

# Financing Rural Development for a Harmonious Society in China:

## Recent Reforms in Public Finance and Their Prospects

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## Abstract

The Government of China has placed strong emphasis on addressing problems related to agriculture, farmers, and rural society, with the development of a “new socialist countryside” designated as a top priority for the Eleventh Five-Year Plan (2006-2010). The financing of public services in rural areas will be a key determinant of the Plan’s success. This report analyzes the performance of the intergovernmental fiscal system—the financing of rural development through counties, townships, and villages—and the impact of recent reforms. The authors show that achieving the government’s objectives will require channeling substantial new resources to rural areas. In addition, ensuring the effective transfer of resources and

their efficient utilization will require fundamental reforms to a wide range of public institutions, including budget and planning processes, personnel management systems, and the organization of government agencies.

The authors argue that a comprehensive reform strategy is needed to address fundamental vertical and horizontal imbalances in the intergovernmental fiscal system. The reforms must reach beyond the fiscal system to build improved accountability mechanisms to improve public service delivery at the grassroots level. And, given China’s size and diversity, reform efforts must focus on improving incentive structures at the county, township, and village levels.

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## **Financing Rural Development for a Harmonious Society in China:**

### **Recent Reforms in Public Finance and Their Prospects**

**Achim Fock and Christine Wong\***

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## 1. Introduction

Over the past few years, the Chinese government has increased its focus on rural development. Premier Wen Jiabao has repeatedly called for attention to the “*sannong wenti*”, i.e., problems related to agriculture, farmers, and rural society.<sup>1</sup> In line with this new focus, the government has significantly increased resources allocated to the rural sector, and introduced many new programs. Beginning with the Rural Tax and Fee Reform in 2002, the government has also implemented a number of reforms aimed at improving the fiscal health of rural governments and alleviating farmers’ burdens.

The government has announced the long-term goal of building a *xiaokang* (well-off) and harmonious society.<sup>2</sup> The 16<sup>th</sup> Party Congress defined the objective of a *xiaokang* society – to be reached by 2020 – to include social, environmental, equality, and many other objectives -- in addition to income and economic growth.<sup>3</sup> As stated by Premier Wen Jiabao, these long-term goals involve “putting people first,” and promoting reform and innovation in accordance with the “five balances” — balancing urban and rural development, balancing development among regions, balancing economic and social development, balancing man and nature, and balancing domestic development and opening wider to the outside world.<sup>4</sup>

Under this strategy, the building of a “new socialist countryside” (NSC) is designated as a top priority for the Eleventh Five-Year Plan period (2006-2010). In his speech to the National People’s Congress in March 2006, Premier Wen Jiabao referred to the project as a

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<sup>1</sup> The key policy objectives related to the *sannong wenti* include increasing agricultural productivity and maintaining food security, raising farmers’ incomes, reducing poverty, and improving environmental sustainability.

<sup>2</sup> The term *xiaokang* society refers to a well-off society in which all people can lead a fairly comfortable life. The term was first used by Deng Xiaoping when reform and opening up were launched in the late 1970s. Deng defined *xiaokang* with reference to a target per capita GDP of US\$800 by 2000. Because of China’s rapid economic growth, a *xiaokang* society as defined by Deng was roughly achieved by the end of the last century.

<sup>3</sup> Areas of a *xiaokang* society set by the Party include, in addition to the GDP per capita growth target (US\$3,000 by 2020), improving democracy; advancing science and education; enriching culture; fostering social harmony; and upgrading the texture of the life of the people. See Jiang Zemin, *Report at 16<sup>th</sup> National Congress of the Communist Party of China*, November 17, 2002. See website: <http://service.china.org.cn>. Many attempts have been made to further specify a *xiaokang* society, and develop indicators and targets for its monitoring. See, for example, China Statistics Press (1999, Appendix 1); UN Country Team in China (2004); Li and Zhu (2003).

<sup>4</sup> Wen (2004).

“major historic task”<sup>5</sup> The target and requirements of building new socialist villages can be summarized as developing production, raising living standards, (creating) a cultured rural environment, (ensuring) tidy and clean villages, and (instituting) democratic management.<sup>6</sup>

This renewed emphasis on rural development is long overdue. The urban-rural income gap has grown over the past two decades and per capita urban incomes now stand at more than three times rural incomes, a ratio that is among the largest in the world. Moreover, under China’s decentralized fiscal system, the provision of public services has also grown increasingly biased in favor of urban, prosperous areas, and the rural areas are disadvantaged. Rural areas were also disadvantaged in the past, when, under the commune system, resources were extracted from agriculture to pay for industrialization. The rural sector was asked to be self-sufficient in the provision of basic services such as infrastructure, health and education. When budgetary revenues were centralized in 1994, the situation worsened for rural, grassroots governments. Since the mid-1990s, even as China grew richer and government revenues improved rapidly the rural sector remained largely self-financed. The result was that in many localities, rural governments were unable to finance mandated services in basic education, public health, water, sanitation, etc. Estimates of the Human Development Index at 0.81 in the urban sector and 0.67 in the rural sector (UNDP 2005) are undoubtedly a reflection of the poorer public services enjoyed by rural citizens.

The true extent to which rural services have lagged behind the growing needs of the rural populace is difficult to ascertain. The current statistical reporting system provides very limited information on service delivery at subnational levels. When such information is available, it is not disaggregated between the rural and urban sectors. Estimates are increasingly difficult to make from regional totals because of the commingling of urban units in what used to be more purely rural categories of counties and townships. The extent of the

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<sup>5</sup> Wen (2006). Earlier, Premier Wen had already stated that “Solving the *sannong wenti* remain the top priority work (*zhongzhong zhizhong*) for the whole Party” and he stressed the guiding principle of “industry feeding (*fanpu*) agriculture,” and cities supporting rural villages. Wen Jiabao’s Explanations on the CCP Suggestions on the Eleventh Five Year Plan on National Economic and Social Development (October 8, 2005). See Xinhua News Agency, October 19, 2005.

<sup>6</sup> In Chinese this is summed up in twenty characters: 生产发展，生活宽裕，乡风文明，村容整洁，管理民主。 A good summary of the history and policy trends and priorities for building a “new socialist countryside” are provided by Minister of Finance Jin Renqing (2006).

inadequacy of rural services in the poor regions can only be glimpsed through anecdotal reports and field visits, which are necessarily limited in scope and coverage. In the course of this study, for example, we visited unheated, un-lit schools in Henan and Yunnan provinces, in localities where winter temperatures often dip below freezing. We also saw many health clinics and hospitals in deplorable condition, with little capacity for providing health care. Most remarkably, because of the pervasive reliance on user charges, even in one of China's most poverty stricken localities we visited, none of the most basic public services were provided free of charge, not even police protection.<sup>7</sup> By the end of the 1990s, it had become increasingly clear that inadequate local public finance was impeding the implementation of key parts of the government's development agenda, such as providing universal basic education and public health (World Bank 2002). The renewed rural focus is the government's response to these problems.

This report analyzes the treatment of rural local governments under China's fiscal system and the impact of recent reforms. By examining the intergovernmental fiscal arrangements, we will show that implementing the NSC program will require substantial new resources to be channeled to the rural sector. In addition, to ensure the effective transfer of resources and their efficient utilization will require some fundamental reforms to a wide range of institutions.

This report is organized as follows: after this introduction, Section 2 examines the intergovernmental fiscal system and recent trends in rural public finance. Section 3 looks at the organization of rural governments and their finances, drilling down to details on the ground. Section 4 turns to the institutional and organizational structure governing rural development to identify some impediments to progress. Section 5 analyzes recent reforms and assesses how far they have come to addressing the problems. Section 6 offers brief concluding comments.

## **2. The Intergovernmental Fiscal System and Rural Public Finance**

We begin with an examination of the current intergovernmental fiscal system (IFS) – the

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<sup>7</sup> Field visit in February 2004.

assignment of expenditures, revenues, transfers, and subnational borrowing. This IFS determines local government responsibilities and the resources they can mobilize; how the system is designed and how well its components work together and have an impact on shaping outcomes.

All countries in the world assign some functions to local governments based on the belief that some services are better delivered by local governments, which are more familiar with local needs and conditions. The subsidiarity principle calls for the provision of services to be devolved to the lowest-level jurisdiction that corresponds to the benefit area (Oates 1972; Tiebout 1956). In general, it is believed that assigning more responsibilities to local governments can be useful for achieving a more efficient allocation of resources and stimulating economic growth, and the worldwide trend is the direction of decentralization (see, for example, World Bank 2005b). However, decentralization may weaken the government's capacity to ensure an equitable provision of services to citizens in different jurisdictions, or to maintain macroeconomic stability (Bahl and Martinez-Vasquez 2006). In countries where administrative capacities are limited and concentrated at the center, devolution of responsibilities may lead to greater inefficiencies and deterioration of services (Prud'homme 1995).

Therefore, economic theory offers no one-size-fits-all template for deciding which level of government should be responsible for the provision of particular services. Because of the existing trade-offs, countries choose different degrees of fiscal decentralization in accordance with their objectives and priorities, as well as their historical circumstances, and any given assignment can only be judged against the objectives set by the central government in its decentralization strategy. Moreover, at any given degree of decentralization, countries have also chosen somewhat different configurations for their IFS, with some countries assigning more own source revenues to local governments while others relying more on the use of intergovernmental transfers.

The provision of public services in rural areas is a challenge in all countries around the world due to three features that are common to rural local governments: weak tax bases, high costs of providing services, and weak administrative capacities for managing resources and services. These are especially marked in remote communities where service provision is

costly due to factors such as geographic conditions or low population density, and where local governments do not have a sufficient tax base to be economically viable. For instance, class sizes may be smaller in schools, public facilities may be used at lower capacities, and a premium may have to be paid to attract qualified teachers, doctors, and administrative staff to work in remote rural areas.<sup>8</sup> Most remote communities do not offer a great many services. In industrialized countries in the OECD, rural local governments draw on a mix of local taxes, user charges, and transfers to meet national standards for minimum service provision – for basic education, health care, sanitation, and infrastructural services. Given their lower revenue capacities and higher expenditure needs, these governments are relatively more dependent on transfers than their urban counterparts.

In China the problems of financing rural governments are not confined to those in remote locations, however, but apply more generally. While high costs and weak administrative capacities are also present in localities in remote regions, virtually all rural counties and township governments (and villages) face large fiscal gaps that are rooted in China's highly decentralized system of finance and the collapse of redistribution during the long fiscal decline of 1980-1996 (discussed later in this section).

### **2.1. The Structure of Intergovernmental Fiscal Arrangements**

China is among the most decentralized countries in the world. Subnational governments at the provincial, municipal, county, and township levels account for more than 70 percent of national budgetary expenditures, and this share has grown in recent years (Table 1). Since the late 1980s, these expenditure shares have corresponded largely to financing responsibilities (World Bank 2002, 2008, Wong 2007). Two other features are salient for China's rural public finance.

First, while in most countries decentralization is to the second, intermediate tier of government, in China it reaches all the way down to the lowest levels, with significant expenditure shares (and thus de facto responsibilities for service delivery) distributed among

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<sup>8</sup> In Canada, municipal spending on all services is considerably higher in remote areas than in the rest of the country – 41 percent higher than in the country on average in the Yukon; 173 percent higher in the Northwest Territories; and 171 percent higher in Nunavut (Kitchen and Slack, year?). In China there is a similar arrangement to provide hardship and remote area subsidies for public employees in remote areas.

each of the five levels of government (Table 1).

**Table 1. Division of Budgetary Expenditures by Administrative Level**

	2005		2004		2003	
	Total	of which, for Education	Total	of which, for Education	Total	of which, for Education
Central	25.9%	6%	27.7%	7%	30.1%	8%
Provinces	18.9%	16%	18.7%	15%	18.7%	15%
Pref. / Cities	22.7%	18%	22.2%	18%	21.5%	18%
Counties	26.7%	48%	25.2%	46%	23.3%	42%
Townships	5.9%	12%	6.1%	14%	6.3%	17%

Source: Calculated from Compendium of Local Fiscal Statistics, 2003, 2004, 2005; and Finance Yearbook of China, 2004, 2005, 2006.

Sitting at the bottom of this structure, rural local governments at the county and township levels in China jointly account for nearly one-third of national budgetary expenditures. They have almost sole responsibility for the provision of vital public services to the rural populace. For example, as shown in Table 1, the high costs of providing basic education explain why the county and township levels account for 60 percent of total budgetary outlays for education. Below the township is still another layer of administration, albeit not a formal level of government. These are administrative villages, which are the basic level of governance for public affairs for most rural citizens; they have taken over many of the functions formerly performed by the people's communes.

The administrative village has important functions in implementing government policies and in the provision of public goods and service. These include the enforcement of government policies in such important areas as land administration and family planning, and, in the area of public finance, the collection of fees and other revenues and the financing and provision of public goods and services. In particular, villages play an important role in the provision of rural infrastructural services and are involved in poverty reduction activities, social welfare, basic education, and public health. Even though most of the public investments and services in which villages are involved are largely financed from above, some crucial resources are still provided by the village level and their provision is supported by the villages. With the call to extend public finance and service delivery into the rural areas, the importance of the village level as a (quasi) government for rural citizens is likely to

increase. The role of administrative villages will be discussed in detail later in Section 3.

The second salient feature of rural public finance in China is that government is organized in a hierarchical structure, which powerfully shapes the way policies and resources reach rural governments. Because the administrative system is “nested,” policy implementation goes through a level-by-level delegation. The central government issues orders and sends resources to the next tier (T), i.e. provinces, and depends on the provinces to transmit the resources downward to the lower levels. The provinces in turn delegate to prefectures/municipalities, and so on down the hierarchy. In this system, interactions are bilateral, involving only two tiers at a time.<sup>9</sup> Given the way this structure is organized, central policies and resources aimed at the rural sector – e.g., *sannong* policies – go through a 5-step process before reaching their intended recipients. This is illustrated in Figure A.<sup>10</sup>

**Figure A. The Transmission of *Sannong* Policies**

Step 1: T1 → T2

Step 2: T2 → T3

Step 3: T3 → T4

Step 4: T4 → T5

Step 5: T5 → Rural areas/citizens/farmers

In this hierarchy, the intermediate levels have significant powers to decide how to transmit policies and resources to the next lower level. This appears especially marked for the provinces. Although neither the Constitution nor the Budget Law (1994) assigns specific authorities to the intermediate levels, they are given these authorities by delegation, often implicitly. Not surprisingly, this decentralized approach has resulted in differing shares of

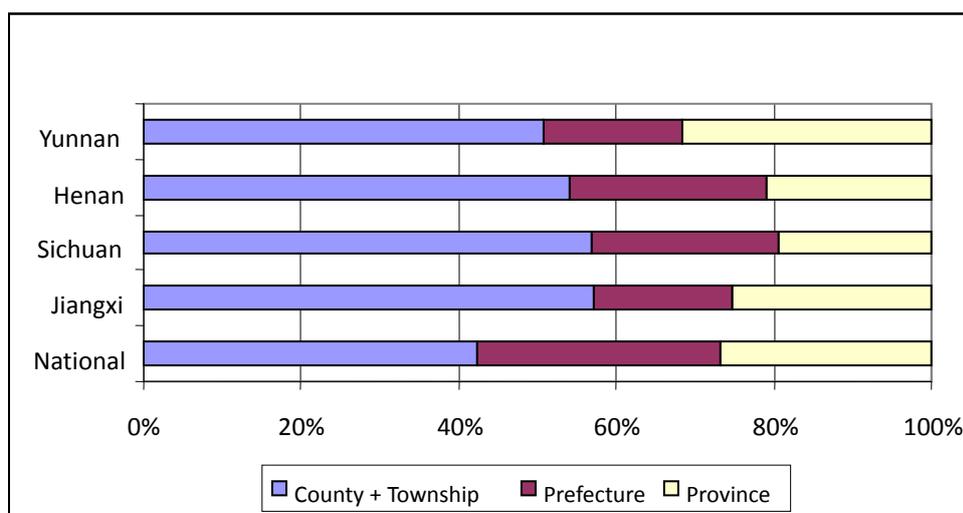
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<sup>9</sup> This explains why the Central Government is unusually small in China, with only 50,000 staff sitting at the apex of a public sector that comprises 33 million employees if public service units are included (see World Bank 2006a).

