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THE FISCAL SYSTEM

This chapter examines the efficiency and effectiveness of the fiscal system of the PRC, identifying areas that need strengthening to provide better support for the economic development of the Western Region. This analysis provides a basis for new policy directions in terms of changes in the tax system, government expenditure, bond financing, and government transfer payments.

Fiscal system

INSTITUTIONAL FEATURES

After the adoption of the open-up and reform policy in 1978, the Government shifted the focus of its investment to the Eastern Region, leading to an imbalance of economic development between the regions. During the Fifth FYP (1976–1980), government investment (within budget) in capital construction in the Eastern Region accounted for 42.2 percent of the total for the whole country, compared with 54.2 percent during the Eighth FYP (1990–1995). Between 1990 and 1995, the investment share of the Central and Western regions dropped from 50.0 percent to 38.2 percent, the Western Region alone suffering a drop from 19.9 percent to 14.7 percent. Recently, the trend has reversed, with the Central and Western regions receiving a record 63.2 percent of inward investment; the Western Region alone received 32.6 percent in 2000, the year the Western Development Strategy was adopted (Table 1-1).

Because of a lack of financial resources, the Western Region suffers from serious deficiencies in all public services: education, science and technology, social assistance, transport infrastructure, public utilities, soil and water conservation, biodiversity conservation, and environmental protection.

The fiscal system dates from the reform of tax assignment in 1994, which clarified the duties and responsibilities of local governments and the Central Government in relation to the financial system, and introduced a level-to-level framework for the fiscal system.¹ As far as the Western Region is concerned, the fiscal system is of greater significance than the financial system, as it provides large transfer payments and special subsidies.

The following are some important features of the system:

- The Finance departments of the Central Government and local governments receive revenues separately on the basis of tax

categories rather than the levels of administrative jurisdiction. All enterprises, large or small, higher or lower in the bureaucratic hierarchy, will be increasingly free from governmental interference, be able to compete on an equal footing, and remit their taxes to the Central or local governments according to the tax law.

- The Central Government and local governments will mainly employ measures such as taxes, bonds, and preferential tax treatment to adjust the business environment for enterprises.
- In terms of expenditure, the Central Government and local governments are responsible for determining the scope and magnitude of public services, subject to the approval of the People's Congress at the relevant level. The Central Government pays for key construction items that are usually large-scale, long-term, and interregional. Local governments finance infrastructure, public utilities, education, health services, and so on at the local level.
- The Central Government also takes responsibility for adjusting the differences between regions mainly by providing local governments with subsidies through transfer payments. The traditional "base number method" will be replaced by the "factor scoring" method, which is more transparent and objective in that it determines the subsidies according to scores.
- The finances of the Central Government and the local governments should be separate from each other. They should have separate budgets in the pursuit of independence and balance.

TAX REVENUE ASSIGNMENT

Under the tax revenue sharing system, the scope of expenditures of governments at different levels should match their respective responsibilities. The Central Government is mainly responsible for expenditure relating to defense, foreign affairs, and the operation of Central Government agencies, as

Table 2-1 Tax Revenue Assignment in the PRC after 1994

Level	Tax	Central Share (%)	Local Share (%)
Central taxes	Domestic excises	100	0
	Customs duties	100	0
	VAT and excises on imports	100	0
Local taxes	Personal income tax ^a	0	100
	City and township land use tax	0	100
	Farmland occupation tax	0	100
	Fixed assets investment orientation tax	0	100
	Land appreciation tax	0	100
	House property tax	0	100
	Urban real estate tax	0	100
	Vehicle and vessel use tax	0	100
	Vehicle and vessel license plate tax	0	100
	Deed tax	0	100
	Slaughter tax	0	100
	Banquet tax	0	100
	Agricultural and animal husbandry taxes	0	100
Shared taxes	Domestic VAT	75	25
	Business tax paid by railroads and headquarters of banks and insurance companies, and 3 resource tax	100	0
	Other business tax	0	100
	Enterprise income tax paid by railroads and headquarters of financial institutions and insurance companies under the Central Government	100	0
	Other enterprise income tax	0	100
	Income tax on foreign and foreign-funded banks	100	0
	Income tax on foreign and foreign funded non-bank financial institutions	0	100
	Resource tax paid by offshore oil companies	100	0
	Other resource tax	0	100
	City maintenance and construction tax paid by railroads and headquarters of banks and insurance companies	100	0
	Other city maintenance and construction tax	0	100
	Security tax collected on stock transactions	88	12
	Other security tax	0	100

Source: Compiled from various laws and regulations on tax revenue assignment.

^a Interest payment from banks and other financial intermediates is assigned to central tax.

well as expenditure for economic restructuring, development coordination among regions, and macroeconomic adjustment. In contrast to other large countries, the PRC has few Central Government activities in the regions. Local governments are mainly responsible for running the government agencies under their respective jurisdictions, as well as spending for economic and social development in their regions.

In accordance with the principle of matching responsibilities with revenues, taxes are divided into Central Government taxes (central taxes), local government taxes, and taxes shared between the Central and local governments. Central taxes relate

to national interests and macroeconomic regulation, and shared taxes to economic development, while local taxes are those that are most suitable for collection by local governments. State tax agencies and local tax agencies are established separately. State taxes and shared taxes are collected by the State tax agencies. Local taxes are collected by the local tax agencies. The Central Government returns part of its tax revenues to local governments on the basis of the growth of local government value-added tax (VAT) and consumption tax. The Central Government provides assistance in the form of fiscal transfers to the least developed regions and ethnic regions (Table 2-1).

GOVERNMENT EXPENDITURE ASSIGNMENT PROCEDURE

Under the Budget Law of 1994, five levels of government prepare budgets: the Central Government, local governments directly under the Central Government, cities divided into districts and autonomous prefectures, counties and cities not divided into districts, and, at the lowest level, municipal districts, townships, and towns (Figure 2-1). The central budget consists of the budgets of the different departments of the Government, and the local budget consists of the general budgets of the local governments directly under the Central Government. The budget year corresponds with the calendar year, starting on 1 January and closing on 31 December. As stipulated in the Budget Law:

Article 12 The National People's Congress examines the central and local draft budgets and the reports on the implementation of the

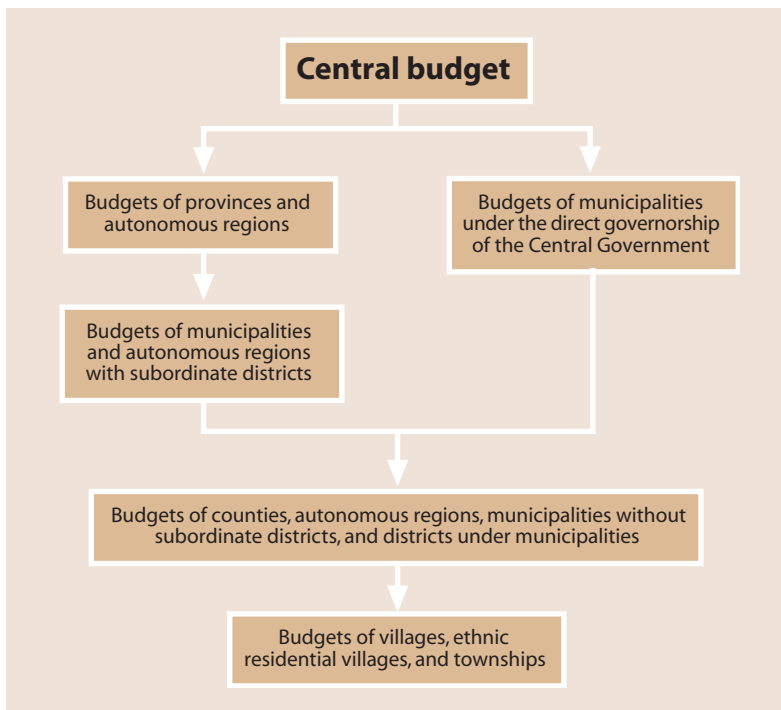
central and local budget, approves the central budget and the report on the implementation of the central budget and alters or annuls inappropriate resolutions made by the Standing Committee of the National People's Congress on budget and final accounts....

