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Ehtisham Ahmad

Should China revisit the 1994 fiscal reforms?

Bonn, September 2011

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Abstract

The 1994 reforms in China were remarkably successful in stabilizing the economy and raising revenues for the benefit of sustainable growth and permitting the central government to redistribute resources to poorer regions through an equalization framework. However, the rise of informal local borrowing in the absence of effective own-source revenues raises possible risks and imbalances in the future. There is thus a need to reconsider the fundamentals of intergovernmental fiscal relations, building on the basis laid in the 1994 reforms.

JEL classification: H2, H5, H6 and H7

Introduction and summary of conclusions

The 1994 Fiscal Reforms in China were spectacularly successful in meeting the immediate challenges that the economy faced at that time—a sharply dropping tax/GDP ratio, and limited ability of the central government to conduct macroeconomic or redistributive policies. The centerpiece of the reform was the VAT to be administered by the newly established State Administration of Taxation. Agreement for the reforms by the provinces was not easy—an involved guaranteeing 1993 levels of revenues, a share of the revenues from the VAT to benefit the high income regions, an equalization system for the less well to do regions, which was to receive more resources over time. The most interesting element was the "revenue-return," which was ostensibly disequalizing but had the advantage of protecting the growth centers along the coast, and was a key element in providing continuing employment opportunities to migrant workers, leading to a sharp drop in poverty and rapidly increasing living standards.

At the time, recommendations based on normative intergovernmental theory suggested that spending assignments should be addressed before the revenue-side. However, the 1994 reforms reversed the order, given the gravity of the overall macroeconomic situation, as discussed below in Section 1, and the realization that the reform of the State-owned enterprises (SOEs) and transferring their responsibilities to local governments would take time. This is illustrative of the "political economy" approach to intergovernmental issues (Ahmad and Brosio, 2006).

The 1993/4 reforms were partial in that the focus was on the tax system and revenue sharing arrangements, and the budget system reforms and spending assignments were not addressed at that time. Even the VAT was not of the standard consumption-type and did not cover the full base. The production type VAT time did not provide refunds or crediting for VAT on capital inputs, and in principle was worse for exporters than the normal consumption-type VAT that typically provides such credits and refunds. Yet the production-type VAT generated revenues in a relatively efficient manner, and export-led growth continued unabated.

There have been incremental reforms since 1994 to the tax assignments, including recently a conversion of the VAT to the standard consumption-type (although not yet to services because of the need to replace the local business tax); rationalization and consolidation of the corporate income tax (CIT); and moving the personal income tax to SAT administration. Both the recent VAT and CIT reforms will be initially revenue-losing, although the rationalization should lead to expanded production and the overall effect may be revenue-neutral. Yet current overall revenues are likely insufficient if future spending needs are examined, including for basic social spending, given the ageing of the population, and also infrastructure needs commensurate with China's status as a leading nation (both revenues and spending are well below OECD averages). This is part of a medium-term agenda for reforms.

More importantly and immediately, local governments lack appropriate own-sources of revenues, and have relied increasingly on land sales and indirect borrowing to meet their

spending needs, which are in turn nebulous. A tightening of the budget and treasury systems (mandating the use of the Treasury Single Account system and injunctions on off-budget operations from the current year—although the effectiveness of the latter has yet to be determined) may lead to increasing reliance on indirect mechanisms to borrow for local investments in urban areas, since formal borrowing remains prohibited under the budget law.

While there is growing local indebtedness,[1] including through bonds issued on their behalf by the central government, local government financing vehicles (LGFVs)[2] or by local Urban Development Investment Corporations (UDICs), local governments have few incentives or resources to service the debt, or be held accountable for it. Banking regulators are reported to be planning to shift some of these loans to separate asset management companies and also write off some debts. While this is sensible, the incentive problems leading to the buildup of debt cannot be solved without addressing the root causes—this will involve a set of interlocking measures to enhance local government accountability. This is a short-run priority.

The short run agenda

The short-term agenda must include measures to address the issue of risks emanating from local government operations, as well as the imbalances in the development and growth patterns, as recognized in the government's medium term strategy. Some of the key measures include

1. An urgent reform of the organic budget law:
    a. This would permit bond issues subject to preconditions; with asymmetric applications likely—especially in the more advanced metropolitan areas;
    b. Other areas that do not qualify for bond issues would have less autonomy: and would continue to rely on direct central support for investment.
2. The regions (provinces/third tier administrations) able to utilize bond issues must be able to supplement shared revenues and transfers by own-source revenues.
    a. This could be based on a piggy-back on the income tax, which could be introduced quickly for the provinces.
    b. The property tax would become the central own-source revenue for qualifying third tier administrations. The base of the tax, and its applications would need to be expanded from the current experimentations in two metropolitan areas.
    c. "Green taxes" can also be introduced quickly and become an instrument that governs incentives for local governments as well as producers.