<sup>10</sup> A number of pilot programs test improvements in administrative efficiency by putting counties directly under the administration of the province, or by putting towns directly under the administration of the prefecture. Till 2008 it is common that put counties directly under the administration of the province (*Sheng Zhiguan Xian*) in fiscal management system. However, while this reduces the number of layers, the principal structure as a nested administration is not changed.

revenues and expenditures managed by rural local governments across provinces. This unusual aspect of China’s public finance system has been noted in earlier studies (see, for example, World Bank 2002). It is also confirmed in the four provinces where fieldwork was conducted for this study. In each of the four provinces, the county plus township shares of expenditures are more than 50 percent of the (subnational) total, significantly higher than the national average of 43 percent (Figure B).<sup>11</sup>

**Figure B. Shares of Budget Expenditures by Level (2003)**



Source: Compendium of Local Fiscal Statistics, 2003.

The share of expenditures accounted for by the provincial government also varies significantly. The provincial share is perhaps more indicative of choice since, unlike other subnational governments, provincial governments have no clear role in the direct provision of services. While averaging 28 percent nationwide (when the four provincial-level municipalities and Tibet are excluded), this share ranges from lows of 13 and 14 percent in Zhejiang and Guangdong, to highs of 49 and 43 percent in Qinghai and Ningxia respectively.<sup>12</sup> The summary descriptive statistics in Table 2 for the 27 provinces and autonomous regions

<sup>11</sup> By themselves, these different shares of the rural sector may be merely reflections of the different degrees of urbanization across provinces. For example, as measured by the share of agriculture in provincial GDP, the four fieldwork provinces are all significantly more “agricultural” (and rural) than the national average. The shares of the primary sector in provincial GDP in 2003 were 1.44, 1.42, 1.37, and 1.22 and in 2004 1.40, 1.34, 1.34, and 1.23 times the national average in Sichuan, Yunnan, Jiangxi, and Henan, respectively (Statistical Yearbook 2004, 2005).

<sup>12</sup> MOF (2003); Compendium of Fiscal Statistics for All Prefectures, Cities, and Counties, 2003.

show the diversity of choices made by provinces.

**Table 2. Descriptive Statistics of Subnational Expenditure and Revenue Shares, 2003**

<b>Expenditure shares</b>	<b>Mean</b>	<b>Std. Dev.</b>	<b>Maximum</b>	<b>Minimum</b>	<b>C.V.</b>
Province	28.0%	9.1%	49.4%	12.8%	0.33
Prefecture	24.4%	8.0%	48.9%	15.0%	0.33
County + township	47.7%	8.2%	63.2%	30.3%	0.17
<b>Revenue shares</b>					
Province	22.1%	8.2%	42.4%	11.4%	0.37
Prefecture	31.2%	6.8%	50.9%	19.0%	0.22
County + township	46.7%	10.8%	65.2%	22.1%	0.23

Note: Data exclude Beijing, Tianjin, Shanghai and Tibet.

Source: China Prefectures, Cities and Counties Fiscal Statistics 2003.

These features of the current intergovernmental fiscal arrangements in China explain two notable outcomes in rural public finance in China: First, the wide variation in the fiscal environments faced by rural local governments in different regions, both in terms of how much autonomy they have in spending decisions, as well as resources available for meeting their expenditure responsibilities. Second, it is not a straightforward process for the central government to implement changes in rural policies since these changes are mediated by several intermediate levels of government.

## **2.2. Expenditure Assignments**

Expenditure responsibilities are only defined in broad terms for central and “local” (i.e. sub-national) authorities in the Budget Law (1994). The law leaves it to the subnational governments to work out how to divide “local” responsibilities and revenues among the four levels. Table 3 shows the broad assignments under the Budget Law.

**Table 3. Division of Responsibilities between the Central and Local Governments**

<b>Central Government</b>	<b>Subnational Governments</b>
1. National defense	1. Local government administration
2. Diplomacy and foreign affairs	2. Local public services
3. Military police	3. Locally financed basic infrastructure & technical renovations
4. Key construction projects	4. Support to agriculture
5. Central Government administration	5. Urban maintenance and construction
6. Public services at the central level	6. Price subsidies

7. Debt service payments	7. Other expenditures
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Source: Adapted from the Budget Law (1994).

Given the absence of specific assignments, in a broad sense the four levels of subnational governments share joint responsibility for all functions not assigned to the central government. In practice, concurrent assignments are common, with all four levels of subnational governments engaged in virtually all budgeted activities (World Bank 2006a). This is illustrated in Table 4, showing a range of major services provided by several levels of government, including rural governments at the county and township levels.

**Table 4. Expenditure Assignments by Government Level**

	Central (T1)	Provinces (T2)	Municipalities (T3)	Counties (T4)	Townships (T5)
Higher education	x	x	x		
Intermediate education		x	x	x	x
Basic education				x	x
Culture	x	x	x	x	x
Basic R&D	x	x	x		
Health	x	x	x	x	x
Family planning			x	x	x
Administration	x	x	x	x	x
Law and justice system	x	x	x	x	x
Social security		x	x	x	x

Source: Adapted from Zhao et al. (2005).

These assignments are largely inherited from the planned economy, when they were designed for purposes of administration, rather than finance. For ease of administration, responsibilities were mostly divided by catchment areas, rather than by function, and the system explicitly permitted concurrent assignments.<sup>13</sup> For example, in education, primary and junior middle schools are the responsibility of subprovincial government at the lowest level – districts and “street communities” in urban areas, and townships in rural areas.<sup>14</sup>

<sup>13</sup> This principle also permitted state-owned enterprises – using pre-tax profits (i.e. state funds) – to run schools and clinics and hospitals for their own staff and their dependents, phenomena that were common with Soviet-type economies.

<sup>14</sup> "In July 2001 the State Council issued an edict that counties should pay all rural teachers salaries for primary through junior middle schools. Implementation began in 2002 in most provinces but negotiations are continuing in many localities over whether the State Council intended a change in expenditure assignment, or simply a cashing responsibility -- where the county would disburse against township funds."

Senior middle schools are usually the responsibility of a higher-level government – municipalities and counties. Provinces are usually involved in education at the university level (where the central government is also involved). Lower-level governments that have resources can and do offer more – townships sometimes have their own senior middle schools and technical vocational schools, and large municipalities often have their own universities. At the same time, provinces directly finance some primary and middle schools that are attached (and subsidiary) to provincial-owned universities and organizations.

What emerged from this system of informal expenditure assignments was that responsibilities for basic education and public health were primarily at the lowest tiers, where the schools, clinics and hospitals are located. This is how counties, townships and city districts came to account for 60 percent of total public expenditures in education and more than 40 percent of those for health. Likewise, social welfare relief is the responsibility of the lowest tier, sometimes jointly with the next higher level. For example, the “five guaranteed households”, a rural welfare program for elderly with no family support, was the responsibility of the village community.

Rural local government expenditures are overwhelmingly concentrated in the provision of social services, administration, and economic services. In aggregate terms these three categories together account for 75 and 80 percent of expenditures at the county and township levels, respectively (Table 5). Recent reforms have moved some expenditure assignments from the township to the county level – most notably the payment of teachers’ salaries in 2002-2003. While these changes have affected the relative shares between the township and county levels, they do not represent a reduction in the responsibilities for rural governments (counties plus townships) as a whole. Instead, many new programs have been rolled out in rapid succession, thus adding to expenditure burdens.<sup>15</sup>

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<sup>15</sup> Examples include the New Cooperative Medical Scheme (NCMS), the recently announced “free rural education” program, the rural minimum living stipends, and others. See World Bank 2008.

**Table 5. Composition of Budgetary Expenditures of Rural Local Governments, 2004**<sup>16</sup>

(Shares of total)	All Subnational Gov'ts	Counties	Townships
1. Capital Investments	22%	17%	9%
2. Economic Services	13%	14%	14%
Agriculture	3%	4%	7%
3. Social Services	32%	37%	36%
Education	15%	21%	24%
Health	4%	5%	2%
4. Administration	21%	24%	29%
5. Subsidies	2%	1%	1%
6. Others	10%	7%	11%
Provision of Services (2 + 3 + 4)	66%	75%	80%

Source: Compendium of Local Fiscal Statistics, 2005.

Local rural governments have had great difficulty in adequately assuming their expenditure responsibilities, although little information is collected systematically in China on the state of services delivered on the ground. However, the high average proportions of total expenditures devoted to service provision imply that many rural counties and townships at the lower end of the income distribution are unable to fund their expenditure responsibilities at adequate levels.<sup>17</sup> Even for the key national priority task of providing nine years of basic education, for example, the Ministry of Education found that at year-end 2002, 431 counties had not reached this target, nearly all of which are in remote mountainous areas. Together these counties had a population of 107 million – more than one-eighth of the rural population (Wang Zhan 2003).<sup>18</sup>

This picture of poor localities straining but failing to provide adequate services can be glimpsed in anecdotal evidence collected during fieldwork for this study. The 2003 consolidated budget (including both the county and its townships) for Hua county, a nationally

<sup>16</sup> Social services include basic education, public health, and social welfare. Economic services include the operating expenses of the agriculture, forestry, animal husbandry, and industrial departments, and the agencies in charge of water conservancy.

<sup>17</sup> This is consistent with the findings of empirical studies, such as World Bank (2002), Heberer (2001) and Chen and Han (2005).

<sup>18</sup> The number of counties unable to provide 9 years of schooling has declined rapidly under the current campaign to extend compulsory education to all. By the end of 2004, the number of counties not achieving this target had been reduced to 284. Even in 2007, though, 93 counties still could not meet this target.

designated poor county in the central province of Henan, is presented in Table 6.

**Table 6. Budgetary Expenditures in Huaxian, 2003**

<b>Expenditure Category:</b>	<b>Per capita (RMB)</b>	<b>Share of total budget</b>
Administration	68	22%
Education	120	39%
Agriculture (incl. forestry, water cons., meteorology)	23	7%
Health	10	3%
Social assistance/relief	15	5%
Capital construction	17	6%
Other	56	18%
Total	308	100%

Source: fieldwork, December 2004.

Even though Huaxian devoted 39 percent of its budgetary expenditures to education, nearly twice the national average for counties, it managed to spend only RMB 678 per student enrolled in basic education, or 62 percent of the national average.<sup>19</sup> With education taking up a large part of available revenues, and administration taking another 22 percent, Huaxian was hard-pressed to find resources to meet all of its responsibilities. Compared to other counties, it spent proportionally less on capital investment, health, and economic services. Even though the county is a major grain producer, Huaxian also spent comparatively little on agricultural services. In 2003 the budget allocated only RMB 23 per capita for the operating costs of all departments related to agriculture, less than one-tenth of that spent in Ninglang county in Yunnan, a remote and mountainous locality that had little agriculture to speak of. The Huaxian county government provided no funding for any other economic services.

### **2.3. Revenue Assignments**

In order for rural local governments to deliver the many assigned vital (and often costly) services, the IFS must assign sufficient revenues to them through own taxes and user charges as well as through transfers. Given the very large regional disparities in income and revenue capacity across regions, transfers play an important role in alleviating horizontal inequities. If this condition is not met (either because of inadequate own revenues and/or inadequate

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<sup>19</sup> See World Bank (2005a); national figure calculated from Chinese Finance Yearbook, 2004.

transfers), the outcome is an inadequate provision of services and large disparities in services across localities. Where resources are inadequate, shared responsibility often leads to higher levels of government delegating responsibilities to lower levels of government. This was especially true in China during the long fiscal decline (Wong 1991, 1997; World Bank 2002).

Since 1994, all taxes have been assigned to the central government, “local” government, or shared. At the outset, the Tax Sharing System (TSS) reform of 1994 had aimed to simplify the revenue sharing system by introducing a simple, transparent, and uniform structure for revenue assignments across provinces. The system was introduced with only a few shared taxes – the VAT (75 percent central and 25 percent local) and the resource tax (assigned to either central or local government by type of resource).

In practice, the system of revenue assignments remained very complicated, especially at the subnational levels.<sup>20</sup> In many localities, especially at the township level, “fiscal contracts” were retained, under which the local government either received or remitted a lump-sum amount or a proportion of revenues (Zhou et al. 2005). The TSS simply added a new layer to the division of revenues – in Chinese this is commonly referred to as the “simultaneous implementation of two (revenue-sharing) systems.” In addition, the extension of the TSS to the subnational level began late, and has been implemented differently in different provinces. The current situation is that “local” taxes are extensively shared among subnational levels. At the county and township levels, rural local governments collect a relatively large number of taxes, but draw their revenues mainly from a few taxes.

Nationwide, the VAT, business tax (BT), and the income taxes (enterprise and personal) are the main sources of revenue for all levels of government as well as for both the county and township levels. In 2003 these four taxes combined accounted for 54 percent and 53 percent of total revenues at the county and township levels, respectively. The importance of these taxes suggests that they are the focus of local revenue mobilization efforts.

At the same time, through the 1990s in nearly all provinces the intermediate levels – the provinces and the municipalities – laid claim to a share of the taxes collected in the counties and townships, making it an increasingly uphill battle for the lower levels to increase revenues.

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<sup>20</sup> This is discussed in detail in World Bank (2002, Chapter 2).

This is illustrated in Table 7, which assembles information from three municipalities, two from Liaoning and one from Shaanxi, whose situations are not atypical. Table 8 assembles data from townships in four provinces to show that, at the bottom of the administrative hierarchy, townships have to “share” revenues from these taxes with the counties after the provinces and municipalities have taken their cuts, again, with strikingly different treatment across provinces.

The multiple claims by different levels of government to the few revenue-rich taxes point to the potential for tension that is inherent in the present system of tax assignment and tax sharing. Under conditions of fiscal stress, the temptation for higher levels to “grab” revenues is undoubtedly great, and the Constitution provides no protection for the lowest levels of government.