Article 13 A local people's congress at or above the county level examines the draft general budget at the corresponding level and the report on the implementation of the general budget, approves the budget and the report on its implementation at the corresponding level, alters or annuls inappropriate resolutions made by the standing committee of the people's congress at the corresponding level on budget or final accounts and annuls inappropriate decisions and orders made by the government at the corresponding level on budget or final accounts....

The people's congress of a township, nationality township or town which has an established budget examines and approves the budget at the corresponding level and the report on the implementation of the budget at the corresponding level and the report on the implementation of the budget at the corresponding level, supervises the implementation of the budget at the corresponding level, examines and approves the adjustment plan for the budget at the corresponding level, examines and approves the final accounts at the corresponding level, and annuls inappropriate decisions and orders made by the government at the corresponding level on budget or final accounts.

The Ministry of Finance and local government finance bureaus prepare the central budget and local budgets, respectively, as well as the final accounts. They are also responsible for the implementation and preparation of budget adjustment plans. Central and local budgets follow the double-entry format.

Figure 2-1 Central and Local Government Budget Scheme



Source: Ministry of Finance website.

TRANSFER PAYMENT

There are three types of intergovernment transfer payment:

- Vertical transfer payments from the Central Government to provincial governments
- Horizontal transfer payments from developed regions to underdeveloped regions
- Poverty-reduction transfer payments from the Central Government to poverty counties

Vertical transfer payment, the major component, includes five channels: tax returns, institutional subsidy (price subsidy), transitional transfer payment, special project subsidy, and end-of-balance subsidy.

Tax returns

Tax returns have the highest volume. The rule is as follows: using 1993 as the base year, for every 1 percent increase in the VAT and excise tax generated by business entities in a particular province or autonomous region, the Central Government increases the tax returns to those provincial governments by 0.3 percent. Although this incentive-based transfer payment does provide an incentive mechanism for provincial governments to attract investment into their respective regions, it places the Western Region, with its slower economic growth and therefore also slower VAT growth rate, at a substantial disadvantage and thus worsens the imbalance between regions.

Institutional subsidy (price subsidy)

Institutional subsidy (price subsidy) refers to the expenditure appropriations from the government budget for price subsidies. These subsidies include those making up the difference between the government sale and purchase prices of grains, cotton, and edible oils, as well as subsidies on the prices of meat, meat products, vegetables, textbooks, newsprint, and periodicals. In 2000, the total subsidy amounted to 104,228 million yuan.

Transitional transfer payment

Transitional transfer payment (TTP) is designed to balance regional disparities. The rule is as follows:

$$TTP = ([\text{standard expenditure} - \text{standard revenue}] \times \text{objective TP parameter} + \text{policy TP amount}) (1 + \text{incentive factor parameter})^2$$

The formula has three parts: an objective factor, which attempts to measure the gap between standard expenditures and local fiscal capacity; a factor for subsidies to regions with large ethnic minority populations and other political considerations; and a factor to reward the provinces for good tax effort. Tax effort is measured as provincial tax collection relative to the national average. Generally, the transfers that a province can expect to receive in a year would be based on its fiscal gap and tax efforts in the previous year.

In principle, this formula is well designed. The problem lies in the measure of “standard” expenditure and revenue. The normal practice is to use the previous year’s figure as the proxy for measuring the standard figure. This actually provides an incentive for local governments to overspend any revenue so as to qualify for a larger transfer payment in future years.

Accordingly, the Western Region received the largest proportion of TTPs owing to its lower capability in collecting revenue. Guizhou, Qinghai, Xinjiang, and Inner Mongolia obtained the most TTP in 1995–1998 (Table 2-2). However, TTP accounted for only less than 2 percent of total subsidies from the Central Government to local governments (Table 2-3); thus, its redistribution function is limited.

Special project subsidy

Special subsidy is mainly applied to special projects, or is extended to rectify industry-specific policies and correct market failure (Chapter 10). Examples are financial and in-kind subsidies for natural disasters, and policy adjustment compensation.

End-of-balance subsidy

The end-of-balance subsidy is a subsidy from the Central Government to local governments to balance deficits at the end of the financial year.

Table 2-2 Transitional Transfer Payments from the Central Government to the Western Region, 1995–1998

	1995		1996		1997		1998	
	Amount (million yuan)	%	Amount (million yuan)	%	Amount (million yuan)	%	Amount (million yuan)	%
PRC	2,071		3,465		5,021		6,064	
Western Region	1,212	58.5	2,364	68.2	2,678	53.3	3,839	63.3
Chongqing		0.0		0.0		0.0	76	2.0
Sichuan	181	14.9	295	12.5	363	13.6	381	9.9
Guizhou	12	1.0	369	15.6	426	15.9	558	14.5
Yunnan	12	1.0	20	0.9	20	0.8	24	0.6
Tibet	55	4.5	100	4.2	177	6.6	210	5.5
Shaanxi	71	5.9	162	6.9	245	9.2	272	7.1
Gansu	71	5.9	132	5.6	206	7.7	229	6.0
Qinghai	104	8.6	191	8.1	294	11.0	397	10.3
Ningxia	104	8.6	159	6.7	193	7.2	221	5.8
Xinjiang	246	20.3	381	16.1	5	0.2	597	15.6
Inner Mongolia	247	20.4	371	15.7	497	18.6	576	15.0
Guangxi	109	9.0	184	7.8	252	9.4	298	7.8

Source: Lou (2000).

Table 2-3 Scale of TTP and Vertical Transfer Payments, 1995–1998

Year	1995	1996	1997	1998
Transitional transfer payments (million yuan)	2,071	3,465	5,021	6,064
Total subsidies from the Central Government to local government (million yuan)	253,406	272,252	285,667	332,154
Ratio of TTP to total vertical transfer payments (%)	0.8	1.3	1.8	1.8

Source: Lou (2000); *China Fiscal Yearbook 2000*.

GOVERNMENT BOND FINANCING

Article 27 of the Budget Law of 1994 permits the Central Government to raise the sums needed for construction investment through domestic and foreign debt. However, Article 28 prescribes that no local government should issue bonds on its own unless there is legal permission or permission is granted by the State Commission. In other words, under usual circumstances, only the Central Government has the right to issue bonds.

To overcome the negative effects of the Asian financial crisis of 1997 on the PRC's exports, the Government adopted an expansionary fiscal policy by issuing more government bonds. The total construction government bonds issued amounted to 100,000 million yuan in 1998, 110,000 million yuan in 1999, and 150,000 million yuan in 2000, and 32 percent of the proceeds were invested in the Western Region. The Government arranged complementary finance of 750,000 million yuan

from local governments, SOEs, and bank loans for investments in several mega projects in infrastructure construction and environmental protection. The Western Region enjoyed favorable treatment. In the first 11 months of 2000, infrastructure investment grew by 18.5 percent in the Western Region, 14.6 percent in the Central Region, and 5.7 percent in the Eastern Region.

The Government plans to issue 150,000 million yuan worth of long-term construction bonds to commercial banks in 2001. Except for several new projects in the Western Region, most of the additional public debt will be applied to projects already under construction. The Government also plans to issue public debt of 50,000 million yuan for the implementation of the Western Region Development Strategy. Projects include, among others, the transfer of gas and electricity from west to east, the transfer of water from south to north, the building of the Qinghai-Tibet railway, and the conservation of ecosystems. While it seems technically and financially feasible to use government bonds to finance these projects, the means of assessing the costs, benefits, social impacts, particularly in minorities, environmental impacts, and risks are unclear and therefore cause for concern.

