in the allocation of the fiscal source among different tiers of the governments. Since the most part of it were controlled by local governments, the control over the extra-budget revenue was another incentive for the local governments in China.

It could be seen from Table 4 that there were two downward slopes (in 1993 and in 1997) and a flat land (during 1989-90) in the profiles of extra-budget revenue of local governments. Actually, these three transformations represent some deep changes of policies, and correspondingly, some significant changes in the definition of the extra-budget revenue over the past twenty years in China.

The fast growth of the extra-budget revenue in the local governments occurred between 1979 and 1988, and this trend was weakened by the control of the central government in 1989 when the policies of the “fund of revenue adjustment” was adopted by the central government. The total amount of it was 9.1 billion yuan (RMB) in 1989, and this policy had been continuing until 1996.

The second growth of the extra-budget revenue was deterred in 1992 when a reform on the accounting system was introduced in China. According to this reform, the remained profit funds were excluded from the definition of the extra-budget revenue, which resulted in a big reduction in the total extra-budget revenue. From Table 4, it can be seen that there was a sharp decline in the profiles of the extra-budget revenues between 1992 and 1993. Now, the uses of remained profits by the SOEs are out of the control of the local governments. So, actually, the new definition of the extra-budget revenue implied a break in the connection between the local governments and the SOEs.

TABLE 4. CHANGES OF EXTRA-BUDGET REVENUE

(1978-1998, 10 million yuan RMB)

Year	Budget revenue	Whole Extra-budget revenue	Ratio of extra-budget revenue to budget revenue (%)	Extra-budget revenue of the Central government	Extra-budget revenue of local governments	Ratio of extra-budget revenue of local governments to the whole extra-budget revenue (%)
(1)	(2)	(3)	(4) = (3)/(2)	(5)	(6)	(7) = (6)/(3)
1978	1132.3					
1979	1146.4	452.9	39.5			
1980	1159.9	557.4	48.1			
1981	1175.8	601.1	51.1			
1982	1212.3	802.7	66.2	270.7	532.0	66.3
1983	1367.0	967.7	70.8	359.9	607.8	62.8
1984	1642.9	1188.5	72.2	470.5	717.9	60.4
1985	2004.8	1530.0	76.3	636.1	893.9	58.4
1986	2122.0	1737.3	81.9	716.6	1020.7	58.8
1987	2199.4	2028.8	92.2	828.0	1200.8	59.2
1988	2357.2	2360.8	100.2	907.2	1453.6	61.6
1989	2664.9	2658.8	99.8	1072.3	1586.6	59.7
1990	2937.1	2708.6	92.2	1073.3	1635.4	60.4
1991	3149.5	3243.3	103.0	1381.1	1862.2	57.4
1992	3483.4	3854.9	110.7	1707.7	2147.2	55.7
1993	4349.0	1432.5	33.0	245.9	1186.6	82.8
1994	5218.1	1862.5	35.7	283.3	1579.2	84.8
1995	6242.2	2406.5	38.6	317.6	2088.9	86.8
1996	7408.0	3893.3	52.6	947.6	2945.7	75.7
1997	8651.1	2826.0	32.7	145.1	2680.9	94.9

Source: *A Statistical Survey of China* (1999)

Despite this, the growth of the extra-budget revenue refreshed after 1994. And this period of growth was stopped in the July of 1996 when a document was issued by the state council to re-define the scope of extra-revenue. According to the new criteria, more than 13 items of administrative fee and tax-add such as the fee of road, the fund of electricity, and several other items of tax-add were shifted from the local governments' extra-budget revenue into that of budget revenue

It is very important to notice that the changes in the definition of the extra-revenue in 1992 and 1996 were different from the previous evolutions in two aspects. At first, the intention of the central government was not simply to draw some fiscal source from the local governments, it tried to rearrange the relationship between the local governments and economic agents, in particular, with the SOEs. Second, the implication of the new definition of the extra-budget revenue in 1996 was not to transfer fiscal source from the local to the central government. The key point emphasized by the new definition is to shift the off-budget revenue into the budget management, and this implicitly admitted some gains of the local governments under the decentralization.

3. Off-Budget Fiscal Sources of Local Governments and the Problem of "Fee"

Apart from the extra-budget revenue, there exist "off-budget" fiscal sources for the local governments. Overall, the off-budget fiscal revenues come from the following five sources.

(1) *Social Security Fund*.

(2) *Capital Collection by the Local Governments*.

(3) *Shifts of the Fiscal Sources within Budget Control to Outside Budget*. It is estimated by sample that the total amount of these illegal fiscal sources is about 30% of the entire amount of the extra-budget revenue [Jiakang (1999)].