**Table 7. Multiple Claims to the Main Taxes, 2003**

Government level (Tax Share in Percent)		Tax Type				
		VAT	BT	EIT	PIT	
Central Government		75	0	60	60	
Liaoning Province	Provincial Government		10	30	20	15
	Anshan Municipality	municipal level	5	30	5	10
		county level	10	40	15	15
	Panjin & Yingkou Municipalities	municipal level	6	28	8	10
		county level	9	42	12	15
Shaanxi Province	Provincial Government		7.5	30	20	20
	Hanyang Municipality	municipal level	2.5	10	..	..
		Liquan county	15	60	..	..

Sources: World Bank (2006a); Zhao et al. (2005).

**Table 8. Sharing Township Taxes, 2004.**

	Province	Hunan		Chongqing			Jilin		Jiangsu		
	County	X.	N.	F.	T.		H.	J.		Y.	W.
	Township				T.	Y.		K.	M.		
<b>VAT</b>	Province						12.5	12.5	12.5		
	County							3.75	12.5	25	18.75
	Township	25	25	25	25	25	12.5	8.75			6.25
<b>BT</b>	Province				40	40	50	50	50		
	County				35	30			50	100	40
	Township	100	100	100	25	30	50	50			60
<b>EIT</b>	Province	12	12				16	16	16		
	County									40*	16
	Township	28	28	40	40	40	24	24	24		24
<b>PIT</b>	Province	12	12		16	16	16	16	16		
	County				4					40*	16
	Township	28	28	50	20	24	24	24	24		24

Source: fieldwork survey.

The high dependence on turnover and enterprise taxes also implies that these fiscal resources are unequally distributed, as enterprises are more concentrated in coastal regions and peri-urban locations. This is illustrated in Table 9, which compares the revenue compositions of selected counties, including two visited by the study team. The poor, agricultural county of Huaxian in Henan drew more than half of its revenues from agricultural taxes, three times the national average for counties. In contrast, the much more prosperous Shuangliu county on the periphery of Chengdu relied on agricultural taxes for only 11 percent of its revenue in 2003, and business taxes alone supplied 35 percent of its revenue.

**Table 9. The Composition of Tax Revenues at the County Level, 2003**

	National Average for counties + townships	Henan Provincial Average	Huaxian	Sichuan Provincial Average	Shuangliu
Per capita Revenues (RMB)		529	269	637	698
VAT	18.3%	16.4%	8.2%	13.0%	12.2%
Business Tax	24.5%	21.4%	10.8%	21.2%	35.1%
EIT	6.5%	6.8%	2.6%	9.8%	5.9%
PIT	4.2%	3.2%	2.4%	4.1%	4.7%
Urban Maintenance and Construction Tax (UMCT)	5.3%	4.8%	1.6%	7.5%	5.1%
Agricultural Taxes	15.9%	24.3%	50.4%	18.6%	11.4%
Other Revenues	25.2%	23.1%	23.8%	25.8%	25.4%

Note: County level includes townships. National average includes counties and county-level cities, but excludes districts.

Source: Compendium of Fiscal Statistics for All Prefectures, Cities, and Counties, 2003.

### *Outside the budget*

Until the Rural Fee Reform was implemented, townships also depended on extra-budgetary fees and levies to finance as much as half of their public expenditures, but aggregate data is not available at the national level. A group of experts at the State Administration of Taxation estimated that legally prescribed fees and levies at the township and village levels totaled RMB 86 billion in 2000 (Yang et al. 2003). If these estimates are correct, fees and levies would have financed roughly one-third of public expenditures at the township level.<sup>21</sup> In addition, illegal fees might have added another RMB 40 billion, and unpaid, compulsory labor would have contributed an amount valued at RMB 59 billion to total township expenditures. Put another way, township finance drew from in-budget resources (own revenues and transfers) RMB 187 billion, and RMB 185 billion -- nearly an equal amount -- from extra-budgetary resources comprising fees, levies, and labor contributions. This aggregate picture appears to be consistent with data drawn from a survey of 50 townships, which show that in 2000, before the RFR, the average township drew RMB 92 from extrabudgetary and self raised funds, compared to tax revenues of RMB 119. Of course, township governments were (and are) not

<sup>21</sup> This was equal to 50 percent of the budget expenditures of RMB 187 billion at the township level (CFY 2001).

the only government units to depend on extrabudgetary resources in China (Wong 1998, Fan 1998). The role of extrabudgetary resources in rural public finance will be discussed further in Section 3.

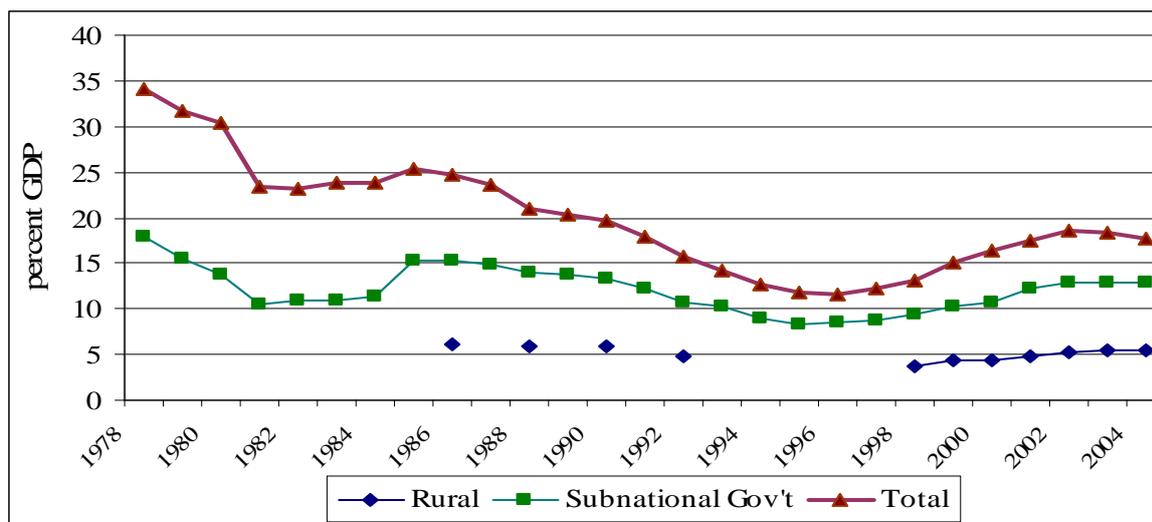
#### **2.4. Aggregate Trends in Rural Public Finance**

Throughout the transition period, governments at all levels have faced enormous upward pressure on public spending, while laboring under a steep fiscal decline that was reversed only in the mid-1990s. Until the TSS reform introduced a new set of tax instruments and tax administration, the relaxation of state control over the economy had led to a rapid erosion of the government's capacity to tax (World Bank 2002; Wong 2005). As the budget shrank from more than 30 percent of GDP to less than 12 percent during 1980-1995, all levels of government felt the squeeze. At the same time, rapid economic growth and urbanization raised demands for new investments in basic infrastructure and improved services. In education, enrollment rates have risen at all levels, and especially in higher education. Health care spending has risen rapidly. Social safety net expenditures have also increased enormously as a result of reforms in state-owned enterprises and the aging population. As explained in the section earlier, most of these demands fell on local budgets. In addition, wages have risen steeply during the transition, driving up the cost of labor-intensive public services – again hitting subnational budgets harder.<sup>22</sup> Figure C shows that, as a share of GDP, subnational expenditures fell from 18 percent in 1978 to 8.3 percent at the nadir in 1996 despite growing demands and the rising costs of local services. Under a transfers system that had been decimated by fiscal decline, cutbacks in public spending fell disproportionately on poor, rural localities.

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<sup>22</sup> This was true starting in the 1980s (Wong 1991).

**Figure C. Changing Expenditure Shares in Percent of GDP**



Source: Calculated from Compendium of Local Fiscal Statistics.

While the TSS saved the Chinese fiscal system by reversing the fiscal decline, its impact on rural public finance was more adverse. Some salient trends are presented in Table 10 to show the changing status of rural public finance. From the mid-1980s, under decentralization both revenue and expenditure shares were increasing for the rural sector and the two were closely balanced. After the central government recaptured a majority share of revenues in the TSS reform in 1994, the trends were reversed. The county and township governments' share of revenues fell sharply, from 30 percent in 1992 to only 17 and 18 percent in 2004 and 2005. On the expenditure side their share fell only moderately, from 31 percent in 1992 to 28 percent in 1998 and 29 percent in 2002. The result of these divergent trends was the growth of a vertical fiscal gap for these local levels, to 8 percent in 1998 and 14 percent in 2005 (or, in GDP terms, to 3 percent).

**Table 10. Trends in Rural Public Finance**

(percent)	1986	1988	1990	1992		1998	2000	2002	2005
<b>Rural share of total expenditures</b>	<b>24.7</b>	<b>28.3</b>	<b>29.7</b>	<b>30.9</b>		<b>28.2</b>	<b>26.2</b>	<b>28.6</b>	<b>32.6</b>
County	19.2	21	21.3	21.6		19.9	18.9	21.9	26.7
Township	5.5	7.3	8.4	9.3		8.3	7.3	6.8	5.9
Township share of rural	22.3	25.8	28.3	30.1		29.3	27.8	23.7	18.1
<b>Rural share of total revenues</b>	<b>21.7</b>	<b>28.6</b>	<b>28.4</b>	<b>30.1</b>		<b>20.3</b>	<b>19.7</b>	<b>17.1</b>	<b>18.2</b>
County	12.5	17.1	16.1	16.6		11.5	12	11	13.3
Township	9.2	11.5	12.3	13.5		8.8	7.7	6.1	4.9
Township share of rural	42.4	40.2	43.3	44.9		43.5	38.9	35.6	26.9
<b>Fiscal gap for rural</b>	<b>-3</b>	<b>0.3</b>	<b>-1.3</b>	<b>-0.8</b>		<b>-7.9</b>	<b>-6.6</b>	<b>-11.6</b>	<b>-14</b>
County	-6.7	-3.9	-5.2	-5		-8.5	-6.9	-10.9	-13.4
Township	3.7	4.2	3.9	4.2		0.6	0.4	-0.7	-1
<b>As % GDP</b>	<b>-0.7</b>	<b>0.1</b>	<b>-0.3</b>	<b>-0.1</b>		<b>-1</b>	<b>-1.1</b>	<b>-2.1</b>	<b>-2.9</b>

Note: \* The fiscal gap is measured as revenue share minus expenditure share.

Source: Compendium of Township Financial Statistics, 1986-1992; World Bank (2002); and MOF provincial dataset 2003; and Compendium of Local Fiscal Statistics, 2005.

More importantly for the rural areas, the TSS also produced sharply divergent trends for townships and counties. Up through 1992, township revenues had grown rapidly, due to the rapid growth of township and village enterprises, and they financed growing expenditures. These trends were reversed after the TSS. Between 1992 and 1998, the township share of revenues fell steeply, as the product taxes from TVEs were converted to VAT, whose revenues were mostly captured by higher-level governments – as discussed earlier. Township revenues continued to fall from 1998 to 2005, with the RFR and the reassignment of the EIT cutting into the rural tax base. The abolition of the agricultural taxes also added to this decline. In 2005 townships accounted for less than 5 percent of total revenues – compared to 13.5 percent in 1992.

The township's share of expenditures also fell from 1992 onward, albeit more slowly than revenue. This decline is mainly caused by the reassignment of some functions to the county level – for example, education, which had absorbed up to 40 percent of township expenditures, was reassigned to counties starting in 2002. In the 1990s it may have also reflected a squeeze on services provided by townships (and villages) as their revenues declined.

In contrast, the county's share of expenditures has increased since the late 1990s even

though its revenue share remained relatively constant. Consequently, the relative power between the county and township level has shifted significantly toward the former. By 2005, the share of the township in the combined (county plus township) budget was only 27 percent on the revenue side and a mere 18 percent on the expenditure side. These figures in fact understate the relative decline of the townships, since the Rural Fee Reform implemented beginning in 2001 has sharply curbed their ability to raise fee revenue and accelerated the process of “hollowing out” of the township level (Kennedy, 2007). The effect of the RFR has hollowed out village finances as well.

The overall trend for the rural sector is toward greater central control. Given the growing fiscal gap, rural local governments are increasingly dependent on central transfers, which, *ceteris paribus*, reduce local government autonomy. Within the rural sector, too, there is a clear centralization toward the county, away from townships and villages, and further from the people.

### **3. The Organization of Rural Public Finance**

The intergovernmental fiscal system sets the rules and determines the resource envelope for rural public finance. In this section we turn to exploring what happens on the ground, at the grassroots local authorities.

#### **3.1. The County**

The county is arguably the most important level of grassroots government, and for achieving the objectives of building the NSC. The number of county-level jurisdictions has declined rapidly in recent years, as an increasing number are being reclassified as urban districts and county-level cities as urbanization has spread throughout China. In 2007 there were 2,804 county level units, including 1,580 counties, 368 county-level cities, and 856 urban districts.<sup>23</sup> Excluding county-level cities and districts, a typical county has 20 towns and townships, perhaps 300 villages, and a population of close to a half million, the vast majority (on average 85 percent) of whom are rural. Agriculture is the largest sector in terms of employment and

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<sup>23</sup> Including national minority autonomous counties.

often still the largest sector in terms of GDP. However, the diversity among counties in size, administrative structure, socio-economic situation, etc. is enormous. For example, a county can have a population ranging from 10,000 in some remote areas to well over 1 million; and a GDP as small as RMB 10 million or larger than RMB 10 billion.

The administrative structure of county government largely corresponds to that of higher levels, but with some variation. Under the “dual rule” system, many county government departments receive instructions from both the county (the Party committee and county head) and administrative guidance from counterpart agencies at higher levels. Almost universally, the institutional structure consists of the Party committee; the government; the people’s congress and the people’s consultative conference; and the judicial organs such as the courts and procuratorate. A typical county government has 25 or more departments or agencies, each of which has a counterpart in the province and at the central level. Usually attached to the county government are hundreds of public service units (PSUs), including hospitals, primary and middle schools, and other units providing services. Included under PSUs are units with core government authority such as the local tax offices stationed in the townships,<sup>24</sup> as well as units that are managed largely as commercial entities. The bulk of county government staff is employed in these PSUs.

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<sup>24</sup> Anomalously, township level fiscal and tax offices are in many provinces classified as PSUs, rather than as core government departments.

In absolute terms the fiscal capacity of counties has increased steadily over the last decade. Since 1995, fiscal expenditures of counties (excluding county-level cities) have increased by close to 15 percent annually, but with slower growth in the 1990s and very substantial growth of around 20 percent since 2000. While county budget expenditures were RMB 323 per capita in 2000, they had more than doubled to RMB 731 in 2005 (Table 11). During the same period, though, the share financed from own revenues had fallen steadily, from around half in the mid-1990s to only one-quarter in 2005.