Major challenges facing the public finance system

The major challenges facing the public finance system are:

- Insufficiency of public finance to meet all the infrastructure, education, health, and ecological protection needs; private sector participation (Chapter 1) is called for
- Effective division of responsibility between the Central Government and the local governments in the provision of public goods
- Prevention of regional protectionism
- Fair and effective rules in guiding government transfer payments to achieve social objectives like poverty alleviation and pollution abatement
- Cautious government bond financing to complement government budgetary financing and implement macroeconomic management

BUDGET DEFICIT AND FISCAL VULNERABILITY

The debt burden of the Government is likely to grow in the short to medium term. The government deficit is 2.82 percent of GDP, which is well below internationally accepted levels (Table 2-4). However, if deficit spending of SOEs (the government-mandated bank loans that partially substitute for a loss in subsidies disbursed through the budget) were taken into account (a debatable approach), what would be the effective budget deficit as a proportion of GDP? For 1990–1991, Wong et al. (1995) estimate a consolidated budget deficit of about 8 percent of GDP including subsidies.³

There was a sharp increase in debt ratio from 12.8 percent in 1990 to 32.5 percent in 1999. Accordingly, the principal and interest payment ratio has also increased from 6.5 percent in 1990 to around 20 percent in recent years (Table 2-5). The Government could find it difficult to meet its debt obligations if revenue growth were to decline sharply. Therefore, the Government may not be able to transfer as much to provincial governments.

In contrast, the PRC is rather cautious in issuing foreign debt. In most years from 1994 to 2000, the debt service ratio stayed below 10 percent, liability ratio was around 15 percent, and foreign debt ratio was below 70 percent (Table 2-6). This may be one reason why the PRC was insulated from the Asian

Table 2-4 Government Budget Deficit, 1990–2000

Year	Total Revenue (million yuan)	Total Expenditure (million yuan)	Balance (million yuan)	GDP (million yuan)	Budget Deficit/ GDP (%)
1990	293,710	308,359	-14,649	1,859,840	-0.79
1991	314,948	338,662	-23,714	2,166,250	-1.09
1992	348,337	374,220	-25,883	2,665,190	-0.97
1993	434,895	464,230	-29,335	3,456,050	-0.85
1994	521,810	579,262	-57,452	4,667,000	-1.23
1995	624,220	682,372	-58,152	5,749,490	-1.01
1996	740,799	793,755	-52,956	6,685,050	-0.79
1997	865,114	923,356	-58,242	7,314,270	-0.80
1998	987,595	1,079,818	-92,223	7,696,710	-1.20
1999	1,144,408	1,318,767	-174,359	8,057,940	-2.16
2000	1,339,523	1,588,650	-249,127	8,818,960	-2.82

Source: China Statistical Yearbook 2001.

Table 2-5 Government Debt Issuance and Payment, 1990–2000

Year	(1) Total Debt Issues (million yuan)	(2) Total Payment of Principal and Interest on Debts (million yuan)	(3) Total Fiscal Revenues (million yuan)	(4) (1)/(3) (%)	(5) (2)/(3) (%)
1990	37,545	19,007	293,710	12.8	6.5
1991	46,140	24,680	314,948	14.7	7.8
1992	66,968	43,857	348,337	19.2	12.6
1993	73,922	33,622	434,895	17.0	7.7
1994	117,525	49,936	521,810	22.5	9.6
1995	154,976	88,296	624,220	24.8	14.2
1996	196,728	135,503	740,799	26.6	18.3
1997	247,682	191,837	865,114	28.6	22.2
1998	331,093	235,292	987,595	33.5	23.8
1999	371,503	191,053	1,144,408	32.5	16.7
2000	418,010	157,982	1,339,523	31.2	11.8

Source: China Statistical Yearbook 2001.

financial crisis of 1997 and the global economic slowdown in 2000/2001. The risk of default on the Government's debts depends on many subjective and objective factors, but the risk is generally perceived to be low.

However, recent tax reforms to reduce agricultural taxes and fees by 26 percent to 30 percent will have a significant adverse impact on government revenue if they are implemented nationwide. Since expenditure is not likely to be reduced in the short to

Table 2-6 Foreign Debt and Risk Factors, 1994–2000

Year	Total Payment of Principal and Interest on Debts ^a (\$ million)	Accumulated Foreign Debt (\$ million)	Debt Service Ratio ^b (%)	Liability Ratio ^c (%)	Foreign Debt Ratio ^d (%)
1994	1,299.0	92,806	9.1	17.1	78.0
1995	869.0	106,590	7.6	15.2	72.4
1996	736.5	116,275	6.0	14.2	67.7
1997	857.7	130,960	7.3	14.5	63.2
1998	928.5	146,043	10.9	15.2	70.4
1999	1,102.9	151,830	11.3	15.3	69.5
2000	n.a.	145,730	9.3	13.5	52.1

Source: *China Statistical Yearbook 2000 and 2001; China Fiscal Yearbook 2000.*

^a Estimated using the exchange rate of \$1=8.25 yuan.

^b Ratio of the payment of principal and interest on foreign debt to the foreign exchange receipts from foreign trade and nontrade services for the current year.

^c Ratio of the balance of foreign debt to the gross national product for the current year.

^d Ratio of the balance of foreign debt to the foreign exchange receipts from foreign trade and nontrade services for the current year.

medium term, the fiscal outlook for the PRC is a concern. A significant increase in tax revenues in 1999 indicated that there may be loopholes in tax collection, especially in the collection of VAT, customs taxes, and personal income tax.

There are potential factors, such as worker layoffs due to SOE reforms, vocational education and training for the unemployed, an aging population, that will

place additional upward pressure on government expenditure. For example, as the population ages there will be higher expenditure on pensions and health. This would put pressure on the Government's fiscal position if there were a sharp decline in the growth of revenues or a slowdown in economic growth.

EXTRABUDGETARY REVENUES AND EXPENDITURES

Extrabudgetary revenue in the form of fees and charges and other miscellaneous items, and extrabudgetary expenditure in the form of special subsidies to local governments, are significantly higher than in advanced countries. In 1996–1998, extrabudgetary revenue accounted for 50 percent of budgetary revenues and extrabudgetary expenditure accounted for 45 percent of budgetary expenditure (Table 2-7), significantly higher than the corresponding figures of 7.0 percent in Australia, 6.9 percent in the US, and 5.5 percent in the UK.⁴

Most provinces and autonomous regions in the Western Region have even higher extrabudgetary revenue (Table 2-8).

In 1998, Guangxi and Sichuan had the highest ratio of extrabudgetary to budgetary revenue of about 80 percent. Extrabudgetary expenditure in the Western

Table 2-7 Government Extrabudgetary Revenue and Expenditure, 1996–2000

Year	Revenue			Expenditure		
	Budgetary (million yuan)	Extrabudgetary (million yuan)	Ratio of Extrabudgetary to Budgetary (%)	Budgetary (million yuan)	Extrabudgetary (million yuan)	Ratio of Extrabudgetary to Budgetary (%)
1996	740,800	389,330	52.6%	793,760	383,830	48.4%
1997	865,110	282,600	32.7%	923,360	268,550	29.1%
	(758,740)*	(388,900)*	(51.3%)	(818,760)*	(373,150)*	(45.6%)
1998	987,600	308,230	31.2%	1,079,810	291,830	27.0%
	(873,250)*	(422,580)*	(48.4%)	(966,120)*	(405,590)*	(42.0%)
1999	1,144,410	338,520	31.2%	1,318,770	313,94	23.8%
	(n.a.)	(n.a.)		(n.a.)	(n.a.)	
2000	1,339,520	n.a.		1,588,650	n.a.	
	(n.a.)			(n.a.)		