3. Improved information flows; risk management and enhanced coordination of overall debt and liabilities are critical.

[1] Recent information released by the PBC puts the extent of local indebtedness at around 30 percent of total Yuan loans, or around Y14.4 trillion, or around 36 percent of GDP. (Peoples Bank of China, 2011).
[2] The LGFVs increased by 25% from end 2008 to over 10,000 by end 2010.

a. As seen in Europe, private sector liabilities, including those of property developers, could become a public sector burden, and must be carefully monitored.
b. The current tightening by the MOF of the off-budget operations of local governments is critical, and effective management requires that there should be full and complete disclosure of local government operations.

The medium-term objectives

In the medium-term, it will be important to build on the solid foundations provided by the 1994 reforms, as China aims to consolidate its position as one of the leading economies of the world. This will require additional efforts in the areas of (1) tax reforms; (2) spending assignments; (3) transfer design; as well as (4) further developing the risk and debt management strategy described above, including also greater interregional coordination and monitoring as well as strengthening of the on-going public financial management reforms.

1. Tax reforms:
    a. This will involve principally the development of the personal income tax, as well as the property tax for the third tier, as well as modified sharing arrangements.
    b. The VAT reforms should be completed with the replacement of the local business tax.
    c. A number of more efficient sharing mechanisms are possible, as the origin based sharing becomes more complicated to operate with problematic crediting and refund mechanisms across local governments. Similarly, sharing of the corporate income tax on the basis of location becomes more complicated as firms establish multi-jurisdictional operations. New sharing arrangements need further work.
2. Spending assignments:
    a. It will be important to work on the spending assignments—this will largely involve the clarification of responsibilities between the "responsible" second and third tiers of government that are capable of having own-source revenues and credit ratings.
    b. Work needs to continue to rationalize social insurance at the appropriate level for pooling of risks, as well as the links with efficient financing arrangements.
3. Further development of the transfer system, the main elements of which were established in 1994:
    a. The authorities need to decide whether to establish equalization for both the second and third tiers—this may be important in rebalancing the economy.
    b. The design and operation of special purpose transfers needs to be examined, especially a greater focus on monitoring of outcomes and using this as the basis for grant allocations in an intertemporal framework. The development of the budget management system should facilitate this extension of the transfer system.
4. The development of the credit allocation mechanism will take time, but the asymmetric possibilities suggest that the reforms could be initiated quickly in some of the more advanced metropolitan areas, and extended as quickly as the public

financial management systems permit. The short-term reforms of the budget process become critical.

To recapitulate, the components of a new fiscal strategy should build on the political economy approach that was displayed in the 1994 reforms. The new reforms are likely to include a deepening of the tax reforms initiated in 1994, reconsideration of spending assignments, strengthening of budget system reforms including the management of sub-national risks and liabilities, and more effective operation of the equalization mechanisms that were initiated in 1994, but that need to be fully implemented in order to assure the balanced growth envisaged in the 12th Five Year plan, and in the medium-term context. The new framework should provide incentives to better address existing imbalances in the economy at all levels, and to prepare it to meet developed country challenges during the course of the next plan period. Thus, while the 1994 reforms remain a good basis for the current success, the further developments identified here are critical in maintaining China's development trajectory and rebalancing the benefits of growth.

I. Chinese Strategy for Fiscal Reforms

Chinese fiscal policy and institutions have tended to be "reactive" to changes in economic strategy, often with significant lags. While this has not always been consistent with established standards, the sequencing has reflected an understanding of the political economy constraints and considerations that was appropriate in the Chinese context. An example of this was with the economic reforms of the early 1980s that unleashed the astonishing growth impetus that has been in evidence since then.