**Table 11. Revenue and Expenditure of Counties, 1995-2005**

Year	Budget Revenue (RMB per capita)	Own Revenue (as share of budget rev.)	Budget Expenditure (RMB per capita)	Budget Expenditure (y-o-y increase)	C.V. of revenues per capita	C.V. of expenditures per capita
1995	183	0.47	192	19%	0.70	0.67
1996	227	0.50	233	21%	0.72	0.73
1997	250	0.50	254	9%	0.71	0.72
1998	267	0.53	267	5%	0.80	0.74
1999	308	0.49	300	12%	0.88	0.71
2000	325	0.46	323	8%	0.84	0.72
2001	418	0.40	405	26%	0.87	0.77
2002	495	0.34	489	21%	0.87	0.74
2003	569	0.34	557	14%	0.90	0.77
2004	647	0.31	636	16%	0.91	0.78
2005	731	0.25	727	14%	1.04	0.87

Source: Based on Compendium of Fiscal Statistics for All Prefectures, Cities, and Counties, various years.

There is tremendous variability across counties. This is shown in the last two columns of Table 11, where the coefficients of variation in per capita own revenues and own expenditures are large, and have been growing. Per capita expenditures of the fiscally richest quintile of counties (excluding urban units) exceed those of the poorest quintile by more than 4 (4.2 in 2003),<sup>25</sup> a disparity that is large even in light of cost differences in service delivery and different expenditure assignments across counties. While the ratio has declined somewhat since the beginning of the decade, it is still higher than in 1995 (of 3.9). In fact, this picture understates the real extent of disparity across localities. Since the capacity to raise

<sup>25</sup> Calculated from Compendium of Fiscal Statistics for All Prefectures, Cities, and Counties, various years.

non-budgetary resources is correlated with land values, which are in turn correlated with economic growth, a more comprehensive picture that includes budgetary and non-budgetary expenditures would likely show even greater disparities across counties.

Moreover, the inequalities between counties are large even within provinces, as well as across provinces (Table 12). These differences may be partly explained by the heterogeneity within provinces, especially in a huge province like Sichuan; they may also reflect the different emphases individual provinces place on fiscal equalization. Through the decade of 1995-2005, there was no clear trend of decline.

**Table 12. Variation of County Budget Expenditures by Selected Provinces**

	Sichuan	Henan	Zhejiang	Jiangsu	Shanxi	Jilin	Hebei
1995	0.65	0.37	0.41	0.26	0.31	0.46	0.33
2000	0.73	0.34	0.40	0.33	0.43	0.44	0.32
2003	0.84	0.29	0.41	0.38	0.30	0.40	0.30
2004	0.83	0.34	0.45	0.41	0.32	0.43	0.38
2005	0.81	0.37	0.38	0.39	0.34	0.41	0.35

Note: Measured as Coefficient of Variation in Per Capita County Budget Expenditure.

Source: China Prefectures, Cities, and Counties Fiscal Statistics, various years. Authors' calculations.

### 3.2. The Township

Townships and towns are the lowest level of the five-tier government structure. In 2007 there were some 34,400 townships and towns. Due to a continued push to merge or eliminate townships, the number is decreasing rapidly (Table 13). The average population of a township is about 24,000. With the exception of a small portion of the population residing in the township seat, township residents have a rural *hukou* (household registration). A typical township has 15 administrative villages, but this number differs widely from region to region.

**Table 13. Declining Number of Townships**

	1985	1990	1995	2000	2005	2007
<b>Number of township-level jurisdictions</b>	72,153	55,838	47,136	43,735	35,509	34,379
<b>of which: towns</b>	-	-	-	-	18,888	-

Source: China Statistical Yearbook 2007, China Statistical Abstract 2008.

The core township institutions are broadly similar to those of the county and higher levels of government. They include a Party committee, specific government sectoral offices, the people's congress, the procuratorate and judiciary, mass organizations,<sup>26</sup> etc. However, this traditional structure is changing. For example, it is not uncommon for the Party committee, the Government Administrative Office, and the people's congress to be combined into one unit, "the office of the Party and government". In addition, the townships have a number of PSUs. In the past, these were often referred to as "seven stations and eight offices", but recent organizational reforms have promoted mergers to create fewer (3-4) "service centers". For example, the agricultural, husbandry, irrigation, agricultural machinery and technology, and forestry units are often merged to create an "agricultural service center"; the arts, sports, and communication sectors into a "cultural service center"; and those sectors related to social security into a "social services center."<sup>27</sup>

The role of townships has varied substantially over time and space, but over the last few years they have generally been demoted and become increasingly subordinated to counties. Townships are descended from the former people's communes, which had been largely self-contained units that provided for basically all public goods and services. The process of emergence of the township varied widely across provinces, however, and the capacity of the replacement organs often depended on whether and how much collective assets there were to inherit. As a result, the division of responsibilities between townships and counties varied across regions, and remained quite fluid (Wong 1997 and World Bank 2002). Townships also assume limited responsibility for rural health care and for social safety, and were responsible for basic education until 2002. In recent years, as the central government has assumed major responsibility for rural infrastructure, the earmarked transfers for project finance are largely turned over to county management.

The core responsibilities of townships are increasingly limited to a few areas, such as those

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<sup>26</sup> For example, the Communist Youth League, the All-China Women's Federation, etc.

<sup>27</sup> This township government structure might be called "one office and three or four centers". Despite formal changes in structure, the centers still assign their employees responsibility for different jobs, such as agricultural techniques, agricultural machinery, culture, and communications, etc. Therefore, in practice there has not been a major change. In our interviews, most of the leaders in the township government still used the old names to describe their internal organization.

related to agriculture or family planning. Of course, townships have responsibility for implementing the policies of higher-level governments and for assisting in the administration of higher-level programs, but as subordinate agents of the counties rather than independent levels of government.

Township finances are largely determined by the “county-township fiscal system”, where the rules are established essentially independently in each county. A “contract” is negotiated between the county and its townships and might differ even among the various townships within the same county.<sup>28</sup> Typical elements of a county-township contract stipulates the “bases” for expenditures, usually made on the basis of the salaries and operational expenses for which the township is responsible; the “bases” for the sharing of local revenues; rules for the sharing of the surplus or deficits between actual revenue collection and the revenue “bases”; “system remittances” or “system subsidies”; and rules on how often the contract would be renegotiated. The rules – and indeed all the arrangements – are highly discretionary and often set incentives that are undesirable from a macro point of view.<sup>29</sup> The sources and composition of township revenues in Table 14 shows the ‘hallowing out’ of township finance.

**Table 14. Structure of Township Revenue, 2000 and 2004**

	2000		2004	
	RMB/capita	percent	RMB/capita	Percent
<b>Local Taxation Income</b>	<b>95</b>	<b>100</b>	<b>129</b>	<b>100</b>
Value-added Tax	18	19	20	16
Business Tax	13	13	42	33
Income Tax for Enterprises	6	6	5	4
Individual Income Tax	7	7	7	5
Agricultural Tax	19	21	26	20
Agricultural Specialty Products Tax	13	14	0	0
Occupied Land Tax	1	1	3	2
Other Income	18	20	26	20
<b>Township-to-County Transfers</b>	<b>34</b>		<b>93</b>	

<sup>28</sup> Important adjustments that determine the sharing of funds (and, hence, power) for several years, such as those on the level of “bases,” are usually the outcome of extensive negotiations between county and township governments. Anecdotal information from our field work suggests that final documents are issued after five or more rounds of discussions.

<sup>29</sup> For example, the incentives for townships to fulfill their revenue base might be so strong that they borrow funds – reportedly even from neighboring townships – in order to be perceived as fulfilling their revenue base.

	2000		2004	
	RMB/capita	percent	RMB/capita	Percent
<b>County-to-Township Transfers</b>	<b>58</b>		<b>84</b>	
<b>Disposable Fiscal Resources</b>	<b>119</b>		<b>119</b>	
Total Extra-budgetary Income	55		53	
Total Self-raised Income (incl. <i>tiliu</i> )	37		10	
<i>Tongchou</i> (township levy)	20		0	
<i>Tiliu</i> (village accumulation)	14		0	
Other	4		10	
<b>Total Fiscal Revenues</b>	<b>211</b>		<b>182</b>	

Source: fieldwork survey.

### 3.3. The Village

Villages figure prominently in the NSC as the basic unit of the xiaokang society in the countryside. In 2005, China had a total of 640,139 administrative villages (China Statistical Yearbook 2007).<sup>30</sup> A typical “administrative village”<sup>31</sup> (*cun*) generally has a population of 1,000 to several thousand people, but can be as small as only a few hundred or as large as 10,000 people. The average village in our sample survey of 100 had a population of about 1,400 people, a labor force of about 700, an average net rural income of RMB 2,600 (2004), and a total cultivated area of about 2,270 mu (150 ha).<sup>32</sup> Most administrative villages consist of a number of “village groups” that are generally established at the level of a natural village. Usually an administrative village comprises only a few village groups, but some have up to ten or even more in the more mountainous areas. These natural villages are the most basic unit of the community; the administrative village is formed to have sufficient scale for local administration and the provision of basic public services.

Village administrations are “self-governing,” and are led by the Party. By law, the village assembly is the highest authority in village self-governance. Day-to-day activities of self-governance are carried out by the village committees. The village head (village committee director) and village committee members are elected by the villagers. However, the village

<sup>30</sup> The number of village committees has declined by about 11.5 percent in the five-year period from 1999 to 2004.

<sup>31</sup> The traditional term “administrative village” is used here, since the formal term “village committee” has a second meaning referring to the self-governing organization of the village.

<sup>32</sup> This sample is described in detail in World Bank (2007 - RPF), Annex 5.

committee is subordinate to the village Communist Party secretary, who is a nominated official.<sup>33</sup>

The specific authority of the village administration, and hence the scope of village finance, is largely undefined and varies widely in practice. As noted earlier, villages play an important, albeit supplementary role, in implementing government policies and in the provision of public services. For example, a road or an irrigation canal passing through a village may be formally “owned” by the township, but in practice the township government takes little responsibility for the operation and maintenance of most small-scale infrastructure. Likewise, responsibility to provide a social safety net may formally be a government responsibility, but the village may still feel the need to engage in this area if the government fails to provide adequate funding. However, the willingness and ability of the various village administrations – under the leadership of the Party secretary – to engage villagers in the provision of public services vary enormously. Moreover, the authority of the village administration vis-à-vis that of the township is not clearly defined and varies quite widely in practice.

The township usually has a strong influence over village finances, including in the direct payment of village cadres. In fact, most village accounts today are administered by the township, and village accounting books are kept with the township. This is intended to reduce corruption at the village level by taking the financial accounts away from the village leadership, but it also limits village authority, and incentive, to manage its own business.

Village revenues are very limited, and constraints have become more accentuated over time. The sources of village revenue are shown in Table 15, which shows village revenues of about RMB 80 per capita in 2004. The salient feature of village finance is the preeminence of non-budgetary sources of revenue. For the “average” village in our survey, only RMB 23

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<sup>33</sup> Usually, the village-level Party institution is a branch of the Party committee at the township level rather than a Party committee itself, so the village-level head is a head of the Party branch committee. The relationship between elected village committees and village Party committees can be contentious. Measures to mitigate this problem include encouraging the village Party secretaries to run for village head, so that he/she combines both positions (one shoulder pole – *yi jian tiao*), or experiments such as those in Shandong or Handan of Hubei that aim at standardizing the power of the respective bodies and include the establishment of a “joint conference of the village Party branch and the village committee” (Fewsmith 2006). In addition to the village committee and the Party committee, most villages have so-called small groups (*xiaozu*) for financial affairs, cultural affairs, etc.

came from in-budget revenues, from transfers and the expanded agricultural tax surcharge. All the rest – nearly RMB 60 – came from fees and rental incomes from collective assets. In 2000, before the rural fee reform abolished the *tiliu* (village fee assessment), the portion of nonbudgetary revenues was even higher.

**Table 15. Village Revenue by Categories, 2000 and 2004**

in RMB per capita		2000		2004	
		Mean	% of total	Mean	% of total
1	Transfers from above	4.6	5.9	17.8	21.7
2	Regular fee assessments ( <i>tiliu</i> )	30.0	38.1	0.2	0.2
3	Surcharges on agricultural tax	0.2	0.2	4.7	5.7
4	Contract payments for land	8.1	10.3	12.0	14.6
5	Contract payments for enterprises	5.8	7.4	7.9	9.6
6	Land and asset sales	15.8	20	23.5	28.6
7	Other revenues	14.3	18.2	16.0	19.5
8	Total revenues	78.7	100	82.1	100.0

Note: “Other revenues” include income from: administration fees charged to village enterprises; shared profits with village enterprises; fines for violating the birth control policy; fines for other penalties; interest, rents, and repayment of credits; collective operations; etc.  
Source: 2005 Village survey data.

Villages vary tremendously in terms of their financial strength, investments, and provision of public goods and services. This is shown in Table 16. In 2004 per capita village revenues were highest in Jilin and Jiangsu, with RMB 156 and RMB 110, respectively. Villages in these two provinces also received the highest transfers. Transfers to other provinces were much smaller, with total village revenue in Sichuan amounting to only RMB 23 per capita. Similarly, per capita capital investments in villages ranged widely, from RMB 353 in Jiangsu to only RMB 63 in Hebei, and per capita village debt was as large as RMB 542 in villages in Shanxi and only RMB 91 in villages in Sichuan.

**Table 16. Village Financing by Province and Poor Villages in 2004**

<i>RMB per capita</i>	<b>Total</b>	<b>Jiangsu</b>	<b>Sichuan</b>	<b>Shanxi</b>	<b>Jilin</b>	<b>Hebei</b>	<b>Poor</b>
<b>Revenues</b>	82	110	23	48	156	41	134
Transfers from above	18	20	9	7	42	3	46
<b>Total Expenditure, incl. debt-financing</b>	95	168	56	52	104	50	85
Recurrent Expenditures	40	62	20	27	54	22	38
Repayment of Principal	13	9	8	8	34	4	29
Total Capital Expenditures	42	97	28	18	17	24	20
Deficit/Surplus	-13	-58	-33	-4	52	-9	50
<b>Total Public Goods Investment</b>	191	353	215	156	78	63	171
<b>Total Village-level Liabilities</b>	253	177	91	542	275	355	664

Note: "Poor" is defined as the 20 percent poorest villages.

Source: 2005 village survey.

### **3.4. Beyond the Budget: Financing Rural Infrastructure**

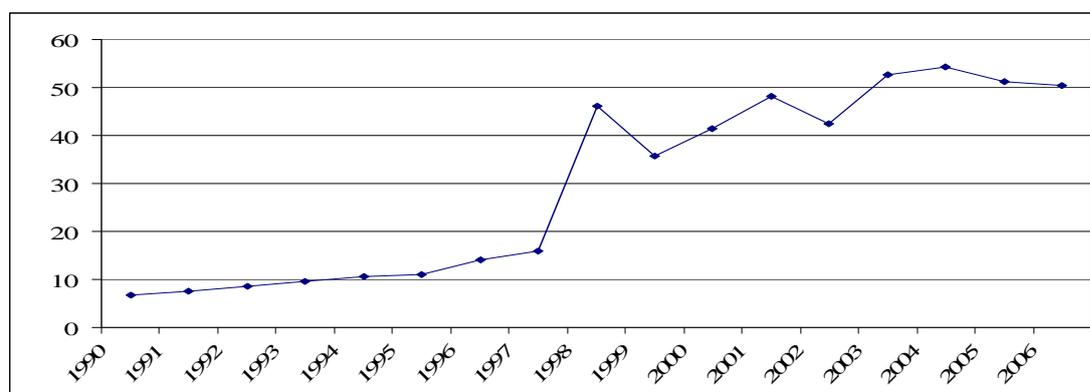
Infrastructure investments are the driving force behind village finance; this is especially true in recent years. Fieldwork studies and survey research consistently find investment in infrastructure such as roads, water supply, irrigation, etc., to be considered the most important public functions played by village authorities (e.g. Zhao et al 2006, Zhang et al 2007, Yi et al. 2008). This was reflected in Table 16, where public goods investments far outstripped recurrent expenditures in the 100 villages surveyed. It is further highlighted in Table 17, where, on average, villages spent RMB 42.5 per capita for capital investments in 2004, compared to recurrent spending of RMB 40.1.