(4) *Private Wealth Storage*. After 1992, many local governments established own companies or shadow firms indirectly controlled by them to collect fiscal sources to support the officials' consumption and other extra expenditures.

(5) *Various Forms of the Fee*. It is estimated that there were 421 forms of the "fee" in China in 1996, among these only 46 items were approved by the central government, while the rest 375 items were imposed by the local governments. And in the same year, the total amount of fees in China was 413 billions yuan (RMB) [Zhang (1999)], which was larger than the size of entire extra-budget revenue.

With the estimation of the fee in China, we could get a more correct estimation about the ratio of fiscal source to the GDP. Since, approximately, the size of the extra-budget revenue is more than half of the budget revenue, and that the size of the off-budget fiscal sources is larger than that of the extra-budget revenue, it is certainly that the ratio of the whole fiscal revenue to the GDP is much far above the ratio (12% in 1998) officially announced by the Chinese government. The actual ratio of this should be around 25%, which is not low if we compare this to that of other developing countries in Asia.

IV. The Tax Reform in 1994 and Its Impacts on the Decentralization

The main goals of the new tax system in 1994 were to raise both the ratio of fiscal revenue in GDP and the ratio of central government's revenue in total fiscal revenue. It is called as "re-centralized" process in China. This certainly affected the incentive mechanism for the local governments.

First, the marginal revenue rate for local governments has been changed. The rate of 100% is no longer valid over the overall tax revenues collected by the local government. Certainly, the local governments could get 100% of the local taxes, the marginal revenue rates over these taxes are the same as before. But, on the other hand, the marginal revenue rate for the local governments to share the main tax—value add tax—is significantly reduced from the rate of 80% or above in the fiscal contract system to the rate of 25% currently. In addition, if the central government's revenue from VAT and consumption tax in a particular province increase above the level of 1993, then they return 30% of this increase to the province concerned. In other words, the marginal rate of VAT and consumption tax for local government is:

$0.3 \times [0.75 \times (\text{VAT increase}) + (\text{CT increase})] + 0.25$ if VAT and CT exceeds the 1993 level
0.25 otherwise.

Apparently, this arrangement would reduce the incentive of the local governments to coordinate with the central government to increase the VAT and CT. They will pay more attention to the local tax, and, this in turn will result in the fact that the growth rate of local taxes is higher than that of VAT and CT. Over the 1994-1998 period, the share of VAT in total tax revenue has slipped from 43 to 37 percent, while the consumption tax has slipped from 9.1 to 8.4 percent.² In contrast, the business tax, mostly a local tax, has risen from 12.6 to 16.2 percent of tax revenue.

Secondly, there were some misleading effects of the tax reform on the revenue share process. In August 1993, the central government announced, that 1993 would be used as the base year for the tax share. That is, in general, the actual revenue of the local governments is regarded as the base, the central government should return a lump-sum grant to the local government to make sure that the local revenue will at least be as large as that in 1993. The central government committed to making a transfer to each province of:

$$\text{TRANSFER} = \text{PRB} - \text{LT} - 0.25 \times \text{VAT}$$

where PBR is the province's base retained revenue and LT is the province's local tax revenue in 1993. In other words, for 1994, the base revenue of each province was taken to be its level of retained revenue in 1993, plus its share of VAT and the grants from the central government. The PRB is actually the local governments' revenue level in 1993, and this revenue level included comprehensive taxes collected by the local governments up to 1993 and on the other hand, from 1994 on, the local governments are only eligible to collect the local taxes and to share the VAT with the central government; and thus, there exists a huge gap between the PRB and the $(\text{LT} + 0.25 \times \text{VAT})$. The TRANSFER is the central government's commitment to ensure the local governments to keep at least the same revenue level as that in 1993. But, the size of the TRANSFER relies on the difference between the PRB(1993) and the $(\text{LT}(1994) + \text{the share of VAT}(1994))$: the greater is the PRB(1993), the greater would the TRANSFER be in the future. And, it should be noticed that the PRB(1993) was based on the "fiscal contracting system", it is an increasing function of the actual tax level collected by the local governments in 1993. This led to a surge in tax collection during the last four months of the year. As Table 5 shows, the growth of local revenue was incredible in 1993. It could be seen in Table 5 that, in Jiangsu, Fujing, Shangdong, Guangxi, Hainan, and Yunnan, the local tax revenue in 1993 grew at the rate of 50% or more. And, overall in 1993, the turnover tax revenue of that year is 49.6% higher than in 1992.