A key component of the reforms was the shift from the command economy system of 100 percent taxation of profits of state owned enterprises and collectives to a lower 33 percent, and the establishment of "special economic zones" as well as preferential rates for foreign owned companies to attract foreign direct investment. A Fiscal Responsibility System (FRS) was established in 1985 that permitted local governments to keep revenues above a stipulated amount—it was argued that this led to incentives for market-preserving federalism.[3] These measures, however, led to a precipitous drop in the Chinese tax to GDP ratio, as well as the central government share of these revenues. The latter was due to the fact that the administration of taxes was in the hand of local governments, which did not have an incentive to share a shrinking pie with the central government. The amounts due to be remitted to the center could be reduced by investing in local industries, e.g., through various exemptions. Another element was due to the ability of local governments to place resources in extra-budgetary funds that did not have to be shared with the center. [4]

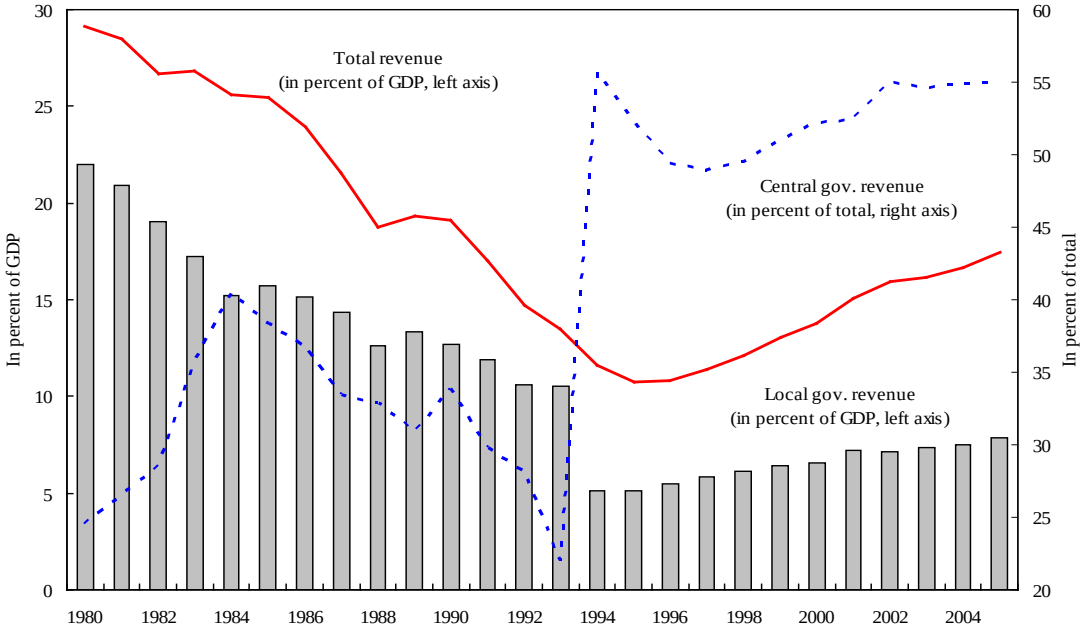
The situation for the central government, by 1992, was quite dire. The central government was quite restricted its ability to conduct macroeconomic policy or any meaningful redistribution (see Figure 1).

The 1994 reforms

The 1994 reforms that also established the State Administration of Taxation, and a new tax sharing system with the VAT as its core, led to a significant change in the revenue to GDP ratio, as well as the position of the central government (see Figure 2). The turnaround in the public finances was immediate, showing the power of a central tax administration to redress incentives to withhold revenues from the center, as well as a more effective tax system, largely due to the imposition of a VAT.

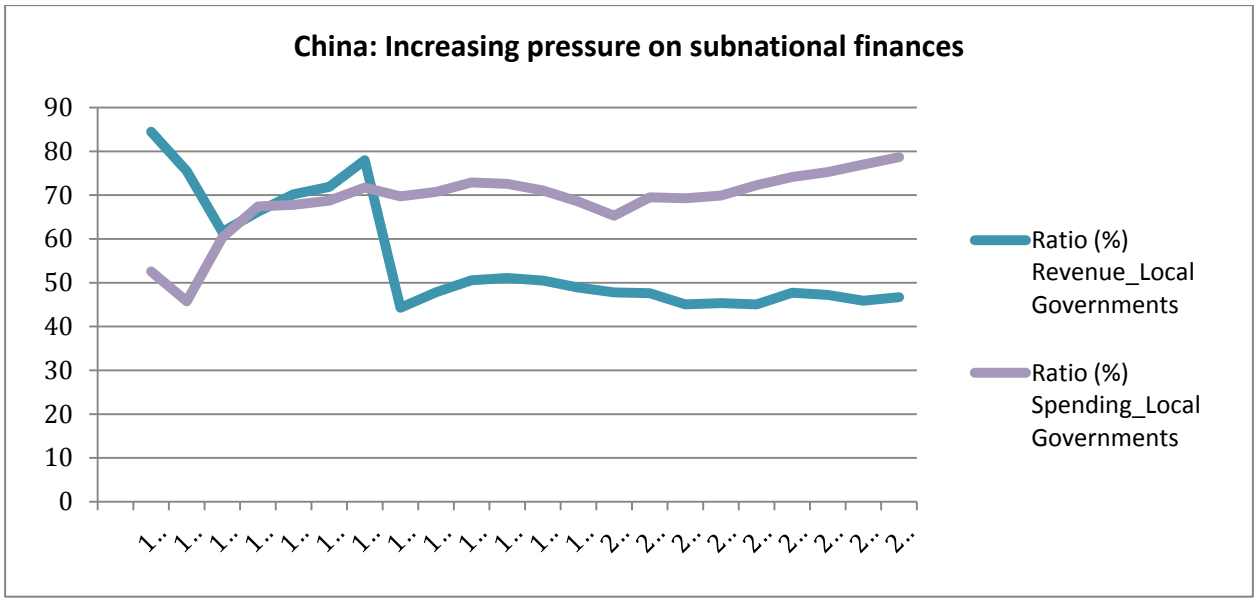
[3] Jin, Qiang and Weingast 2005, and also Qian and Weingast, 1996.
[4] See Wong 2000, and Husain and Stern 2008.