**Table 17. Village expenditures by category**

<i>RMB per capita</i>	2004	
	Mean	% of total
<b>Expenditures for recurrent costs</b>	<b>40.1</b>	<b>64</b>
Salaries	14.4	21
Administration	6.7	13
Maintenance	8	15
Social welfare	6.1	5
Others	5	9
Repayment of principal	12.9	16
<b>Capital investment expenditure</b>	<b>42.5</b>	<b>33</b>
Financed by current rev	17.3	21
Financed by debt	25.2	12
<b>Total expenditures excl. debt</b>	<b>70.3</b>	<b>100</b>
Total expenditures incl. debt	95.5	112

Source: 2005 village survey.

Nationwide, spending on rural basic infrastructure has increased enormously in recent years. Reflecting the tilt toward the rural areas, the government took the opportunity of the fiscal stimulus program (introduced in 1998) and the new resources created through state bond issues to channel additional funding to rural infrastructural investments. In 1998 alone, the amount jumped by RMB 30 billion, leading to a near tripling of expenditure from the level of 10-15 billion in the mid-1990s (Figure D). Since 2003, annual spending on rural basic capital investment has remained above RMB 50 billion.

**Figure D. Rural basic capital investment spending (RMB billions)**

Source: CSY 2007.

The increased funding from the central government enabled an enormous expansion of

investment in rural areas, with ramifications through all three levels of rural authorities. Under the current intergovernmental assignments, the responsibility for infrastructural investment is dispersed among all levels of government in China. Until 1985, at the subnational level all capital expenditures were approved and financed by the provinces, but they have since been devolved to each locality (World Bank 2002). All three levels of rural government engage in infrastructural investments, financed largely with extrabudgetary resources including debt.

As local governments are not legally permitted to borrow, however, this has created a dilemma where local governments are reluctant to report on debt – and the capital investments they financed. Moreover, the planning and budgeting for capital investment is not integrated with the budget, and reporting is scattered. For these reasons, complete and accurate data on infrastructural investments are virtually nonexistent in China.

Paradoxically, because they are not required to submit periodic reports to the fiscal system, which focus on budgetary resources and largely ignore nonbudgetary items, village accounts – to the extent they exist – tend to present a more comprehensive treatment of resources used. In this section we rely heavily on village accounts and extrapolate from them to other levels.

The increased central funding has created more local spending requirements. In the villages surveyed, annual infrastructural investments almost quadrupled from 2000 to 2004. Table 18 shows per capita investment rising from RMB 48 in 2000 to RMB 191 in 2004, while the share of government financing jumped from 21 to 59 percent. In 2000, when villages were largely financing infrastructure on their own, village commitments accounted for about 47 percent of the total. In addition, households contributed about 18 percent through special assessments on farmers (*jizi*). The picture changed dramatically by 2004, when transfers from higher level governments financed 59 percent of the total, or more than RMB 100 per capita. Because of the quadrupling of total spending, however, contributions from the villages also increased in absolute terms, from RMB 23 in 2000 to RMB 44 in 2004, and that from households from RMB 9 to RMB 21. In addition, since the data in the table looks only at financial investments and excludes the unpaid labor input by the villagers themselves, it understates household contributions to infrastructure by about RMB 10 per villager, about 5

percent of total investment.

**Table 18. Funding of Village Capital Investments**

	Mean (RMB /capita)	Percentage financed from:			
		Gov't	Village Committee	Farmers	Others <sup>b</sup>
<b>2000</b>					
Roads & Bridges	15	23	47	29	2
Irrigation & Drainage	10	42	31	21	5
Drinking Water Supply	4	5	2	4	90
Others <sup>a</sup>	19	12	66	11	11
<b>Total</b>	<b>48</b>	<b>21</b>	<b>47</b>	<b>18</b>	<b>14</b>
<b>2004</b>					
Roads & Bridges	124	65	23	11	1
Irrigation & Drainage	20	51	28	10	11
Drinking Water Supply	18	43	24	19	14
Others <sup>a</sup>	30	52	13	7	28
<b>Total</b>	<b>191</b>	<b>59</b>	<b>22</b>	<b>11</b>	<b>8</b>

a. Others include schools, clinics, electricity, office buildings, green for grain, telephones, cable television, broadcasts, etc.

b. Others includes donations from abroad, donations from enterprises, donations from universities, small group investments, private investments, investments from power supply corporations, investments from broadcast bureaus, etc.

Source: 2005 village survey.

The same process has also driven up expenditures for infrastructure at the township and county levels. According to our survey of 50 townships, in year 2000, investments were only RMB 77 per capita for building roads, schools, irrigation, and other public goods infrastructure projects. By 2004, this amount had nearly tripled, to RMB 217.<sup>34</sup> At the township level a large part of the increase was for rural roads, which accounted for more than half of total investments in 2004 (Table 19).

<sup>34</sup> The townships are not always aware of infrastructure investments in their villages that are financed purely by the villages themselves. Hence, the figures presented underestimate the total capital investments in a township. This also explains, at least in part, the differences between what is stated here and what is stated by the villagers (see section below) regarding the share financed by the village.

**Table 19. Funding of Township Capital Investments**

	Mean	Percentage from...		
		Higher government	township	village
	2000 <sup>a</sup>			
<b>Total</b>	77	26	64	10
Roads & bridges	22	23	57	20
Irrigation	11	48	31	21
Drinking water	8	45	49	6
Schools	26	16	83	1
Clinics	1	11	89	0
Other <sup>b</sup>	9	24	75	1
2004				
<b>Total</b>	217	53	37	10
Roads & bridges	115	60	30	10
Irrigation	31	32	58	10
Drinking water	17	67	18	15
Schools	19	43	53	4
Clinics	4	58	42	0
Other <sup>b</sup>	31	45	43	12

a: Total sample is 50 townships in five provinces; only 48 townships have complete information; 1 missing in Shaanxi and 1 missing in Hebei.

b: Others include electricity, office buildings, green for grain, telephones, cable television, broadcasts, etc.

Source: 2005 township survey.

Increasing capital investments have put enormous pressure on village, township and county finances, at a time when reforms are sharply cutting revenues especially at the village and township levels. As shown in Table 19 for the townships surveyed, township contributions have in fact declined substantially as a share of total capital investments, from almost two-thirds (64 percent) in 2000 to just 37 percent in 2004. Nevertheless, this still represented an increase in absolute terms, from about RMB 49 per capita in 2000 to RMB 80 per capita in 2004.

#### *Land, asset sales, and debt*

It had been shown earlier in Table 15 that regular fee assessments (*tiliu*) had provided some 40 percent of revenues for villages in 2000, and a roughly equal amount was drawn from contract payments for land and collective enterprises and land sales. With the rural fee

reform eliminating the *tiliu* but receiving only 60 percent in revenue replacement transfers in 2004, villages had to rely more heavily on the latter, especially land-related fees and the sale of land use rights and other assets. Among 100 surveyed villages, the number selling land rights increased from 3 to 4 per year in the early 1990s to 24 in both 2003 and 2004, or nearly one-quarter of our sample. Other assets, including buildings, equipment, and timber, were increasingly sold as well – we found almost a tripling in the frequency of sales, from 10 times in 1998 to 29 times in 2004. Revenue from these sales in 2003 and 2004 that went to the village (after netting out compensation to households) averaged RMB 35,000 per village, in addition to the RMB 35,000 for land-related transactions.

Nationwide, revenues from land transactions have become an important part of the income of local governments at the municipal, county, township and village levels. Official data show that from 2001 to 2003, total revenue from land-use right transfer fees was as high as RMB 910 billion (World Bank 2005a). In some municipalities and counties, these revenues were greater than the governments' fiscal revenues. In addition, local governments are increasingly taking out loans using requisitioned land as collateral through the creation of "land banks," and these loans have become an even greater source of funds than the land-use right transfer fees in many areas. Together, a joint State Council Development Research Center-World Bank study found these land transaction-related revenues to be financing 80 to 90 percent of total investment in infrastructure in many areas (World Bank 2005a, Zhang 2007).

Aside from selling assets, local governments are borrowing. Our survey found total village liabilities amounted to more than RMB 250 per villager in 2004.<sup>35</sup> This implies a total debt of all villages in China equal to about RMB 240 billion. Table 20 shows the size and sources of village debt in 2004.

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<sup>35</sup> There are large differences across provinces in the magnitude of these debts (Table 16). The highest debt was in Shaanxi, at RMB 462.1, followed by Jilin (RMB 397.2), and then Hebei (RMB 338.6), Jiangsu (RMB 145.2), and Sichuan (RMB 45.4).

**Table 20. Village Liabilities in 2004**

<i>RMB per capita</i>		Mean	Percentage >0	Percent of total
1	Total	253	86	100.0
2	Financial institutions	120	58	47.5
3	Higher levels of government	21	25	8.2
4	Enterprises	36	46	14.1
5	Unpaid wages	14	41	5.7
6	Farmers	42	53	16.4
7	Other	21	25	8.2
8	<i>Estimated % to be repaid</i>	55		

Source: 2005 village survey.

Selling assets and borrowing are common mechanisms used by governments around the world to finance capital investments. If managed properly, these are considered efficient and equitable means of finance for long term capital. As long as the investments yield returns greater than or equal to the financing costs of these debts, the debts should be financially sustainable, and there is no intergenerational transfer of burdens. In all countries, however, the challenge is to keep a close watch over local borrowing to ensure macroeconomic stability and sustainability. What is worrisome in the Chinese case is the lack of transparent information on the scale of local government debt and its growth. Based on data from 57 counties in three provinces, Wang (2006) estimates county government debt to be as high as 14 percent of GDP. As for the sale of land use rights, the need to impose limits is urgent, to safeguard farmers rights and ensure adherence to national priorities for urbanization and food security. Given the current ambiguous property rights over agricultural land, the risk of abuse of farmers is high.

#### **4 Institutional Impediments to Improving Rural Public Finance**

The discussion above has highlighted the diverging trends between recurrent and capital spending at the village and township levels: while reforms were reducing the role of these two levels in the provision of social services and moving resources and responsibilities to the county, policies to improve rural infrastructure were having the opposite effect – creating growing burdens for villages and townships and exacerbating their fiscal gaps. This section turns to the institutions and organization of government to identify some impediments to the

efficient functioning of rural public finance. These include the weak and constrained planning and budget processes at rural governments, the distorted incentives embedded in the personnel system for public employees, the multiplicity of government agencies managing agriculture and rural affairs, and the weak information system for monitoring and evaluating rural development.

#### **4.1. The Planning and Budgeting Processes**

Despite the high degree of expenditure decentralization in China, local governments lack formal autonomy over budget decisions (World Bank 2002, OECD 2005). All taxing power resides with the central government, and local governments have little leeway for revenue mobilization *within the budget*.

On the expenditure side, the large and growing number of spending mandates cascading down from higher levels constrain allocative autonomy at the lower levels. When aggregated, these mandates sometimes exceed the fiscal and administrative capacities of local governments. For rural governments, this is exacerbated by the multiplicity of upper level agencies that are making policy and sending directives downward.

The high dependency on transfers, in a system where more than half of the transfers are earmarked for specific spending purposes, also severely limits the fiscal authority of local governments. On average, county governments depend on transfers for about one-half of their expenditures, and the share is much higher for townships and villages, as well as for poor counties.<sup>36</sup>

The weaknesses of the transfers system are legion, chief among them leakage and lateness. Sitting at the bottom of the multi-tiered administrative system, rural governments are the most disadvantaged. Funds often do not reach them in line with the annual budget process or even the next planning period. Uncertainties in the availability of specific projects and of transfer funds further undermine local budgeting. In fact, expenditures financed by earmarked transfers are frequently not included in local budgets at all because the funds do not pass through the

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<sup>36</sup> In keeping with the new practice of Ministry of Finance, these figures for transfers exclude tax rebates.

fiscal system, and reconciliation is done at a later time, if at all. We found, for example, in fieldwork to Ninglang County (Yunnan), that more than half of the budgetary expenditures are not budgeted by the county. Similarly, in Huaxian we spoke with township leaders who basically had no information about a road project in their township, since it was implemented by the county. Zhao et al. (2005b) reports that “no one at the grassroots levels has a comprehensive account of earmarked subsidies that pass through their territorial unit.”

The usefulness and efficiency of large numbers of often small projects designed at higher – often central – level is questionable. This is illustrated by the agricultural departments in Huaxian, a poor county in Henan. The county’s Agriculture Bureau received and implemented 13 different types of project transfers in 2002 and 2003, an increase from 10 in 2001. The average size of these transfers, aside from a large “good seeds” project worth RMB 4 million, was only around RMB 150,000. In addition to the Agriculture Bureau the county has many agriculture-related line bureaus, including an Animal Husbandry Bureau, an Agricultural Mechanization Bureau, a Forestry Bureau, a Water Resources Bureau, a Grain Bureau, a Land and Natural Resources Bureau, a Comprehensive Agriculture Development Bureau, etc. All of these have their own earmarked transfers.

The personnel system imposes another severe constraint on county governments’ ability to implement a better budget process. Decisions on the complement of agencies and staff positions assigned are approved by a joint Party-government agency set up at each administrative level and by higher-level committees that ultimately report to the State Commission on Public Sector Reform. Local governments have little power to change their formal institutional and personnel structures. Moreover, the salaries and benefits of government employees are also determined by the higher levels. Since personnel costs are by far the largest component of expenditure for local governments – accounting for some 70 percent of total subnational budgetary expenditures in 2004, taking the decision power over personnel out of the budget severely undermines the budgeting process.

The personnel system creates distortions in local government incentives. Nominally, China maintains a nationally unified civil service system under which the central authorities set the basic salary scales and levels, and these apply to public employees at all administrative

levels. National standard salaries for a country as large and diverse as China naturally lead to overpayment in the economically poorest areas and underpayment in richer areas relative to the economic strength and salary levels of those localities. To compensate, rich areas provide large supplementary payments to “top up” basic salaries, and these are generally much less controlled.<sup>37</sup> In poorer areas, the overpayments contribute both to excessive staffing costs and growing pressure to add staff. These tendencies have been greatly exacerbated by the rapid growth in government salaries in recent years -- 15 percent p.a. during 1998-2003, and with another hefty increase in July 2006 (CFY 2007).