Source: *China Statistical Yearbook 2001; Lou (2000).*

* From 1997 onward, the extrabudgetary expenditures do not include the intrabudgetary government fund (fee). To maintain the comparability of figures for 1997 and 1998, the government fund figures were deducted from budgetary revenue and expenditure and added to extrabudgetary revenue and expenditure. The results are shown in parentheses.

Table 2-8 Budgetary and Extrabudgetary Revenue in the Western Region, 1996–1998

Region	1996			1997			1998		
	Budgetary Revenue (million yuan)	Extra-budgetary Revenue (million yuan)	Ratio of Extra-budgetary to Budgetary (%)	Budgetary Revenue (million yuan)	Extra-budgetary Revenue (million yuan)	Ratio of Extra-budgetary to Budgetary (%)	Budgetary Revenue (million yuan)	Extra-budgetary Revenue (million yuan)	Ratio of Extra-budgetary to Budgetary (%)
Southwest									
Chongqing				5,930	6,946	117.1	7,113	5,422	76.2
Sichuan	20,901	20,790	99.5	17,290	18,279	105.7	19,729	15,910	80.6
Guizhou	4,946	3,837	77.6	5,588	4,587	82.1	6,534	3,486	53.4
Yunnan	13,001	5,831	44.9	15,042	8,689	57.8	16,823	6,568	39.0
Tibet	244	178	73.0	300	280	93.3	364	156	42.9
Guangxi	9,051	9,304	102.8	9,915	10,213	103.0	11,967	9,829	82.1
Northwest									
Shaanxi	6,760	4,033	59.7	7,655	6,186	80.8	9,333	4,518	48.4
Gansu	4,337	3,174	73.2	4,691	3,739	79.7	5,403	2,718	50.3
Qinghai	958	636	66.4	1,092	760	69.6	1,277	480	37.6
Ningxia	1,268	853	67.3	1,407	1,103	78.4	1,775	844	47.6
Xinjiang	4,831	4,622	95.7	5,452	4,801	88.1	6,539	4,344	66.4
Inner Mongolia	5,726	3,753	65.5	6,608	5,053	76.5	7,767	2,880	37.1

Source: Lou (2000); *Finance Yearbook of China 2000*

Table 2-9 Budgetary and Extrabudgetary Expenditure in the Western Region, 1996–1998

Region	1996			1997			1998		
	Budgetary Expenditure (million yuan)	Extra-budgetary Expenditure (million yuan)	Ratio of Extra-budgetary to Budgetary (%)	Budgetary Expenditure (million yuan)	Extra-budgetary Expenditure (million yuan)	Ratio of Extra-budgetary to Budgetary (%)	Budgetary Expenditure (million yuan)	Extra-budgetary Expenditure (million yuan)	Ratio of Extra-budgetary to Budgetary (%)
Southwest									
Chongqing				101,010	67,420	66.8	125,760	51,470	40.9
Sichuan	326,730	192,390	58.9	275,100	164,500	59.8	320,930	151,920	47.3
Guizhou	99,580	35,900	36.1	111,830	43,260	38.7	133,090	33,700	25.3
Yunnan	270,390	60,850	22.5	313,200	87,480	27.9	328,000	60,680	18.5
Tibet	36,850	1,590	4.3	38,210	2,440	6.4	45,320	980	2.2
Northwest									
Shaanxi	121,790	38,940	32.0	137,720	58,640	42.6	166,200	42,530	25.6
Gansu	90,950	30,550	33.6	104,300	36,130	34.6	125,340	27,410	21.9
Qinghai	32,710	6,350	19.4	36,470	8,280	22.7	44,000	4,300	9.8
Ningxia	29,520	8,680	29.4	33,630	11,040	32.8	45,120	7,380	16.4
Xinjiang	114,890	47,470	41.3	123,350	42,240	34.2	145,990	41,380	28.3
Inner Mongolia	126,380	36,300	28.7	142,910	49,120	34.4	170,310	26,950	15.8
Guangxi	157,010	87,430	55.7	170,840	99,250	58.1	198,360	92,730	46.8

Source: Lou (2000); *Finance Yearbook of China 2000*

Region is on a par with the national average (Table 2-9).

The high ratio of extrabudgetary to budgetary revenue and expenditure indicates a lack of discipline and therefore increases the vulnerability of the fiscal system in several ways.

- Since the local governments have discretionary power to collect fees and charges from

economic entities with weaker bargaining power, SMEs and agriculture will suffer the most from the excess burden. This will increase the production cost and therefore the competitive disadvantage of the private sector, which is dominated by SMEs and agriculture farmers.

- The discretionary nature of fees and charges will also increase the uncertainty in doing business

and therefore reduce the incentive for long-term investment.

- Extrabudgetary revenue and expenditure reduce the capability of the Central Government to implement macroeconomic fiscal policy.
- This loophole will also leave room for corruption and other rent-seeking behavior.
- Because of lack of discipline and transparency, extrabudgetary expenditure is lower in efficiency than normal budgetary fiscal expenditure.

DECLINING SHARE OF INVESTMENT OF THE CENTRAL GOVERNMENT

In the last decade, the Central Government's share of investment in fixed assets and capital construction was much lower than the average in the 1980s. Even in 1999 and 2000, when the Government implemented an expansionary fiscal policy, the percentage of state budgetary appropriations in fixed assets was only 6.2 percent and 6.4 percent, respectively, well below the 13.6 percent figure in the 1980s (Table 2-10).

The Central Government contributed more in capital construction. The Western Region as a whole enjoyed favorable treatment in 2000. State budgetary appropriations for investment in capital construction were 1.9 percent higher than the national average, at 14.5 percent of total budgetary appropriations. However, there were wide variations within the Western Region, with appropriations for capital

investment in Tibet accounting for over 63.5 percent of total budgetary appropriations while those in Sichuan were the lowest at 6.7 percent (Table 2-11).

Therefore, government finance has become less important in investment in the last decade, but the Western Region still relies more on public finance than other regions in the PRC.

That said, in 1999 and 2000 the absolute volume of public-financed investment was increasing and the growth rate was even higher than the GDP growth rate. This was mainly due to the improved fiscal discipline that increased tax revenues and the expansionary fiscal policy that aimed to increase domestic aggregate demand in recent years. The decline in the ratio of public-financed investment is largely attributable to the increase in private investment. This trend is likely to continue in the Tenth FYP.

PUBLIC FINANCE GAPS IN THE DEVELOPMENT OF THE WESTERN REGION

State budgetary financing and government bond financing are unlikely to be sufficient to support the proposed infrastructure investment and environmental protection projects in the Western Region.

In the Tenth FYP, the proposed railway projects amount to 100,000 million yuan. Building State-level expressways to link various hubs in the Western Region requires an annual investment of about 700,000 million yuan to 800,000 million yuan. The

Table 2-10 Total Investment in Fixed Assets, by Source, 1980–2000

	State Budgetary Appropriations (million yuan)	Domestic Loans (million yuan)	Foreign Investments (million yuan)	Fundraising and Other Sources (million yuan)	Total (million yuan)	Percentage of State Budgetary Appropriations (%)
1980s in total	386,083	539,907	149,584	1,773,576	2,849,150	13.6
1991	38,043	131,473	31,889	358,044	559,449	6.8
1992	34,746	221,403	46,866	504,995	808,010	4.3
1993	48,367	307,199	95,428	856,236	1,307,230	3.7
1994	52,957	399,764	176,895	1,153,096	1,782,712	3.0
1995	62,105	419,873	229,589	1,340,919	2,052,486	3.0
1996	62,588	457,369	274,660	1,541,240	2,335,857	2.7
1997	69,674	478,255	268,389	1,709,649	2,525,967	2.8
1998	119,739	554,289	261,703	1,935,961	2,871,692	4.2
1999	185,214	572,593	200,678	2,016,980	2,975,465	6.2
2000	210,945	672,727	169,624	2,257,714	3,311,019	6.4

Source: China Statistical Yearbook 2001.