Figure 1. China: Revenue, 1980-2005



Note: The graphs represent trends in tax revenues.
Source: China: Statistical Yearbook, Various Years, Ahmad 2008.

Figure 2



Note: The ratios are relative to total (central and local) revenues and spending.
Source: China: Statistical Yearbook, 2009

A political economy compromise was needed in order to "persuade" provinces to relinquish tax space to the central "State Administration of Taxation (SAT)". This involved several elements to ensure that no province would lose from the reforms (a lump-sum component to assure that the 1993 levels of revenues would be maintained in nominal terms (this would

decline over time); a share in the revenues of the new taxes (especially the VAT), and an additional albeit slowly declining "revenue-returned" over and above the lump-sum and revenue-shares. A key component of the reforms was an equalization framework based on international best practice (standardized assessments of revenue capacities and spending needs), but the amounts allocated for equalization would be increased gradually. [5]

It was recognized at the outset that additional tax reforms would be needed over time. Given the pressing revenue needs, the VAT implemented in 1994 was of the investment type, i.e., with no credit given for investment and capital goods. This introduced distortions, but it was felt that the adjustments could be made over time.

Similarly, the authorities did not attempt to solve all issues with the corporate income tax with the 1994 reforms—which were designed to consolidate the taxation of Chinese-owned firms. These firms were subjected to the Interim regulations on Enterprise Income Tax 1993; #137—which consolidated the Interim SOE income tax (1984); SOE income regulatory tax (1984) and interim Collective Enterprise Income Tax (1985) and the Interim Private enterprise income tax (1988). Foreign firms continued to be subjected to the Foreign Investment Enterprises and Foreign Enterprises Income Tax (1991); #45. [6]

Administration by ownership type was continued—with local administrations continuing to administer the enterprise income tax on local firms, and the SAT administering the others. This helped to "sell" the idea of a SAT to the provinces. Moreover, differential regimes of corporate income tax between foreign and Chinese owned firms were maintained, together with generous tax incentives for the former—largely to encourage foreign investment. Despite the common nominal statutory rate of 33 percent, the effective rate for the foreign firms was at least 10 percentage points lower.[7] An agenda for corporate income tax reforms remained, even after the significant advances made in 1993.

Assessment

The main objectives of the 1994 reform were achieved quite quickly, as seen in Figure 1. The overall tax to GDP ratio increased rapidly. And the central share of the total increased to the levels expected in the 1980s, before the responsibility system distorted local government incentives, and has remained at that level since—affecting the ability of the center to "redistribute resources" and to conduct an active regional policy.

The composition of the transfer system after the 1994 reforms is shown in Table 1. The "revenue-returns" are seen as a major component, and we return to this issue below as it played a major role in the political economy compromise to get the reforms initiated and to ensure that the twin objectives of growth and employment generation in the aggregate would be maintained—albeit at the cost of exacerbating regional inequalities.

[5] See Ahmad (2008), Wang and Lou Jiwei (2008).
[6] See Brean (1998).
[7] Li, Jinyan (2007).

Table 1 Composition of total central transfers after 1994 reforms

	Share of total transfers from the center (in percent)
Total transfers	**100**
Revenue returned	**48.9**
Old system	**2.7**
Equalization transfers	**17.9**
Specific purpose	**30.6**

Source: China Statistical Yearbook

Intergovernmental concerns, particularly bringing on board the provinces was part of the political economy solution that was so well designed by the Chinese authorities in 1994. The equalization framework was commensurate with best practices, yet the amounts available for redistribution were limited. More resources were allocated for the gradually declining "revenue returns" (Ahmad, 2008).