In practice, local governments often add more employees than approved, resulting in “overstaffing.” Overstaffing, i.e., local governments employing more staff than the number of approved posts, is widespread in China, and was found by the study team in all three counties visited.<sup>38</sup> On the one hand, the hiring of such additional staff may reflect a mismatch between officially approved posts and staffing requirements. More often, though, this is a way for local government leaders to support specific individuals and their families, in particular since the hiring process for such staff is usually much less transparent than that required, for example, for civil servants at higher-level governments. Moreover, a number of county governments still regard it as their responsibility to offer jobs to any college graduates of their county, if they cannot otherwise find a job. This tendency to increase staffing levels leads to soft budget constraints for county governments since salary payment for all government-employees is the top priority of the government and a cause for bail-outs by higher-level governments.

The pernicious effect of overstaffing on rural services can be glimpsed in the example of agricultural agencies in an extremely poor county in Yunnan (Table 21), where overstaffing had inflated personnel costs to absorb the entire budget, leaving little operating costs to provide services. As a result, the staff in these bureaus rarely went to the fields since there was no

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<sup>37</sup> During the salary reforms starting from 1998 the Central Government had called for a *Sunshine Salary* that would put all salary items into a formal payment list, but to date the policy has not been implemented as a national standard.

<sup>38</sup> Additional staff are usually hired in PSUs rather than in core government agencies, and they often have a different employment status than regularly-hired personnel.

money for fuel for the agency vehicles.<sup>39</sup>

**Table 21. Uses of Budget Appropriations for Agricultural Units, Ninglang County, 2003**

(RMB 10,000)	<b>Total</b>	<b>Salary</b>	<b>Operating</b>
Agriculture Bureau*	251.0	249.5 (99.4%)	1.5 (0.6%)
Animal Husbandry Bureau	106.8	105.5 (98.8%)	1.2 (1.2%)
Forestry Bureau	367.6	365.6 (99.5%)	2 (0.5%)

Note: The Agriculture Bureau excludes the Animal Husbandry Bureau, but includes the Farm Machinery Bureau, Seed Bureau, etc.

#### **4.2. The Organizational Structure at the Central Level**

Compounding the complicated transmission of policies and resources downward is the complexity of communication horizontally across government agencies. Currently many government agencies are involved in the financing and implementation of public goods and services for rural development, including at the central level. Under the leadership of the State Council, the two “super-ministries,” i.e., the National Development and Reform Committee (NDRC) and the Ministry of Finance (MOF), have the greatest decision-making power. They are not only planning and coordinating bodies for the other line agencies, but they also channel funds through their own systems. For instance, the Food-for-Work (FFW) poverty program and other infrastructure-related programs are administered by the NDRC; the Comprehensive Agriculture Development (CAD) program is implemented by the State Office for CAD under the MOF (SOCAD) and its corresponding agencies at the subnational level.

The line agencies with the most direct involvement in agriculture and rural development include the Ministry of Agriculture (MOA), Ministry of Water Resources (MWR), Ministry of Land and Natural Resources (MLR), State Forestry Administration (SFA), Leading Group Office of Poverty Reduction (LGOPR), and State Grain Administration (SGA). Many others have leadership responsibility over vital services that are provided in rural areas, including the Ministry of Education (MOE), Ministry of Health (MOH), Ministry of Civil Affairs (MOCA), Ministry of Communications (MOC), Ministry of Labor and Social Security (MOLSS), Ministry of Science and Technology (MOST), the Central Meteorological Administration

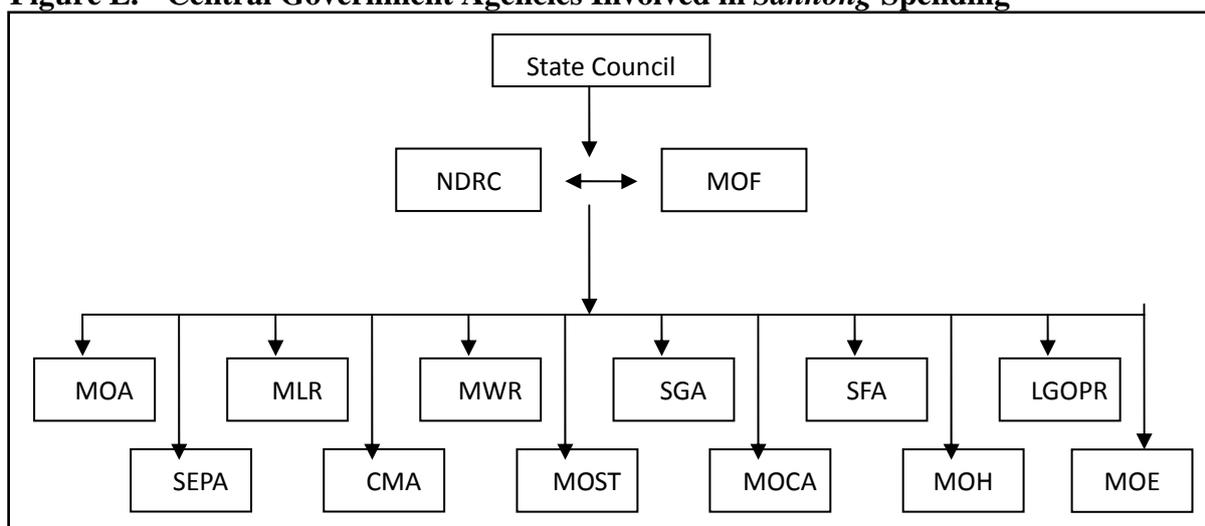
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<sup>39</sup> Fieldwork, February 2004.

(CMA), the State Administration of Quality Supervision and Inspection and Quarantine (AQSIQ), and even the Commission for Science and Technology and Industry for National Defense. A summary presentation is shown in Figure E below.

Many other central-level agencies are also involved in rural development, though not necessarily in the implementation of interventions that use central fiscal resources. These include mass organizations like the All-China Women’s Federation (ACWF), the Communist Youth League (CYL), and the Supply and Marketing Cooperatives. Of course, last but not least, the most powerful organs defining rural development and its financing are those Party and “hybrid” (Party and government) agencies such as such as the Leading Group for Financial and Economic Affairs and the State Commission on Public Sector Reform (SCPSR).<sup>40</sup>

**Figure E. Central Government Agencies Involved in *Sannong* Spending**



Source: Adapted from the website of the Central People’s Government of the PRC: [http://www.gov.cn/gjjg/2005-08/01/content\\_18608.htm](http://www.gov.cn/gjjg/2005-08/01/content_18608.htm); Xinhua information.

Responsibilities at the central level are not clearly delineated, and gaps and overlaps of responsibilities and lack of coordination lead to inefficiencies. For example, there are overlapping responsibilities between the NDRC, broadly responsible for planning, and the MOF, responsible for budget planning (and execution). A lack of coordination can lead to a situation where the NDRC’s planning and approval of capital investments are not in line with

<sup>40</sup> The official English-language name of this committee, often referred to as the “post establishing committee,” is the State Commission on Public Sector Reform.

the MOF's planning and allocation of recurrent costs for the operation and maintenance of an investment. Similarly, some types of investment funded through and implemented by SOCAD, e.g., for land preparation or irrigation and drainage, might also get support from the MWR or the MOA or, in poverty areas, the LGOPR or the NDRC-administered FFW program. However, there is no centralized monitoring and evaluation system that allows the central government to comprehensively assess the overall programs; in which counties, townships, and villages they are implemented; and their efficiency and impact.

The complexity of this fragmented and overlapping structure becomes more concrete when looking at specific functions. For example, Liang (2003) points out that “the present administrative management system ... still carr[ies] the characteristics of the planned economy. Problems of division among departments and detachment of management continue to exist, especially in managing agricultural and rural economic affairs. According to statistics, fourteen ministries and commissions (or administration bureaus) are involved in governing the process before, during, and after production. Among them, eight agencies are involved in the management of the quality and safety of farm produce, eight for agricultural investment, six for processing and distribution of farm produce, and five for management of agricultural production materials.” Since each agency allocates funding in its functional area, this complex management structure would tend to produce and perpetuate the current fragmentation and earmarking of central transfers into numerous programs.

This organizational structure at the Central level is mirrored at all four other levels of government, further adding to the complexity. The structure of government agencies described for the central level is largely replicated at the province, prefecture, and county levels. At the township level, so-called “stations” or “centers” and their staff correspond to the government structures at the higher levels.<sup>41</sup>

Basically all of the functions covered by the various agencies at the central level are covered by those at each of the subnational levels as well. Responsibilities are not restricted

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<sup>41</sup> Variations exist across localities, generally due to historical reasons. For examples, some provinces, prefectures, or counties might have both a Bureau of Agriculture and a Bureau of Animal Husbandry, with both reporting vertically to the MOA; or there might be a “Rural Affairs Office” and an Agricultural Commission with larger, coordinating functions across sub-sectors.

to policy-making and implementation, but often involve the channeling of funds and, not infrequently, the need to allocate fiscal resources at many government levels.

## **5. Recent Reforms and Their Impact**

The rural sector has been the arena for some of the boldest fiscal reforms during this decade. Starting with the Rural Fee Reform in 2001, a number of measures have been introduced – the abolition of agricultural taxes, adjustments to the Tax Sharing System, the *yixian weizhu* reform to move the payment of rural teachers’ salaries to the county level, the reform to put counties directly under provincial administration, the “three rewards and one subsidy” program, etc. All of these have aimed at strengthening rural public finance. They reflect a clear recognition by government that rural governments are operating under severe financial constraints, and that problems of rural public finance constitute a bottleneck to building a harmonious, well-off society.

Eliminating rural fees and abolishing agricultural taxes were by far the most important reforms affecting rural public finance in recent years. Because they were implemented close together and their effects are similar and cumulative, these two reforms are often lumped together and considered as part of a comprehensive reform of rural taxes and fees called the “rural tax and fee reform” (农村税费改革). However, we will discuss the two reforms separately since they were driven by different motives, and have different impacts on rural public finance. Nevertheless, throughout this report we will also adopt the shorthand of “rural tax and fee reform” to refer to these two reform programs, hereafter RTFR.

### **5.1. The Rural Fee Reform**

In a speech in April 2000, then-Vice Premier Wen Jiabao called the RFR one the most important reforms in the rural sector over the past 50 years, whose impact is comparable to that of the Land Reform in the early 1950s and the return to household farming in the early 1980s.<sup>42</sup> The RFR was first piloted in Anhui province starting from the late 1990s. It was adopted for

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<sup>42</sup> “Vice Premier Wen Jiabao speech at the conference on disseminating Anhui’s experience and mobilization for RFR pilots, April 13, 2000.” Reprinted in State Council RFR Work Group (2001).

step-by-step nationwide rollout in 2001, with implementation in most provinces in 2002 and 2003.

In introducing the RFR in 2000, Premier Zhu Rongji explained the reform in this way:

“Promoting the RFR is the fundamental strategy for protecting the legal rights of farmers and reducing their burdens. The basic approach in the RFR is to raise – by an appropriate amount – the existing rates of the agricultural tax and the agricultural special products tax, while abolishing all administrative fees that are levied on farmers, including the unified township levy and the village accumulation levy.”<sup>43</sup>

The reform began with twin objectives: to reduce the overall fiscal burden on farmers and to impose a more structured framework for financing government at the grassroots levels by bringing previously extra-budgetary revenues and expenditures on budget. These objectives were intertwined: the fact that grassroots governments were financed mostly off-budget prior to the RFR meant that they generally operated free of oversight from higher levels and unrestrained by tax laws. The proliferation of fees and their growing burden on farmers were a major cause of widespread rural protests in the late 1990s.<sup>44</sup> Thus, the RFR was an important component of the nationwide reform of extra-budgetary fees beginning in the late 1990s that sought to curb the growth of extra-budgetary revenues and bring them onto the budget as much as possible (World Bank 2002).

According to official statements of the time, it appeared that the RFR began as a tax rationalization and budget reform measure that sought to bring township and village finance more fully into the budget. By banning extra-budgetary levies, the government aimed to harden the budget constraints and curb the excesses in “taxing and spending” at the grassroots level. Prior to the RFR, there was a common saying in the countryside: “the first tax is light, the second tax is heavy, and the third tax is a bottomless pit” (*toushui qing, ershui zhong, sanshui shi ge wudidong*). The “first tax” referred to the agricultural tax. The “second tax” was the

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<sup>43</sup> “Speech at the CCP Economic Work Conference, November 28, 2000.” Reprinted in State Council RFR Work Group (2001).

<sup>44</sup> These are well documented in two popular books on the plight of farmers. Cao (2000) and Chen and Chun (2004). See also Bernstein and Lu (2003).

township and village levies that were explicitly permitted, and the “third tax” was the additional fees, levies, compulsory investments, and donations that local officials often used to fund capital investments and other extra-budgetary expenditures. The RFR merged the “first” and “second” taxes and eliminated the “third” tax, thereby significantly reducing the overall burden on farmers. More importantly, by fixing the tax rates and tax base, the reform set an upper limit for the farmers’ tax obligations. Henceforth, fund-raising for infrastructural investments would require approval by village assemblies.

The positive outcomes of the RFR are unambiguous. The overall burden on farmers was dramatically reduced as the numerous ad hoc and sometimes abusive and excessive fees and levies were eliminated. In the first years of the reform, it had also brought a large component of extra-budgetary revenues into the budget for unified allocation, in the form of an expanded agricultural tax. In the words of one official in Henan province: “The RFR raised the quality of resources by concentrating them in the fiscal system” rather than through fees collected by disparate agencies and local governments.

To help offset the loss of revenue from the RFR in 2001 the central government introduced the rural fee reform subsidy. The RFR subsidy is allocated across provinces according to their level of development by the formula of “1-8-5-0.”<sup>45</sup>

To illustrate the impact of the RFR, some calculations for Henan, a category 1 province, are presented in Table 22. They show that in 2000, prior to the RFR, fees and levies had accounted for some 82 percent of the revenues available at the township level in the province, while agricultural taxes accounted for only 18 percent of the total. After the RFR, in 2002 the expanded agricultural taxes generated roughly half of the revenues in the rural sector. Transfers from the central and provincial governments together provided another 36 percent of the total. In the reform plan, it was assumed that a modest level of voluntary contributions from farmers (RMB 15 per capita per annum) according to a case-by-case approval method (*yishi yiyi*) would provide 13 percent. These calculations left a funding gap of 4 percent in 2002 – a

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<sup>45</sup> Under this formula, provinces are divided into four categories to replace revenues by the RFR subsidy: (i) central and western provinces that are grain “exporters,” 100 percent; (ii) central and western provinces that are not grain “exporters,” 80 percent; (iii) coastal provinces that are grain “exporters,” 50 percent; and (iv) coastal, non-grain-exporting provinces, 0 percent.

small amount to be offset by cost savings. The total “burden reduction” to farmers was 39 percent (with tax payments and voluntary contributions totaling RMB 6.23 billion).<sup>46</sup> As it turned out, since farmers did not approve any contribution under the *yishi yiyi* system, the actual burden reduction was 48 percent. Depending on how much village-level infrastructure was built and financed by the government, this left up to 17 percent less revenue available for spending.