Table 2-11 Investment in Capital Construction, by Source, 1999

	State Budgetary Appropriations (million yuan)	Domestic Loans (million yuan)	Foreign Investments (million yuan)	Fundraising (million yuan)	Others (million yuan)	Total (million yuan)	Percentage of State Budgetary Appropriations (%)
PRC	159,407	358,635	85,218	523,310	139,678	1,266,248	12.6
Western Region	41,330	79,906	10,198	112,030	41,521	284,986	14.5
Chongqing	5,000	5,327	221	7,125	3,077	20,748	24.1
Sichuan	4,031	18,060	3,558	26,139	8,473	60,260	6.7
Guizhou	2,682	5,638	696	4,871	1,542	15,428	17.4
Yunnan	3,380	8,392	239	14,851	3,632	30,494	11.1
Tibet	3,717	212	2	1,323	601	5,854	63.5
Shaanxi	4,348	7,192	1,243	10,375	5,583	28,740	15.1
Gansu	2,989	7,211	485	5,798	3,815	20,298	14.7
Qinghai	2,114	2,631	150	2,310	2,139	9,343	22.6
Ningxia	1,517	3,552	197	2,279	839	8,384	18.1
Xinjiang	4,278	9,484	852	18,576	4,281	37,470	11.4
Inner Mongolia	3,579	4,821	1,289	8,090	3,845	21,623	16.6
Guangxi	3,697	7,386	1,267	10,296	3,695	26,341	14.0

Source: China Statistical Yearbook 2001.

4,200-km gas pipeline from Xinjiang to Shanghai will cost 300,000 million yuan. The Bureau of Civil Aviation plans to build or upgrade 20 airports and the total investment will reach 5,000 million yuan.

The disposable government income in 1999 was made up of 1,144,400 million yuan in tax revenues and 110,000 million yuan in government construction bonds, which was much lower than the required investment.

INDIRECT TAXATION

The major component of the tax reforms of 1994 was the introduction of VAT to replace turnover taxes. Three features of the VAT system are of particular significance for the Western Region:

- It does not apply to the services sector, particularly retail and wholesale trade.
- It does not give allowances for taxes paid on capital goods. In other words, it is production-based, not consumption-based. This distortion favors the Eastern Region, which has less heavy industry than the Central and Western regions.
- The Bureau of State Taxation issues VAT invoices and receipts only to companies whose annual turnover exceeds 1 million yuan for retailers, and 1.8 million yuan for wholesalers.

“Small taxpayers,” defined in the Tax Law as business entities with a turnover of less than 1 million yuan for retailers and less than 1.8 million yuan for wholesalers, find it difficult to trade with “normal taxpayers.” Some small taxpayers also illegally use

normal taxpayers’ official VAT invoices and receipts to do business.

In introducing a production-based VAT rather than a consumption-based one the Government probably thought that by not allowing for the deduction of capital inputs, it could maintain steady tax revenues. Also, in the context of soft budget constraints, it could abate overheating in the capital investment sector, that is, reduce companies’ (especially SOEs’) incentive to invest in capital goods more than necessary. These constraints on introducing a consumption-based VAT still exist, although to a lesser extent, thanks to the microeconomic reforms that have hardened the soft budget constraints at the firm level.

ENTERPRISE TAXES

The current tax assignment is biased against secondary industry and SOEs. In 1999, SOEs contributed 65 percent of total enterprise tax revenues in 1997 even though, as a whole, they made losses. From 1993 to 1995, the percentage of tertiary industry output in GDP decreased slightly from 32.7 percent to 31.3 percent, while the tax burden on enterprises decreased from 8.5 percent to 3.1 percent. SOEs dominate the Western Region. As a result, the tax burden on enterprises in Ningxia is 1.6 percent higher than the national average, higher than in Guangdong, Zhejiang, and Jiangsu by 3 to 5 percent in 1998. Yunnan’s industry tax burden is 23.7 percent, 14.8 percent higher than the national average of 8.9 in 1994.⁵

A recent study extended the conclusion to the whole Western Region.⁶ Table 2-12 illustrates the major findings. In 1998, all provinces in the Eastern Region, except Beijing, Tianjin, Shanghai, Guangdong, and Liaoning, had tax burdens 7 percent to 8.8 percent below the national average. The Central Region had tax burdens of around 6 percent to 8 percent while the Western Region's was above 10 percent. The regressive tax burden is mainly due to the tax on agriculture, which dominates the Western Region. The elimination of tax differentiation in sectors should correct this regression.

TAX ON HOUSEHOLD INCOME

The Individual Income Tax Law of 1999 updated the law originally passed in 1980. The law prescribes a range of tax rates ranging up to 45 percent. It also provides many exemptions. The law is ineffective, despite the efforts of the National People's Congress to strengthen the control of tax evasion. Table 2-13

lists total income and disposable income for a typical urban resident in each region and the ratio of disposable income to total income. The ratio is essentially the same and very close to 100 percent; this implies the tax is flat (essentially zero) and income tax has not yet had the function of redistributing incomes.

Even for the richest 10 percent of urban residents, per capita disposable income was over 99 percent of per capita total income in 2000.

TAXES ON FARMERS

The tax burden on farmers comprises a combination of state taxes and levies by townships and villages (Table 2-14).

While the total average percentage of the taxes is under 10 percent of gross income, and less in the poorer provinces, they nevertheless impose a severe burden on poor households. In addition to the taxes and levies, local governments levy other charges on peasants, including fines, 5 to 10 days' corvee labor a year, and a variety of special fees. The Government has announced that it intends to abolish the township and village levies, phase out corvee labor, and raise state agricultural taxes.⁷

The taxes on farmers comprise the agricultural tax and surcharge, the special products tax, the slaughter tax, the farmland utilization tax, and the education surcharge. A problem with special fees is that, like the township and village levies, they are regressive. The proposal is that the only tax would be the tax and surcharge on crop production and the special products tax.

UNEVEN FISCAL EXPENDITURES IN THE WESTERN REGION

Table 2-15 shows the growth of fiscal resources in the Eastern, Central, and Western regions from 1978 to 1998. Although the growth rates are similar, the absolute (relative) disparity in fiscal expenditures per person has expanded from 22 yuan (69.9 percent) to 292 yuan (64.4 percent), mainly because of the current tax revenue returns rule implemented in the PRC.

Table 2-12 Tax Burden on the Regions, 1993–1998

Region	1993 (%)	1994 (%)	1995 (%)	1996 (%)	1997 (%)	1998 (%)
Eastern	10.35	10.15	9.69	9.51	11.16	11.44
BTS ^a	19.47	21.17	20.31	20.11	23.25	23.11
East without BTS	8.69	8.22	7.82	7.66	9.02	9.35
Central	9.02	8.09	7.53	7.14	7.47	7.81
Western	11.06	10.70	9.79	9.39	9.85	10.40
PRC	10.15	9.93	9.14	9.01	9.94	10.3

Source: Zhang and Liu (2001).

^a Beijing, Tianjin, and Shanghai.

Table 2-13 Taxes on Urban Households, 2000

Region	Per Capita Disposable Income (yuan)	Per Capita Total Income (yuan)	Per Capita Disposable Income/Per Capita Total Income (%)
Eastern	7,849.88	7,901.15	99.35
Central	5,169.21	5,196.10	99.48
Western			
Southwest	6,146.31	6,181.37	99.43
Northwest	5,149.46	5,179.29	99.42
PRC	6,279.98	6,316.81	99.42

Source: China Statistical Yearbook 2001.