Several distinguished commentators have criticized the overall transfer system as being "regressive". [8] In a static sense, the criticisms are valid, in that more resources were being channeled to the richer coastal regions than the poorer interior (Figure 3). The transfers, together with revenue shares, also probably accentuated regional inequalities in public spending (Figure 4), although population movements within China likely moderated the effects on households—leading to lower overall poverty and unemployment—the main concerns of the policy makers.

Thus, in a dynamic sense, the authorities were probably right in their assessment and policy design—for two reasons. This included the pace of SOE reforms as well as the structure and operations of the labour market—in particular the "floating workers."

First, the main concern of the Chinese government was to avoid major disruptions in production patterns, and aggregate employment generation potential. This meant that resources could not be suddenly diverted from the regions that were benefitting from growth and investment in the mid-1990s. Together with a relaxation of internal migration rules, the "floating population" of migrant workers probably played a significant role in the reduction of rural poverty, despite the fact that resources continued to be allocated to the coastal regions, and may have accentuated interregional inequalities. Yet this was a rational policy response, in keeping with the impressive political economy calculus of the 1994 reforms.

[8] See e.g., Hofman and Yusuf (1995), Husain and Stern (2008) and Qiao, Martinez-Vasquez and Xu (2008).

The second reason was that in 1994 the Chinese government did not have the time to address the spending assignment issue—despite the prescriptions of traditional theoretical constructs of intergovernmental finance. This was because it was decided that the disentangling of social responsibilities of the SOEs would not be undertaken overnight, especially given the political reactions that had been seen in a "big bang approach" to this issue in the USSR. Without this disentanglement, addressing the spending assignments in 1994 would have been meaningless, and was not attempted despite some earnest advice to do so.

The situation now has changed, both vis a vis SOE reforms, local government responsibilities, and the labour employment potential of the interior. Thus, a more balanced and equitable approach can now be undertaken without danger of upsetting the apple cart. We turn now to the components of what could be the case for a 1994 redux.

The main consequence of the 1994 reforms has been a "recentralization" on the revenue side (Ahmad, Li and Richardson, 2001). This has increased the vertical imbalances between the center and the subnational entities, at the same time that there has been a further increase in the subnational spending responsibilities. The resulting pressure on subnational finances in general, as seen in Figures 1 and 2. In combination with tighter budgetary controls (see below) that have blocked off some of the mechanisms for local government flexibility, including extra-budgetary sources of finance, the increasing pressures are in evidence in newer and less well regulated policy tools, such as indirect access to credit.