Thirdly, under the new fiscal arrangement in 1994, the connection between the local government and economic agents like the SOEs has been changed greatly. With more and more money loss in the SOEs supervised by the local government, it is natural for the local governments to throw out this burden if the SOEs are no longer the source of fiscal revenue for them. The new fiscal arrangements in 1994, which shifted the power of collecting the VAT to the central government, encouraged the local government to separate from the SOEs. In many provinces or cities, the local governments actively involve in the process of selling out the SOEs. As a result, the number of SOEs has been reduced recently. It is reported that, during

² Ministry of Finance: *China Fiscal Yearbooks*, 1995 and 1999.

TABLE 5. BUDGET REVENUE OF LOCAL GOVERNMENTS

(unit: 100 million yun)

Provinces	Year of 1992	1993	1994	1995	1996	1997	1998
Beijing							262.0
Taijing							
Hebei	101.2	144.2	95.2	120.0	151.8	176.1	206.8
Shanxi	58.0	72.4	53.8	72.2	84.2	92.8	104.2
Inner-mongolia	39.1	56.1	68.2	76.3	93.2	111.3	131.2
Liaoning	252.4	316.5	400.0	453.6	520.8	580.8	647.4
Jilin							
Heilongjiang	84.6	108.1	8.6	101.3	126.9	150.6	179.3
Shanghai				702.5	874.0	1070.95	1146.0
Jiangsu	153.9	227.2	135.8	167.0	213.0	248.4	275.6
Zhejiang	118.4	166.6	209.4	248.5	291.8	340.5	401.8
Anhui				147.0		230.8	262.1
Fujian	75.4	110.6	149.7	184.6	215.1	251.3	281.4
Jiangxi	49.4	65.7	88.7	105.2	123.6	134.9	145.7
Shangdong	139.3	194.3	134.7	179.0	241.7	304.4	352.4
Henan	104.03	139.2	93.3	124.6	162.1	192.6	208.2
Hubei	94.1	115.1	77.5	99.7	124.5	139.9	169.0
Hunan	92.8	127.6	85.9	108.2	130.4	137.2	156.8
Guangdong			298.7	382.3		543.95	640.8
Guangxi	61.2	96.0	62.3	79.4	90.5	99.2	119.7
Hainan	15.0	29.1	27.5	28.5	30.7	31.6	36.5
Chongqing							
Sichuan			99.4	121.1	154.1	172.9	197.3
Guizhou							
Yunnan	109.3	204.9	67.6	98.3	130.0	150.4	168.2
Tibet	15.6	18.7	30.2	37.6	33.7	37.0	43.7
Shaanxi	51.0	62.9	83.3	95.2	117.2	140.0	156.9
Gansu							
Qinghai	18.0	21.5	24.2	27.7	31.4	35.3	45.8
Ningxia	7.7	10.9	7.2	9.0	12.7	14.1	17.8
Xingjiang						135.3	148.5

Source: *Statistical Year Books* (various provinces 1999)

1997-98, the total number of the industrial SOEs had been reduced from 110000 to 64700 [China Statistical Year Book (1999), pp.421].

Fourthly, with fiscal re-centralization, the fiscal situations of the local governments become difficult. With more and more pressure of social security expenditure, and the spending for infrastructures, and with inter-provincial migration, the local governments are faced with higher pressure of deficit. In 1998, almost all of the local government's deficits were compensated by the inter-governmental grant from the central government.

Last effect of the new tax reform is the fact that, with the shortage of fiscal source, the only avenue open to local governments is to develop extra-budgetary and off-budgetary

resource. Thus, the local governments were more dependent on the extra-budget revenue.

V. Conclusions

This paper discussed the process of fiscal decentralization in China during the past twenty years. In the fiscal contract system, the local governments were offered with a very high power of incentives to keep fiscal revenue for local development. The relationship between the local governments and the enterprises during that system was not a pure one of public finance, whereas it more like an agent relations to stand together to bargain with the central government. The falling share of the central government's revenue in the GDP in China happened for different reasons in different periods. In the first decade of the economic reform, the falling trend was closely related with the provision of the incentive for both the SOEs and the local government, whereas at the second stage of the reform, with the serious problem of loss making in the SOEs, the dwindling share of the central government in the GDP came from the dependence of government revenue on the SOEs. The evolution of the concept of the "extra-budget" implies some secret for the reallocation of the fiscal sources between the central and the local governments in China. If we put this together with the "off-budget" revenue, then it could be seen that the local governments still control about 70% of the whole fiscal source at the present. In order to re-centralize the fiscal resources, the new tax system was introduced in 1994, and the incentives in the fiscal contract system have been changed by this reform since; hence, the power of the incentive for the local governments has been lowered.

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