Table 2-14 Per Capita Taxes and Levies on Rural Households,^a 1999

Province/Autonomous Region	(1) Gross Income (yuan)	(2) State Taxes (yuan)	(3) Township Levies (yuan)	(4) Village Levies (yuan)	Taxes/Gross income [(2)+(3)+(4)]/(1) (%)
Inner Mongolia	5,000	376	3	46	9.4
Xinjiang	4,551	107	106	164	9.6
Sichuan	2,697	39	9	43	4.7
Ningxia	2,375	35	5	50	5.7
Guizhou	1,589	21	2	14	3.1
Yunnan	1,516	8	3	12	2.1
Gansu	1,445	26	12	19	4.4

Source: Statistical yearbooks of local governments.

^a Excluding herdsmen households.

Table 2-15 Growth of Fiscal Resources in the Regions, at Current Prices

Item	1978		1998		Average Annual Growth Rate (%)
	Amount (yuan)	% of Eastern Region	Amount (yuan)	% of Eastern Region	
Eastern Region					
GDP per capita	464	100.0	8,914	100.0	15.9
Fiscal revenue per capita	485	100.0	602	100.0	1.1
Fiscal expenditure per capita	73	100.0	823	100.0	12.9
Central Region					
GDP per capita	310	66.8	4,958	51.4	14.9
Fiscal revenue per capita	67	13.8	280	46.5	7.4
Fiscal expenditure per capita	52	71.2	476	57.8	11.7
Western Region					
GDP per capita	251	54.1	3,859	43.1	14.6
Fiscal revenue per capita	45	9.3	269	4.3	9.3
Fiscal expenditure per capita	51	69.9	531	64.4	12.4

Sources: *Local Fiscal Statistics of 1998*.

Policy implications for the fiscal system

A good public finance strategy for regional development should have the following objectives:

- Provide a level playing field for the Central Government and local governments to supply local goods
- Operate an effective and fair tax system that creates minimal undesirable distortions in the economy
- Clarify responsibility for infrastructure investment between levels of government and the rationale for selecting major infrastructure investments
- Operate a system of transfer payments between local governments that equalizes services and fiscal capabilities

- Operate an effective and efficient system of government bond financing (and other forms of financing) to complement the fiscal system

The fiscal policies should support the basic objectives of good public finance and cover institutional arrangements, tax assignment, government transfer payments, and government bond financing. Other sources of financing will be discussed in Chapter 3.

INSTITUTIONAL ARRANGEMENTS TO PROVIDE A LEVEL PLAYING FIELD

The following progressive institutional reforms are desirable:

- Governments' ability to collect taxes should be enhanced through the following measures:
 - Encouraging bank transfer, instead of cash exchange, for business-to-business transactions and even business-to-customer transactions

- Implementing a computer-based tax registration system linked to bank accounts to discourage tax evasion
- Introducing tax substantiation and a severe punishment system
- Establishing a nationwide credit approval system to discourage wrongdoing
- The tax system should be made more transparent and equitable in its application across firms, with fewer arbitrary interpretations of tax laws and regulations to prevent rent-seeking behavior. The key ingredients of reform here are clear rules, capable of simple enforcement, and specialized education and training. One important step would be to clarify or eliminate vague provisions in various laws that provide opportunities for government interference in private economic activities. Under this principle, the long-term benefits of preferential company income tax treatment in the Western Region are doubtful.
- The Government should begin a systematic effort to simplify the system of fees and taxes levied on the private sector. Converting the large extrabudgetary revenue and expenditure items to in-budget items could make the whole system more transparent and accountable. From the firms' point of view, taxes are more predictable and manageable than discretionary fees and other charges. The fact that local governments are not allowed to adjust the rate of local taxes or create new taxes to meet their needs has in many cases encouraged them to impose arbitrary and nontransparent fees. As a result, the burden on firms is uneven, in terms of both size and location. To rationalize and simplify this system, it will be necessary to decentralize some taxation powers and rights to revenue, where appropriate, and to make policies more consistent across locations *in the long term*.
- In the absence of an appropriate public administration system that maintains the regional competition and free mobility of

resources among regions, decentralizing taxation power may actually deteriorate the uneven tax burdens on firms in different regions. Therefore, *in the short term*, the Central Government could maintain its monopoly power in the design of both central, local, and shared tax, but use a more fair and efficient transfer payment system to balance the disparities in local tax revenues.

A FAIR TAXATION SYSTEM WITH LESS DISTORTION

Public finance economics show that a “good” public finance system should satisfy the following conditions: (i) horizontal and vertical equality in tax burdens; (ii) broad tax base and moderately progressive marginal tax rate; (iii) liabilities matched with public expenditure; and (iv) simplicity.

Preferential tax

To leverage the development of the Western Region, the Government has introduced a preferential tax policy summarized in the *Circular of the State Council on Policies and Measures Pertaining to the Development of the Western Region*.⁸ However, streamlining the taxation system to reflect the aforementioned principles is a higher priority than offering preferential tax treatment in the promotion of economic development in the Western Region. This is so for the following reasons:

- Preferential tax introduces a distortion to the market. It will encourage multibranch firms to transfer their reported profits to their branch in the Western Region while still having most investment and production capacities in other regions.
- Preferential tax is short-run in nature and uncertain in the future. This will encourage firms to invest in projects with short time horizons or to reestablish firms when the preferential period expires so as to continue to take advantage of preferential tax. This will leave room for rent-seeking activities and corruption.
- It makes the collection of tax revenues complex and less transparent.

Table 2-16 Policy Recommendations for Tax Reform

Areas Needing Improvement	Negative Effects on the Development of the Western Region	Policy Recommendations
<p>Value-added tax Production-based VAT disallows offset of VAT for the purchase of fixed assets and foreign-imported capital goods</p>	Discourages capital-intensive enterprises from investing in fixed assets and import of high-tech capital goods	Introduce a consumption-based VAT, consistent with the depreciation of fixed assets, to allow the offset of VAT on the purchase of fixed assets
Small enterprises (defined as enterprises with annual turnover of less than 1 million yuan in the production sectors or 1.8 million yuan in the wholesale sector) are not eligible to use the designated VAT invoice	Makes it hard for SMEs to deal with enterprises eligible to use the designated VAT invoice, and therefore discourages the development of the private sector	Introduce a VAT number system to replace the eligibility test of using the designated VAT invoice Encourage the development of an e-commerce-based recording and processing system
Enterprises can claim 10% offset only on the purchase of transport services	Increases the tax burden of enterprises that rely more on transport services	Streamline the VAT rate to make it neutral to goods and services transactions
<p>Resources tax Tax rate is too low to reflect the negative externality of using natural resources</p>	For the resource-rich areas concentrated in the Western Region, too low and too narrow resources tax encourages the waste of resources and lowers the tax revenues of local governments	Increase the resources tax rate to (i) reflect opportunity costs (including negative externalities) of using resources; and (ii) increase local governments' tax revenues
Tax base is too narrow		Widen the tax base to include the use of forest, grassland, and water resources
<p>Business tax on tertiary industries Business tax is inconsistent with level of taxation of the primary and secondary industries</p>	Encourages local governments to be involved in the operations of tertiary industry, and distorts the industrial structure Due to the under-development of tertiary industry, local governments collect less tax than in the Eastern region.	Merge business tax into VAT and company income tax to reduce its distorting effects
<p>Consumption tax (excise) Tax base is too narrow and tax rate is too low for some goods, like cigarettes, wine, and petrol</p>	Reduces the tax revenues of the Government and its ability to make transfer payments	Widen the tax base to include more luxury goods and increase the tax rate for goods with significant externality and having "demonstration effects"
<p>Company income tax Tax evasion and tax avoidance are prevalent</p>	Reduces local governments' capability to provide local public goods	Encourage bank transfer-based transactions
<p>Personal income tax Tax evasion and tax avoidance are prevalent</p>	Reduces local governments' capability to provide local public goods Fails to reduce income disparities between regions	Enhance the withholding system and encourage the bank transfer-based transactions
<p>Agriculture taxes and fees Agriculture taxes and fees are too high; discretionary fees are prevalent</p>	Impose heavy tax burden on farmers in the Western Region	Reduce agriculture taxes and fees and impose strict rules on the charging of fees on farmers

Source: Compiled by the consultants.