Figure 3 Overall transfers across provinces, circa 2000

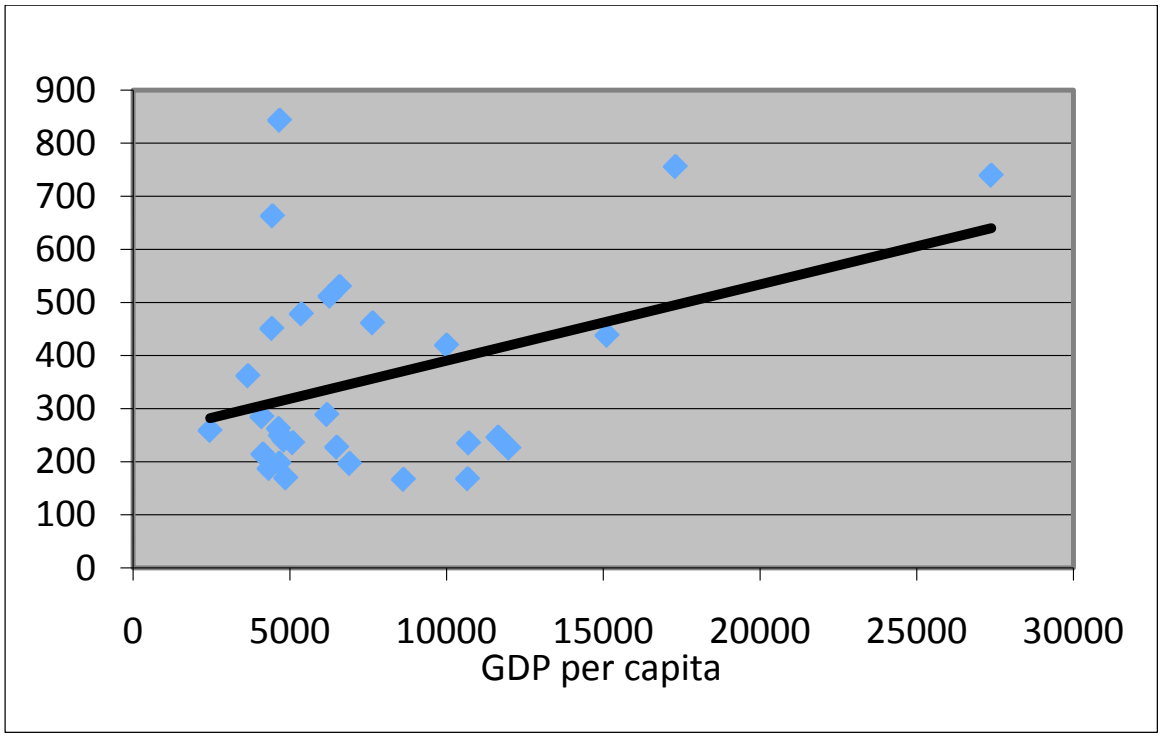
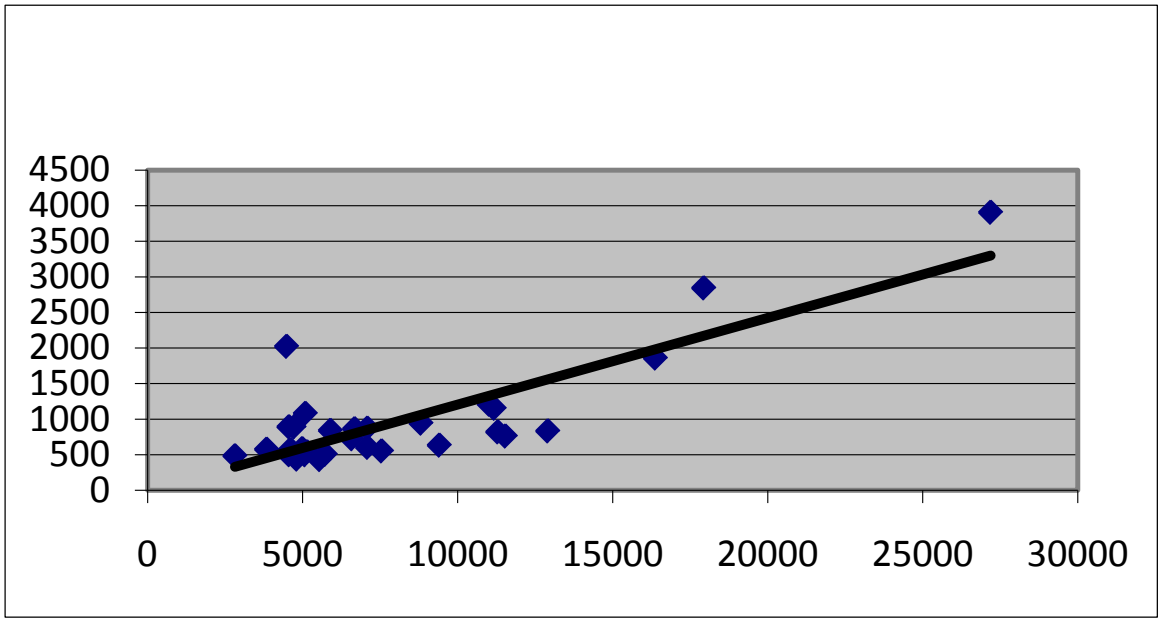


Figure 4 Regional disparities in provincial per capita spending, circa 2000



Source: Ahmad, Fortuna and Singh 2004.

The revenue-sharing mechanisms have exacerbated the sub-national difficulties in an uneven manner—across, and likely within provinces.[9]

II. Gradual Reforms since 1994

Fiscal challenges in an international perspective

Since 1994, the Chinese government has undertaken some basic reforms to strengthen their toolkit of fiscal instruments that puts them in a much better position to address the challenges of dealing with an increasingly sophisticated and complex economy that now rivals the most advanced in the world. Yet, the challenges of dealing with the new realities are significant, and there are substantial gaps and challenges on both the revenue and spending sides that would need to be addressed as part of a coordinated strategy over the medium-term.