**Table 22. Rural Revenues Pre- and Post-RFR in Henan**

Revenue source (RMB billion)	2000	2002 (actual)	change
Agricultural tax	0.9	3.73	+2.83
Agricultural tax surcharge (20%)	-	0.75	+0.75
Agricultural special products tax	0.66	0.19	-0.47
Slaughter tax	0.05	0.06	+0.01
Special products tax on tobacco	0.2	0.2	0
<b>Total agricultural taxes</b>	<b>1.81 (18%)</b>	<b>4.93 (51%)</b>	<b>+3.12</b>
Township unified levy	2.6	0	-2.6
Village levy	2.35	0	-2.35
Other fees and levies	3.4	0	-3.4
<b>Total non-tax revenues</b>	<b>8.35 (82%)</b>	<b>0</b>	<b>-8.35</b>
<i>Central government subsidy</i>	-	<b>2.82 (29%)</b>	<b>+2.82</b>
<i>Provincial subsidy</i>	-	<b>0.7 (7%)</b>	<b>+0.7</b>
<i>Farmers voluntary contribution*</i>	-	<b>1.3 (13%)</b>	<b>1.3</b>
<b>Total available revenue</b>	<b>10.16</b>	<b>9.75</b>	<b>-0.41 (4%)</b>
<b>Total paid by farmers</b>	<b>10.16</b>	<b>6.23</b>	<b>-3.93 (-39%)</b>

Note: Figures in parentheses refer to shares of total available revenues

\* Projected, with a ceiling set at RMB 15 per year from farmers.

Source: Fieldwork, and Henan Statistical Yearbook 2004.

## 5.2. Associated Reforms of the RFR Program

From the outset, the architects of the RFR program had planned for restructuring rural governments and reducing staff to be core components of the RFR that would provide cost savings to offset revenue losses from the fee reductions.<sup>47</sup> In a speech to the National RFR

<sup>46</sup> It should be noted that the calculations and reported figures for the impact of the RFR on the “burden reduction” should be used with care. While all calculations show substantial impacts, reported numbers are often not exact and not fully consistent.

<sup>47</sup> These are included in the Implementation Document on the RFR issued in 2000: Chinese Communist Party Central Committee Document No.7, jointly issued by the CCPC and State Council. Reprinted in State Council RFR Work Group (2001).

Work Conference in November 2000, Vice Premier Wen Jiabao stated:

“Here I want to emphasize several points: First, in the process of piloting the RFR, the localities should stay focused on reducing farmers’ burdens and ensuring discipline in grassroots government behavior. The reform should start by reorganizing government and reducing staff to cut expenditures, rather than relying wholly on central transfers to fill fiscal gaps. Central transfers are to be used only as a transitional aid to ensure the normal functioning of grassroots governments.”<sup>48</sup>

In many localities there were proposals to consolidate villages, townships, and school districts to create more efficient scales for service provision, along with calls for reducing staff in schools and government agencies (State Council RFR Work Group, 2001). Following issuance of CCCPC Document No. 30 in December 2000, the Central Committee Office and State Council Office jointly issued a document calling for an average 20 percent reduction in the number of staff posts at the municipal (prefectural), county, and township levels, to be set by the provincial authorities and implemented on a level-by-level basis.<sup>49</sup> This call is reflected, for example, in Huaxian (Henan province), in an implementing document on the RFR calling for a reduction of “no less than 27 percent” in staff size in government and Party organizations, and controlling the overall number of public service unit (PSU) staff. The document calls for limiting the number of posts to 30 in small townships, and 35 in large townships. In villages, the number of officials is to be limited to 5-7 in large villages with a population exceeding 5,000, and 3-5 in most villages. To further control costs, subsidies for village officials are to be kept at no more than RMB 200 per staff per month. Non-production-related expenditures should also be controlled, including setting limits on subscription fees for newspapers and magazines and abolishing entertainment expenditures at the village level. According to the Ministry of Civil Affairs, 876 townships in 20 provinces were dissolved or merged in the first 9 months of 2004, bringing cuts of some 86,400 jobs and RMB 864 million in budgetary

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<sup>48</sup> Speech on November 4, 2000. Reprinted in State Council RFR Work Group (2001).

<sup>49</sup> Chinese Communist Party Central Committee Office and State Council Office, “Some Opinions on Personnel Downsizing at the Municipal, County, and Township Levels,” December 26, 2000. Reprinted in State Council RFR Work Group (2001).

savings.<sup>50</sup>

These associated reforms are crucial to sustain the “burden reduction” objective of the RFR reform. As illustrated by the numbers in Table 22 above, subsidies from higher-level governments replaced about 35 percent of the pre-RFR revenues in 2002, accounting for two-thirds of the reduction in farmers’ burdens. To prevent the burden from “rebounding” or negatively affecting public expenditures, additional sources of savings would have to be found. One such source is improved efficiency due to farmers’ participation in project selection. For the first time, the RFR presents the public with the possibility of choice – farmers can vote (with a two-thirds majority) to “tax” themselves to undertake infrastructural investments (*yishi yiyi*). This new arrangement will presumably weed out unwanted projects and ensure a more responsive pattern of investment. Another potential source of savings is from cutting rural administration and raising efficiency in service provision. The reform design of the RFR explicitly relies on these efficiency gains to alleviate burdens also by encouraging farmers’ involvement in the delivery of goods and services.

### **5.3. Agricultural Tax Abolition (ATA)**

The RFR was quickly followed by the abolition of agricultural taxes. In 2003 the government announced that beginning in 2004 provinces should try to reduce the agricultural tax rates (just raised to 7 percent under the RFR) by 1-3 percent per year, to reach a zero rate by 2007. This reform was further accelerated, with the government announcing in December 2005 that the tax had already been abolished in all but three provinces.<sup>51</sup> By early 2006, it had been completely abolished nationwide.<sup>52</sup> Building on this momentum, in February 2006 the agricultural special products tax and the slaughter tax were also formally abolished.<sup>53</sup>

The ATA was a response to the growing complaints that the agricultural taxes were unfair.

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<sup>50</sup> *China Daily*, November 17, 2004.

<sup>51</sup> These were Hebei, Shandong, and Yunnan. Even in these provinces, the tax had been abolished in more than 210 counties. Jin Renqing interview in *People’s Daily*, December 31, 2005.

<sup>52</sup> The Decision of the Standing Committee of the National People’s Congress on Abolishing the Regulation of the People’s Republic of China on the Agriculture Tax, issued December 29, 2005, formally abolished the agricultural tax effective January 1, 2006.

<sup>53</sup> Decision of State Council Order No. 459, issued on February 17, 2006, for immediate implementation.

The architects of the RFR reform had not anticipated that the expanded agricultural tax, within the context of a substantial overall reduction in “burdens” on farmers, would become a lightning rod for criticism. The reality, though, is that while urban citizens are exempted from personal income taxes (PIT) on the first RMB 9,600 of annual income –an amount that was doubled in 2005, no such exemption existed for the much poorer rural citizens since agricultural taxes were unrelated to incomes. In this light, the argument that fair treatment of all citizens under the tax law required the abolition of the agricultural tax found resonance among policymakers.<sup>54</sup> From the perspective of revenue considerations, this was also easily affordable since even the expanded agricultural tax, together with the animal husbandry tax had produced only RMB 33.4 billion in 2003, equal to 1.7 percent of current revenues (Finance Yearbook 2004). In net revenues terms, the “yield” was even lower for these two taxes since they were notoriously costly to collect from the two hundred million rural households.

While the ATA was welcomed for bringing further reductions in the farmers’ burdens, it injected some confusion into the ongoing reforms and up-ended all the careful plans for revenue-replacement under the RFR. Moreover, following so quickly on the RFR, the ATA directly undermined two principal objectives of the RFR – that of imposing a more structured framework on rural public finance and hardening the budget constraints on grassroots governments. Abolishing the agricultural taxes also further diminished the already slim local tax base, especially in inland, rural localities where, aside from agriculture, there is little economic activity to tax.

The immediate effect of the ATA was twofold. First, it imposed a much greater burden on central transfers, both in quantity and duration. While transfers were always required under the RFR to fill the revenue gap, they were meant to be transitional, and would be reduced or streamlined as cost savings are realized from improved efficiencies and associated reforms. With the elimination of the agricultural taxes, however, the gap is now larger, and transfers will be needed for a long period until new taxes can be found to rebuild the revenue base in rural communities.

Second, it has created new urgency for implementing the associated reforms to generate

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<sup>54</sup> See, for example, Yang et al. (2003).

some cost savings. On the positive side, the abolition of the agricultural tax has eliminated the need in local finance departments for the large corps of tax collectors who had been deployed to perform the mammoth task of going door-to-door to collect the tax.<sup>55</sup> Unfortunately, progress on downsizing appears elusive. Available data shows fiscal-supported population at the subnational levels continuing to grow, at least through 2005, with the share of county and township staff remaining stubbornly static (Table 23).

**Table 23. Fiscal-supported staff at subnational governments by level.**

	Total (million)	%		
		Province	Prefecture	County + Township
2000	40	9.1	18.3	72.6
2001	41	10.5	18.0	71.5
2002	42	10.8	17.8	71.5
2003	43	9.8	17.7	72.5
2004	45	12.6	17.5	69.8
2005	46	13.9	17.5	68.6

Source: Compendium of Fiscal Statistics for All Prefectures, Cities, and Counties.

#### **5.4. The Immediate Revenue Impact of the RTFR**

The revenue gap at the local level is substantial. As shown in Table 22 earlier, provincial officials in Henan had counted on the expanded agricultural tax to replace a significant part of the revenues lost from eliminating the fees and levies – roughly RMB 3 billion (compared with the RMB 2.9 billion in central subsidies in 2002). With the abolition of the agricultural taxes, however, these calculations became obsolete, and a larger gap emerged in rural finance. By 2005, agricultural tax revenues had fallen to RMB 360 million, and central subsidies were financing more than RMB 9 billion, or three-quarters of rural revenues in the province.

What is the size of the revenue gap nationwide? Many estimates have been made, and central government offices have been inundated by wildly inflated reports of “lost revenues” from local governments. Two sets of estimates are presented in Table 24. The first comes from a speech delivered by then-Vice Premier Wen Jiabao in April 2000 at a national conference on Anhui’s RFR experience, and the second from a group of experts at the State

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<sup>55</sup> In the counties visited by the mission, up to three-quarters of the staff in township-level finance departments were assigned to collect the agricultural tax.

Administration of Taxation (SAT).<sup>56</sup> These estimates vary significantly, especially in terms of the size of illegal fees and levies and the valuation of compulsory labor – two components of the farmers’ burdens for which aggregate statistics do not exist. Under the higher estimate by Yang Yuanwei and his colleagues (Yang et al. 2003), prior to the RFR total resources available to township governments may have been as high as RMB 216 billion. With the elimination of fees and the abolition of agricultural taxes, township governments are almost entirely dependent on transfers from higher levels. Despite a rapid escalation in recent years, central subsidies for the RFR and agricultural tax replacement totaled only RMB 98.6 billion in 2006, leaving a shortfall of as much as RMB 120 billion for township governments in the aggregate. Put another way, according to the estimate of Yang and his colleagues, post-RFR grassroots governments have at their disposal less than half as much as before the RTFR. Even under the more benign scenario described by (then-Vice) Premier Wen, they have 14-19 percent less.

**Table 24. The Effect of the RTFR on Rural Revenues**

(billion RMB)	Wen Jiabao	Yang et al.
Figures from:	1997	circa 2000
Total collected revenues:	114.3	160
of which: agricultural taxes		34
township and village unified levies		59
other fees and levies		27
irregular fees and levies	20	40
plus: compulsory labor contribution	8.1	59
Total mobilized resources	122.4	219
Replacement revenues		
Central transfers (2006)*	98.6	98.6
Revenue loss under the RTFR (1)	-17.5 (-14%)	-61.4 (-28%)
Revenue loss under the RTFR (2)	-23.6 (-19%)	-120.4 (-55%)

Note: \* includes rural fee reform transfer 75.1 billion and transfer to counties and townships in difficulties (three rewards and one subsidy) 23.5 billion. (1) Includes only legally permitted fees and levies, and excludes compulsory labor valuation. (2) Includes total mobilized resources.

Source: Wen Jiabao speech at National Conference on Anhui’s RFR Experience, April 13, 2000 (reprinted in State Council 2001); Yang et al. (2003); Xu (2006) and Jin (2006, 2008).

Of course, the revenue impact of the RTFR varies by region and by administrative level, in accordance with the respective weight of the agricultural taxes in their total revenue – hitting

<sup>56</sup> This group is led by Yang Yuanwei, a leading figure in the Tax Policy Department at the SAT.

hardest those localities most dependent on these taxes. Data in Table 25 below show that across provinces, the weight of agricultural taxes varied from 17 percent of total revenues in Anhui to nearly zero in Tibet. In this table we provide an illustrative ranking of provinces according to the revenue impact of the RTFR.

The rankings presented in Table 25 are approximate because the 2003 data already reflect some reductions in agricultural tax revenues from the RTFR, and therefore understate the effect of the reform on provincial revenues.<sup>57</sup> Excluding Yunnan, Table 25 shows the most affected provinces to be Anhui, Henan, and Hubei, where the reforms will reduce revenues by some 10 percent or more. At the bottom, there are nine provinces and cities where the impact will be less than 1 percent of total revenue, and another eight where the impact will be less than 4 percent of revenue.

**Table 25. Ranking of Estimated Revenue Impact by Province (% of total revenue), 2003**

Province and national ranking	Taxes to be eliminated*	Five agric. Taxes	Province and national ranking	Taxes to be eliminated*	Five agric. taxes
1. Anhui	12.09	17.12	18. Chongqing	4.72	8.34
2. Henan	11.96	14.25	20. Jiangsu	3.33	10.17
3. Yunnan	10.86	13.57	23. Liaoning	2.31	6.18
4. Hubei	9.96	12.79	28. Guangdong	0.71	4.90
6. Jiangxi	9.52	10.92	34. Shanghai	0.01	7.54
15. Sichuan	6.83	8.32	35. Tibet	0.00	0.03
<i>average</i>				4.75	8.52
<i>standard deviation</i>				3.76	3.46
<i>coefficient of variation</i>				0.79	0.41

Notes: Taxes to be eliminated include the agricultural tax, animal husbandry tax, and agricultural special products tax. Shares are as a percentage of total provincial revenues. "Provinces" include some major cities such as Dalian and Xiamen. Yunnan is excluded because of the large portion of tax revenues accruing to tobacco, which will not be affected by ATA.

Source: Based on Compendium of Fiscal Statistics for All Prefectures, Cities, and Counties, 2003.

<sup>57</sup> For the agricultural special products tax, for example, the RFR had reduced the scope of what could be taxed and reduced the rates by as much as one-half on many products. In Henan, for example, revenues from the agricultural special products tax had fallen from RMB 937 million in 2001 to only RMB 271 million in 2003.