- It reduces the tax revenues of local governments as well as their capacity to provide local public services.

A direct lump-sum subsidy, proportionate with the total investment volume, is an alternative to preferential tax without the shortcomings identified above.

Reform of the tax system

The decentralized tax assignment is quite modern and consistent with international best practice. However, some areas still need strengthening. While all these reforms would apply to the whole country, the Western Region would benefit the most from tax reform. The suggested reforms are as follows (Table 2-16):

- Introduce a consumption-based VAT to allow the deduction of capital inputs and high-tech equipment. Most countries allow the deduction of capital inputs,⁹ and this will make VAT neutral to various inputs. A production-based VAT will undoubtedly distort firms' decision on the appropriate combination of capital and labor, unless the Government is deliberately promoting labor-intensive technology and industry. Even then, there are policies more suitable than a distorted VAT system, such as a direct subsidy for labor inputs. The expected reduction in the tax revenues following the introduction of a consumption-based VAT could be compensated by (i) introducing institutional improvements that reduce tax avoidance and evasion, as suggested in the previous section; (ii) widening the VAT base to apply the same tax rate to the service sector; (iii) widening the tax base of resource tax and consumption tax, and (iv) increasing the tax rate as the last resort.
 - Introduce a VAT registration number for each business entity, as implemented recently in Australia as part of its new goods and services tax (GST) system, which imposes 10 percent tax on all goods and services trading (except for basic foods, education, and health). The measure would complement or replace the official VAT invoice and receipt system, which issues official VAT invoices and receipts only to companies with annual turnover of more than 1 million yuan for retailers and 1.8 million yuan for wholesalers. Abolishing this discriminatory VAT treatment would facilitate market exchange. The use of computers could minimize the increase in administrative work.
 - Streamline the VAT rate to make it neutral to goods and services (especially for transport services).
 - Increase the resources tax to reflect the environmental costs of the extraction of resources, and use the collected tax to finance ecological protection projects.
 - Abandon the business tax on tertiary industry and merge it with VAT to reduce the distortion between industries.
 - Widen the base of the consumption tax to charge a higher rate for selected luxury goods with "demonstration" nature.
 - Introduce a tax-withholding system and encourage bank transfers to reduce income tax evasion.
- Reduction of the tax burden on farmers**
- There is a need to reduce the tax burden on poor farmers, many of whom live in the Western Region. The current income tax is rather regressive in that higher income urban households pay no tax while lower-income farmers pay 2–10 percent in taxes and levies. A progressive income tax scheme, as implemented in all developed countries, is needed to achieve horizontal and vertical equity in the fiscal system.
- GOVERNMENT INFRASTRUCTURE INVESTMENT**
- Although government investment in infrastructure is widely regarded as pivotal in promoting economic development in the Western Region, international practices illustrate that the Government should pay particular attention to, and correctly address, the following concerns:
- In the PRC, it is difficult to reconcile the allocation and control of public funds with development objectives. Budgetary allocations largely reflect historical allocations and the bargaining powers of local governments, and do not allow for new emphases on particular activities or for the phasing out of others.
 - Governments must choose between new construction and maintenance, and between rural and urban sectors among regions. Allocating expenditures to different activities on the basis of social rates of return is an important method of establishing priorities. Political

achievement should give way to economic analysis. Analysis of such returns in most developing countries reveals the critical importance of maintenance over new construction. Other activities that deserve priority over new investment include the completion of unfinished projects.

- Increase spending on basic, lower-cost rural infrastructure, and cut back high-cost mega projects. This should be an economic priority that will contribute significantly to poverty reduction. Moreover, integrating agricultural development with industrial development by building up rural industrial infrastructure would allow rural industries to prosper and rural populations to become employed in industry without major dislocation.
- Strengthen the work of the National Audit Administration under the Audit Law of 1994 in auditing the benefits of budgetary expenditures on infrastructure projects.

GOVERNMENT TRANSFER PAYMENT AS A MEANS OF POVERTY ALLEVIATION

The tax system may not be the ideal means of remedying regional imbalance, owing to the potential distortions in the market and the ineffectiveness of the personal income tax system. Therefore, government lump-sum transfer payments should play the leading role in poverty alleviation in the Western Region. International experience illustrates that a transparent and accountable lump-sum subsidy system is desirable and provides a feasible means to achieve this objective.

Regular transfer payment

The five channels of government transfer payment could be merged into *regular transfer payment* (tax returns, institutional subsidy, and transitional transfer payment) and *special subsidy* (special project subsidy and end-of-balance subsidy). In addition, a social security safety net

should be established to provide assistance for the poor.

There are different views on the relative merits of rules-based government transfer payment versus government discretionary transfer payment. Rules-based transfer payment is more transparent and accountable, but less flexible in dealing with widely differing conditions such as those that exist in the Western Region. Discretionary transfer payment, on the other hand, is more flexible and thus able to take special circumstances into account. However, discretionary transfer payment leaves great scope for abuse and corruption. The optimum mix depends on the institutional capability of the governments, especially the accountability of the local governments.

In principle, regular transfer payment is used to balance regional fiscal capabilities. It could be justified on the grounds that: (i) it should meet the minimum funds requirement with which local governments are able to perform their normal functions; and (ii) it should help people of different regions to have equal access to public services, avoiding excessive differentials in the provision of public services.

Further studies are needed to design a fair and effective regular transfer payment system. One option is to adopt the “factor scoring” principle, that is, find a set of proxies to measure the *potential* capability (not the *actual* revenue, as in the current system) of local finance, the *potential* need of public services in each province and autonomous region (not the *actual* expenditure), and the level of economic development. The regular transfer payment should function by filling the disparity gaps between local government revenues and the funds required to supply minimum public services.

The transfer payment from the Federal Government to state governments in Australia is widely regarded as “good” practice in economic literature. Box 2-1 documents the details of the practice.

Box 2-1 Fostering Interregional Equity Through Fiscal Equalization in Australia

Although Australia is a federal country comprising eight states and territories, most taxation power is assigned to the Federal (Commonwealth) Government, which accounts for almost three-fourths of general government revenue. The federal nature of the system is preserved through large-scale intergovernmental fiscal transfers: in 1998–1999, these totaled about US\$20,000 million equivalent, about half of which came in the form of unconditional block grants.

The fiscal transfer mechanism is designed to address both vertical and horizontal fiscal imbalances. The vertical imbalance is addressed by transferring enough resources to permit states and local governments to spend almost 50 percent of general government expenditure (while raising about one-fourth of revenue). The Australian system also has a mechanism to partly remedy the horizontal fiscal imbalance—differences in revenue capacity among the states—by focusing on equal access for all citizens to certain basic social services.

Until World War II, the annual negotiation between the states and the Federal Government concerned both the total amount of grants to be allocated and their distribution among the states. This generated a great deal of contention and the zero-sum nature of the allocation system made a national consensus very difficult. In the system introduced since then, the annual negotiation has centered only on the

total amount. As soon as that figure is agreed, the allocation among the states follows a formula designed to equalize access to basic social services (thus providing a greater per capita amount to poorer states).