While the 1994 reforms dramatically improved China's overall revenue position relative to the immediate past, the domestic resource mobilization effort is far short of levels in the industrialized, as well as in the advanced transition countries (see Table 2). The social contract in these countries is at least as encompassing as that in a "*xiaokang* society", and the patterns of an ageing of the population are not dissimilar. Thus, one would expect much higher spending on health care as well as education in the future, in addition to the current

[9] It has not been possible to examine the changes that might have occurred within and across provinces, some of which are considerably larger than most decentralized countries in the UN.

emphasis on infrastructure, and there would be a need to mobilize commensurate additional resources.

China does fairly well in the comparisons with other advanced countries in relation to the VAT/taxation of goods and services. The big differences are in relation to the income taxes, as well as property taxes and the whole area of subnational own-source revenues, and this suggests areas in which further efforts may be needed in China.

Of course, the aggregate picture hides key elements in the level of provision and financing of public spending in the advanced countries and in China. The first related to sub-national own-revenues and accountability in the level of provision. In the advanced countries, even those that are unitary, there tends to be at least one major revenue source over which the lower levels have some control, usually of the rate (administration does not have to be at the same level for the definition of own-source revenues to apply). Note that revenue shares are like transfers—the local government cannot vary these, and hence these are generally not sufficient in addressing the ability or the incentives of the local government to repay debt, for example. In China, much of the local revenues are generated through shared taxes, or taxes over which the local jurisdiction has little or no control, and hence one can say that this is an area that needs to be examined further not just in the context of the tax reforms, but also in examining the scope for local hard budget constraints, and effective management of sub-national liabilities and debt (these issues are discussed further below).

Table 2 Chinese public finances in international perspective

	China	*France*	*Germany*	*Japan*	*Sweden*	*Canada*	*USA*	*Russia*	*Ukraine*
	2008	2007	2007	2006	2007	2007	2007	2007	2007
Revenue	20.0	49.7	43.9	35.1	56.4	41.4	34.4	47.9	42.3
Tax revenue	17.5	28.8	26.8	18.2	35.9	29.6	21.6	27.2	22.7
Income taxes	4.5	10.5	12.5	8.8	18.8	17.4	13.8	8.7	9.9
Goods and services	9.5	10.8	10.6	2.6	12.8	7.8	4.5	8.1	10.9
Others	2.7								
o/w property		4.6	0.9	0.3	1.2	3.4	3.1 ..		0.2
Nontax revenue	2.5								
Social Contributions	4.4	18.0	16.5	10.9	12.9	5.2	7.0	6.1	13.1
Expenditure	22.3	51.4	43.9	35.5	52.0	37.3	36.0	35.5	40.7
Social Benefits	4.5	23.1	24.6	17.8	18.3	8.8	12.2	9.7	17.2
Functional spending									
Health	**0.7**	7.1	6.2	7.0		7.1	7.6		3.7
Education	**2.5**	5.8	4.0	3.8		5.6	6.1		5.7

Note: all values are percentages of relevant GDP; details for China on spending from GFS Yearbook for 2006
Source: IMF, Government Finance Statistics Yearbook, 2008, World Bank; IMF #IV Staff Report China 2010; 10/238.

A second major difference between China and most of the advanced countries relates to pensions and social insurance. In most of the latter, pensions are treated as part of a national commitment, involving as it does, both interactions between generations, as well as across jurisdictions. The pooling of intertemporal risk is enhanced when the actions are undertaken at the national level. In the Chinese case, these responsibilities were devolved

from the enterprises to the local governments in the initial stages of the reforms, and have remained largely local in scope. Although national pooling was recommended by a World Bank mission as far back as 1989,[10] even pooling at the provincial level has proved to be difficult to achieve, and remains an objective for the current five year plan.

The absence of own-source tax handles for local governments, combined with the increasing devolution of spending responsibilities, and inability to rationalize spending that should normally be the responsibility of higher levels—especially involving the pooling of risks, such as for pensions or unemployment benefits has led the local governments to greater reliance on operations involving land. Given the "grey" property rights in China, local governments have been able to "exploit" loopholes, exploit tenants especially in adjoining rural areas. A significant incentive is the ability of local governments to leverage such assets for spending purposes that tend to be off-budget, and off the radar of higher levels of government.

Part of the problem has been that, as the budget process has been tightened, the sources of funds at the discretion or control of the local governments have dwindled, and there is a reluctance to lose the remaining resources—these include pensions, as well as the funds now being collected under the Urban Development Investment Corporations (UDICs). International experience suggests that clarity in spending responsibilities; together with appropriate own-source revenues; are critical in engendering incentives for improved governance at the subnational level.