At the county level the dependence on agricultural taxes varies even more widely. In Table 26 we present summary data from rural counties in Yunnan and Henan provinces. The average share of the five agricultural taxes was 32 percent among counties in Yunnan and 37 percent in Henan, but the maximum share was around three-quarters in both provinces. The 2005 data reflects the effect of abolishing agriculture taxes while retaining the tax on tobacco, which remains important in some counties, albeit a much smaller number.

**Table 26. The Share of Agricultural Taxes in County Revenues, 2003 and 2005**

	2003		2005	
	Yunnan	Henan	Yunnan	Henan
Maximum	77%	75%	50%	26%
Minimum	1%	5%	0%	0%
Average	32%	37%	19%	5%
Standard deviation	14%	16%	14%	5%
Coefficient of variation	0.46	0.44	0.74	1.16

Note: This is the sum of five taxes: the agricultural tax, animal husbandry tax, agricultural special products tax, farmland occupation tax, and title tax. The slaughter tax is also often included, but this tax generates insufficient revenues to make a difference.

Source: Based on Compendium of Fiscal Statistics for All Prefectures, Cities, and Counties, 2003, 2005.

The fact that counties vary so widely in their dependence on agricultural taxes means the RTFR may have potentially large distributional impact across localities depending on how provinces pass through the revenue replacement subsidies from the central government. For provinces such as Henan, which receives 100 percent replacement for revenue losses, the impact could still be differentiated across affected counties depending on the choices made by the province. Agricultural counties in provinces that receive only partial subsidies may be more likely to suffer net revenue losses.

Finally, the impact of the RTFR falls overwhelmingly at the township level. This is not only because townships and villages had been so reliant on fees and levies, but also because agricultural taxes had accrued mostly to the township level, and townships were in turn the most dependent on agricultural tax revenues. As shown in Table 27, in 2003, while agricultural taxes constituted 8.7 percent of total revenues for subnational governments, they were less than 2 percent of provincial revenues but 31 percent of township revenues. The fact

that the revenue losses are concentrated at the lowest levels of the administrative hierarchy means that central monies have to travel a long way to reach the intended recipients. Under the current intergovernmental fiscal system, this path is not assured.

**Table 27. Share of Agricultural Taxes in Total Revenues by Administrative Level, 2003**

	All agricultural taxes	Agricultural taxes to be abolished*
Subnational Total	8.7	4.3
Province	1.6	0.0
Prefecture	6.3	0.2
County	8.1	2.6
Township	31.1	27.3

Note: \* The agricultural tax, animal husbandry tax, slaughter tax, and agricultural special products tax. The farmland occupation tax and the title tax remain.

Source: Based on Compendium of Local Fiscal Statistics, 2003.

### 5.5. Other Reforms Affecting Rural Governments

Aside from the RTFR, two other reforms implemented in recent years have had a significant impact on rural finances. These are the measure to “complete” the TSS reform introduced in 2002, and the “three rewards and one subsidy” introduced in spring 2005. Both are policy responses to the increasingly evident fiscal problems of rural governments that were manifested by the wave of wage arrears for teachers and civil servants and public protests by farmers starting in the late 1990s. In his report to the National People’s Congress in March 2002, noting that many governments at the county and township levels were unable to meet their payrolls in full for civil servants, Minister of Finance Xiang Huaicheng called for government to “gradually establish a mechanism to ensure normal payment of wages, accelerate changes in the functions of counties and townships, and create conditions for fundamentally overcoming financial difficulties in counties and townships.”<sup>58</sup>

#### *Completing the TSS reform at the sub-provincial levels*

“Completing the TSS reform at the sub-provincial levels” is a major reform to correct many of the problems of the Tax Sharing System. At the first cut, it calls for “completing” the TSS reform by eliminating the fiscal contracts that have remained in use at the sub-provincial levels,

<sup>58</sup> Reports indicate cumulative arrears of RMB 6.5 billion at year-end 2001 (Xiang 2002).

as discussed earlier. More importantly, the reform aims to inject transparency and order into sub-provincial fiscal relations, by simplifying the intergovernmental system, injecting greater uniformity in revenue-sharing, and strengthening the fiscal capacity of counties and townships (especially the poor ones).

This reform was introduced with little fanfare, when the State Council issued a “notification” to central agencies and provinces in December 2002. The document calls on provinces to: (1) rationalize and clarify expenditure responsibilities among sub-provincial levels, (2) rationalize the division of revenues; (3) improve the system of sub-provincial transfers; (4) adjust the fiscal role of townships to fit their economic conditions, specifically by reassigning responsibilities of smaller townships in less developed areas to counties. It also calls for strengthening supervision over townships to ensure compliance with national regulations against borrowing or providing guarantees for projects; and (5) strengthen budget management to improve the efficiency of public expenditures.

The most important changes stipulated in the document, aside from revamping the revenue-sharing arrangements among subnational levels, were the reassignment of some functions from the township to the county, and a call to end unfunded mandates being pushed on counties.

Significantly, the State Council document also calls for a decentralized approach to implementing this reform. While the thrust of the reform is to increase resources at the county and township levels, the document calls for different treatments depending on local conditions. In localities where per capita fiscal disparities are “relatively small,” it calls for reducing the provincial and prefectural revenue shares to improve incentives for revenue mobilization at the grassroots levels. In localities where fiscal disparities are “relatively great,” it calls for raising revenue shares at the higher levels, and using these resources for equalization transfers to the counties and townships. In implementation to date, different approaches can be seen across localities. In some, provincial authorities have reduced the number of shared taxes at the provincial level to leave more resources to the lower levels. In Henan, for example, provincial authorities have turned over some 60 percent of the provincial tax base to the municipalities. However, the change applies only to “new revenues”, so the effect will be gradual. In Jiangsu,

early implementation of these changes reduced the provincial share of revenues to roughly 20 percent of the total. In contrast, Liaoning province is increasing the provincial share. Even within a single province, the direction of change differs across municipalities. For example, in Liaoning, Anshan municipality is choosing to end its sharing of the VAT, enterprise income tax (EIT), PIT, and business tax collected by the counties. This decentralizing thrust in Anshan contrasts with that in Panjin and Yingkou municipalities, which are taking 40 percent of the local portion (after sharing with the province) of the VAT, EIT, PIT, business tax, and real estate tax collected by the counties (World Bank 2006a).

### *The “Three Rewards and One Subsidy” Program*

The “three rewards and one subsidy” program was rolled out in May 2005. It is the product of a high-level task force appointed by the National People’s Congress in 2004 to investigate the fiscal problems of counties and townships.<sup>59</sup> The program’s stated aim is to “solve” the problems of “fiscally poor” counties within three years. The program was funded with an allocation of RMB 15 billion from the central budget for 2005. The amount had risen to 23.5 billion in 2006, and in 2007 it was 33.5 billion. The program is designed to support and enhance completion of the TSS reform by boosting the incentives for revenue mobilization and provincial equalization efforts, as well as by the more painful downsizing reforms. It also rewards grain-producing counties to offset their fiscal disadvantages.

## **6. Summary and Conclusions**

Government efforts to channel resources toward pro-poor, pro-rural programs continue to gather momentum. Addressing an assembly of the Political Bureau in Beijing in February 2008, President Hu Jintao urged government officials at all levels to devote themselves in building a government ‘by the people, for the people’, and one that ensures all Chinese enjoy the fruits of the country's economic development. “The government should provide education

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<sup>59</sup> This information is based on MOF Document No. 77, May 8, 2005, “Notification on the 2005 Central Budgetary Rewards and Subsidies to Local Governments in Providing Assistance to Counties and Townships to Resolve Fiscal Difficulties,” and interviews at MOF, February 2005.

for the young, medication for the ill, care for the old-aged and housing for the homeless."<sup>60</sup> This was earlier voiced at the 17th Party Congress in October 2007, which reaffirmed the importance of upgrading public services in building a Harmonious Society in China. The Report of the Congress emphasized that on the basis of economic development, more attention must be paid to guaranteeing and improving people's livelihood and promoting social reform, expanding public services, improving social management, and promoting social equity and justice. Since the most glaring shortfalls in these services are virtually all in the rural areas, redressing them will require strengthening rural public finance to provide the resources to support these laudable goals.

The reforms implemented during this decade have already succeeded in achieving some key objectives, chiefly reducing farmers' burdens, ensuring that teachers' salaries are paid, reducing out-of-pocket costs for schooling, extending the coverage of cooperative medical insurance, channeling more resources to rural infrastructure, etc. Other reforms, such as extending the TSS to sub-provincial levels, pilot reforms in provinces directly managing county finances, counties managing township finances, treasury reform, the "three rewards and one subsidy" program, and the consolidation of jurisdictions (in particular townships and villages) have also made progress in the intended direction, but will take more time to produce clear effects. For example, completing the TSS reform applies only to incremental revenues, and merging townships and villages will also require time to implement and to yield their intended results.

However, while each of the reforms has achieved specific successes, their overall effect has been more mixed. This is partly due to the contradictions existing among the reforms – for example, while several of the reform measures are intended to enhance the fiscal resources of county and township governments (as well as village authorities), the RTFR has eliminated a good part of their revenue bases. The number and pace of introduction of recent reforms is proving overwhelming at the grassroots levels, especially since the reforms have also brought dramatic shifts in authorities and resources among the three levels of rural government. As a result, not all are implemented as intended, and the net effects of these changes on the

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<sup>60</sup> Xinhua in English, downloaded 2/24/08.

efficiency and responsiveness of rural services are as yet unclear. Some of them could well be negative.

More importantly, these reforms are not yet moving toward building a healthier, more sustainable intergovernmental fiscal system. The reforms have led to a growing vertical fiscal imbalance as own revenues have further reduced for local rural governments while the “tilt to rural” policies have pushed up expenditure needs. Although under the government’s policy to “give more and take less” from the rural sector and more central transfers have been made available, this strategy also carries risks. International experience shows governments tend to manage “own” resources better than funds from other sources. China is already an outlier in transfer-dependency, with local rural governments now dependent on transfers to finance more than half of their expenditures (two-thirds when tax rebates are included). The recent trend will make it even more so. While the potential negative effects of a high dependency on transfers can be managed through a strong accountability system and, in particular, an effective transfer system, such systems are not yet in place.

The current intergovernmental transfer system is inefficient and recent equalization efforts have been insufficient to offset the growth in income disparities across provinces. Since the late 1990s the government has introduced many new transfer programs. This includes transfers targeted at poor and rural regions, and the overall amount of “fiscal capacity” transfers has grown rapidly. However, the system still puts far too little into ameliorating the large disparities in fiscal capacity across localities relative to the size of the disparities in per capita budgetary expenditure across localities. In addition, the efficiency of the system is limited due to the large number of earmarked transfers, whose design and implementation requirements as well as monitoring and evaluation needs are not matched by the existing capacity in the highly complex administrative system.

Although increased transfers have allowed more public spending, the increased dependency on – often earmarked – transfers has worsened budget efficiency, the ability to allocate budgets according to local needs, and possibly budget discipline at the local levels. The proliferation of transfers has increased the complexity and created inefficiencies of spending. Budget discipline has not improved. Evidence such as the emergence of new fees via

the creation of “project entities,” land sales, local-level indebtedness, and persistent overstaffing raise serious questions about the sustainability of the reforms and about the central government’s approach that relies heavily on an increase in (mostly earmarked) transfers to address issues in agriculture and rural development. In the process, progress in some areas has only served to expose and highlight the need for further reforms and increased focus on the delivery of public services for the NSC.

The autonomy of the grassroots levels is extremely limited. Rather than strengthening the township and village levels to enhance their capacity to provide public goods and services to citizens, reforms have greatly weakened their positions as revenue sources and authorities are, *de facto* and *de jure*, transferred to the county. This stands in contrast to the national policy of strengthening village institutions such as *yishi yiyi* and other democratic measures. However, these participatory institutions not only require political support, but – in order to be meaningful – also authority over financial resources.

The lessons we draw from the analysis in this report can be summarized as follows:

First, the complex administrative and organizational structures impede resource flows and policy change. As the central government introduces new policies and increase resources devoted to rural areas, these changes have to be mediated by each successive level of government as well as all agencies before they reach the intended recipients. With so many layers and compartments, the process will hardly be straightforward.

Second, given this complex administrative structure, monitoring and supervision are of the utmost importance in keeping the reforms on course to achieve program objectives. This poses a tremendous challenge since the availability, reliability, and timeliness of information are at present weak. For example, it is impossible to track what public resources are spent on rural development by each government level. Since the statistical reporting system – on fiscal resources or the public services that they finance - does not delineate “rural” as a category, it is not possible to fully identify what government spends in rural areas or on rural citizens. Since 2005 the Ministry of Finance has introduced a new category called “sannong spending” in an effort to track what resources are devoted to the rural sector, but MOF officials emphasize that it is very much a work in progress.

Third, it is increasingly clear that the inefficiencies of many local governments are a formidable obstacle to improving rural public finance. Many of these inefficiencies cannot be addressed solely through increased funding, but instead require reforms in administrative structures, personnel management, and incentive systems for the governments more broadly. In fact, the low quality of services observed during the field visits to Henan and Yunnan can in part be attributed to allocative decisions by local governments that were unfavorable to rural citizens. For example, the rural schools that had no money for heating or electric lighting had so many teachers that on average each teacher taught only twelve hours per week. In the same vein, agricultural extension services, police stations, and even emergency medical services were often spending nearly all of their budgetary appropriations on staff expenditures, leaving little or no funding for the vehicles or fuel needed to take them to the field. These allocative decisions can be traced to the distorted incentives created by the current system of budgeting, which uses staff numbers as the basis for calculating expenditure needs for local governments (and hence for the determination of transfers). The incentive to expand staff size in poorer regions is reinforced by the system of a nationally unified civil service wage-setting, which makes remuneration for public employment extremely attractive compared to local incomes.

Given this context, the government faces a substantial challenge to implement its current program to build a New Socialist Countryside and a Harmonious Society that brings benefits to all. Since the start of this decade the Government of China has put a strong emphasis on addressing the problems related to agriculture, farmers, and rural society, with the development of a “new socialist countryside” designated as a top priority for the Eleventh Five Year Plan (2006-2010). The financing of public services in rural areas will be a key determinant of success.

This report analyzes the performance of the intergovernmental fiscal system – the financing of rural development through counties, townships and villages; and the impact of recent reforms. We show that achieving the government’s objectives will require substantial new resources be channelled to rural areas. In addition, ensuring the effective transfer of resources and their efficient utilization will require fundamental reforms to a wide range of public institutions including budget and planning processes, personnel management systems,

and the organization of government agencies.

We believe a comprehensive reform strategy is needed. Such a strategy should address the fundamental vertical and horizontal imbalances in the intergovernmental fiscal system by introducing clear and appropriate expenditure assignments, increasing own revenues for local governments, and improving transfers. The comprehensive reforms must also reach beyond the fiscal system to build improved accountability mechanisms with strengthened coordination, monitoring, and enforcement powers, including enlisting the help of communities, villages and rural citizens to improve public service delivery at the grassroots levels. Finally, given China's huge size and diversity, reform efforts must also focus on improving incentive structures at the county, township, and village levels to ensure implementation of national policies.

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