According to the allocation principle, each state is given “the capacity to provide the average standard of state-type public services, assuming it does so at an average level of operational efficiency and makes an average effort to raise revenue from its own sources.” This simple and powerful principle sets all the incentives in the right direction. Because these averages are *assumptions* used in the allocation formula, each state has a positive incentive to raise its revenue effort and its service efficiency above the national average. If it succeeds, it retains the increase in revenue and all the cost savings, and the national averages for the following years are automatically raised, adding a dynamic dimension to the fiscal and efficiency incentives.

In 1997, one of the authors asked the Chairman of the Australian Grants Commission whether the efficiency of the system depended on the relative interregional equality of income evident in Australia. He replied, rightly, “And how do you think it got that way?” Assuring that each citizen has access to quality basic education and health is probably the best single route to remedying both interpersonal and interregional income inequalities in the long term.

Source: Schiavo-Campo and Sundaram (2001).

Nationwide social security safety net¹⁰

As an alternative or supplement, a social security network should be able to supply most functions of government transfer payment to the poor without the shortcomings of lump-sum transfer. This is especially true in the transfer payment to individuals. It has an additional merit that could guarantee that the fund actually reaches the poor. In fact, a well-functioning social assistance and social security system should be in place before any other transfer payment schemes are introduced.

The specific objectives of social security include insurance, protecting people against risks such as unemployment; income smoothing, allowing people to protect their living standards in old age by redistributing income from their younger years; and poverty relief, ensuring at least a minimum standard of living. The changes in labor markets that economic reform brings require a fundamental reform in the old system of income transfers: a widening wage and income distribution means that transfers must be targeted in ways that take more account of differences in circumstances; the loss of job security after SOE reform makes developing unemployment benefits urgent and means that transfers can no

longer be administered by enterprises. Both these changes call for strengthening the administration of social security.

Broadly, social safety nets can take two forms: transfers, whether in cash or in kind; and programs that give people earning opportunities. There is a strong presumption that, where transfers are paid, they should be in cash wherever possible: cash payments leave buying decisions to the recipient, they are more transparent in budgeting, and they do not interfere with market prices. In some circumstances, however, benefits in kind have advantages: they usually maintain their value during inflation, and in specific cases, they may be well targeted and could avoid “hijacking” by local governments.

For those in absolute poverty in the Western Region, additional ways to relieve poverty will be necessary, but before such measures can be implemented, the absolute poor must first be identified. There are three broad ways to identify the absolute poor:

- *Income-tested social assistance.* Assistance to individuals or families with incomes below a specified level is appropriate for the lifetime

poor and in cases where contributions cannot be calculated or enforced. But broadly based, income-tested social assistance presents several problems: it creates important disincentives against work; the necessary tax rates are unsustainable for poor countries; determining eligibility is administratively demanding and costly; and income testing can be stigmatizing and intrusive and thus politically contentious. These problems are serious for the Western Region, especially where poverty is transient and often shallow, so that many people move into and out of poverty.

- *Targeted relief using poverty indicators.* It is sometimes possible to identify the poor through an indicator of poverty that is easier to measure than income. For example, an income test for all families with children is administratively costly, but family allowances—a fixed amount per child per month—are paid without income in Australia. Other uses of indicator targeting include help for pregnant women and infants through nutrition programs and medical checkups, and help for schoolchildren through free meals and health checks. Old age, particularly in single-person households, is another good indicator of poverty and is relatively undemanding administratively.
- *Self-targeted poverty relief.* The Government could try to subsidize goods consumed mainly by the poor. Another approach is to offer subsistence cash payments in return for work. Such “workfare” has advantages: the only people who participate are those who are genuinely poor, and recipients may be allowed to preserve their dignity by working. Broader benefits may accrue where the work creates useful infrastructure such as roads.

GOVERNMENT BOND FINANCING AND OTHER SOURCES OF PUBLIC FINANCE

To improve the efficiency and effectiveness of bond financing, the Government should:

- Improve the regulation system for investment in public debt projects, and strengthen control over the quality of each project and the management of funds.
- Ascertain that sufficient complementary funds are in place on time and that the speed of project construction is assured. All the regulations concerning constructors of a project, bidding procedure, monitoring mechanism, quality standards, and default punishment must be well contracted and the relevant authority must have the legal power to carry out and arbitrate the contract.
- Obey the budget and the final settlement of accounts strictly to avoid opportunistic behavior. An alternative capital resource would be to issue a construction lottery in the Western Region. Nowadays, the purchase ratio of lotteries in the PRC is rather small, leaving much room to be exploited. Only 6 percent of the population has bought lottery tickets, and there seems to be no market in the rural areas. However, with 6,000,000 million yuan of savings in their accounts, people can afford to purchase the tickets.

Notes

- 1 This was not the first time since 1949 that the Government had made major changes in the tax system. The Central Government initially assumed financial power, then decentralized it, then assumed it again. The frequent transfer of fiscal power is closely related to the national economic regulation system and changes in economic and political conditions.
- 2 The formula had two parts: an objective factor that attempted to measure the gap between standard expenditures and local fiscal capacity, and a factor for subsidies to regions with large ethnic minority populations. The latter was in line with the PRC policy for improving the welfare of its minorities.

The fiscal shortfall was determined by standard expenses on wages of civil servants, standard administrative expenses, agriculture and other productive expenditures, and other expenditures such as price subsidies. On the other hand, special transfers to provinces with minority regions were determined by the fiscal gap between the minority regions and the national average.

In 1996, another factor was added to the formula to reward the provinces for good tax effort. Tax effort is now measured by provincial tax collection relative to the national average. Generally, the transfers that a province was expected to receive in 1999 would be based on its fiscal gap and tax efforts in 1998.

3 Wong, Heady, and Woo (1995).

4 World Bank (2001b).

5 Lunjun Zhang (1999).

6 Zhang and Liu (2001).

7 *Report on the Outline of the Tenth Five-Year Plan for National and Economic and Social Development.*

Delivered at the Fourth Session of the Ninth National People's Congress on 5 March 2001 by Zhu Rongji, Premier of the State Council:

The system of administrative fees and taxes in rural areas needs to be reformed by abolishing all administrative fees imposed exclusively on farmers, such as contributions to township and village public accumulation funds and at the same time by raising the current rates of agricultural tax and special agricultural product tax where it is appropriate. This is a sound policy for safeguarding the legitimate rights and interests of farmers and reducing their burden.

8 The Circular states:

The corporate income tax of enterprises in government-encouraged sectors that are

financed with either domestic or foreign investment in the Western Region should be collected as a reduced rate of 15% for a certain period of time. Upon approval by the provincial government, enterprises based in autonomous regions, prefectures or counties may also be granted reduction or exemption of corporate income tax for a certain period of time. New enterprises engaged in transport, power, water conservancy postal services, broadcasting and etc. in the Western Region are eligible for a two-year tax holiday and a 50% reduction for the next three years following the tax holiday. No agriculture tax should be levied for ten years on income from cultivate land for the purpose of ecological protection. By analogy with tax exemption in railway and commercial airport construction, no occupation tax will be collected for taking cultivated land to build state-level highways and province-level highways. Provincial governments in the Western Region should decide on any reduction or exemption of taxes for taking cultivate land to build other types of highways. If domestic or foreign investors invest in the Western Region in sectors where investment is encouraged by the government or sectors with a competitive edge and need to import advanced technology and equipment to facilitate their invested projects, these imports, except for those not exemptible by government regulations, should be exempted from tariffs and import value added tax, provided that the imports are purchased within the total amount of investment.

9 Cnossen (1998).

10 The policy recommendations are consistent with the views expressed in World Bank (1997).