Tax reforms

Since 1994, some of the main deficiencies with the VAT and the Income Taxes have been addressed, and experimental work has been initiated with respect to resource taxation and property taxes. However, these have been stand-alone reforms without the adjustments in the transfer system that accompanied the 1994 reforms, and are likely to have had a differential impact on the allocation of resources across provinces given the revenue-sharing arrangements.

1. VAT

The VAT was initially designed as investment-type, with no credit or refunds being allowed on purchases of capital goods. This discriminates against domestic firms relative to imports. This arrangement was used largely to maximize revenues, but did not affect greatly the export-potential. Recently, the VAT has been moved to a consumption-type arrangement, implying that purchases of capital goods would be allowed to be credited against VAT liabilities on the sales of goods by firms. This is in line with international experiences, and reduces distortions against domestic firms. As the exchange rate has appreciated, it became imperative that this distortion affecting exports should be removed.

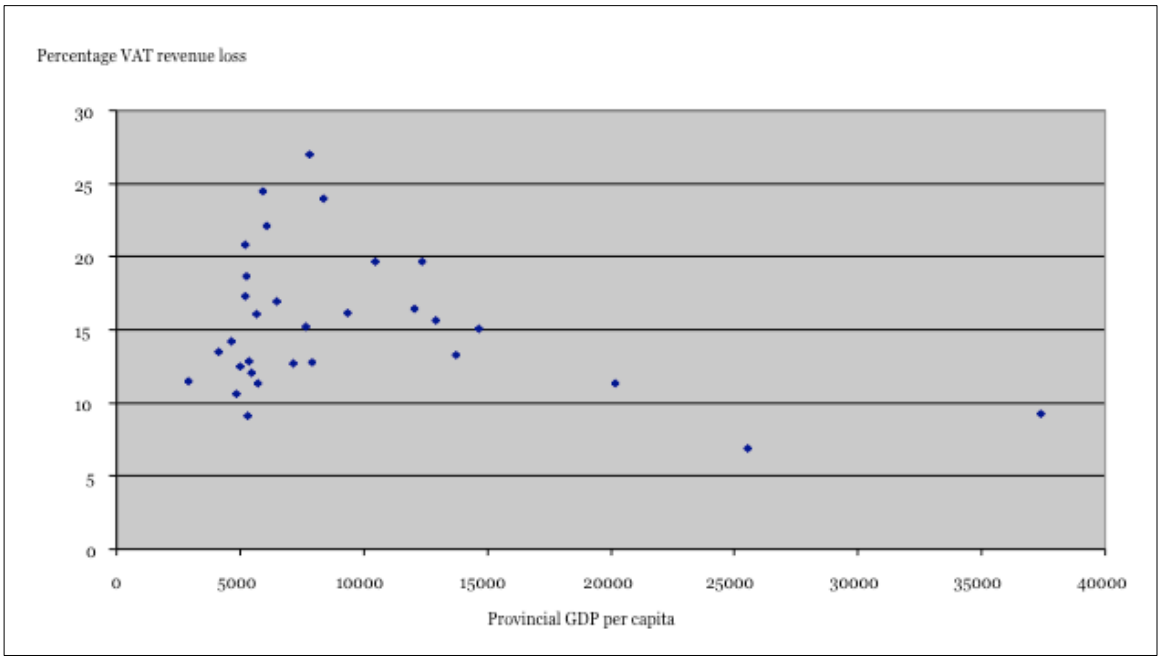
The move to a consumption-type VAT is not revenue-neutral and would have reduced the overall take from the VAT. Moreover, the impact of the revenue losses would be felt in a random manner by provinces, being the highest in the middle- income provinces (see Figure 5 for a simulated estimation of losses). Interestingly, the richest provinces, Shanghai, Beijing

[10] See World Bank 1990.

and Guangdong, do not do badly in terms of this reform, losing on average less than 10 percent of their VAT share.

Of course, the VAT reform agenda is not complete, and comes into direct interplay with subnational finances in its final stage—when and if the business tax is replaced by the VAT. Again, there is a differential pattern of gainers and losers, and a compensation mechanism similar to that devised in 1994 may be needed again, and it is clear that this final stage can only be implemented as part of a broader reform. Figure 6 illustrates the relative losses for provinces. Again, the richest provinces do not lose as much as those in the middle—the interior provinces. Of course, in this case, there is no overall revenue loss, indeed the central revenues increase substantially—and a mechanism could be devised to compensate the losing provinces, either through a change in the sharing percentages, or through the equalization transfer system. The establishment of a complex dual VAT system, such as in Canada, could be considered in the longer term, but for the moment the Australian mechanism of using the equalization framework to provide resources to the provinces may be appropriate.[11]

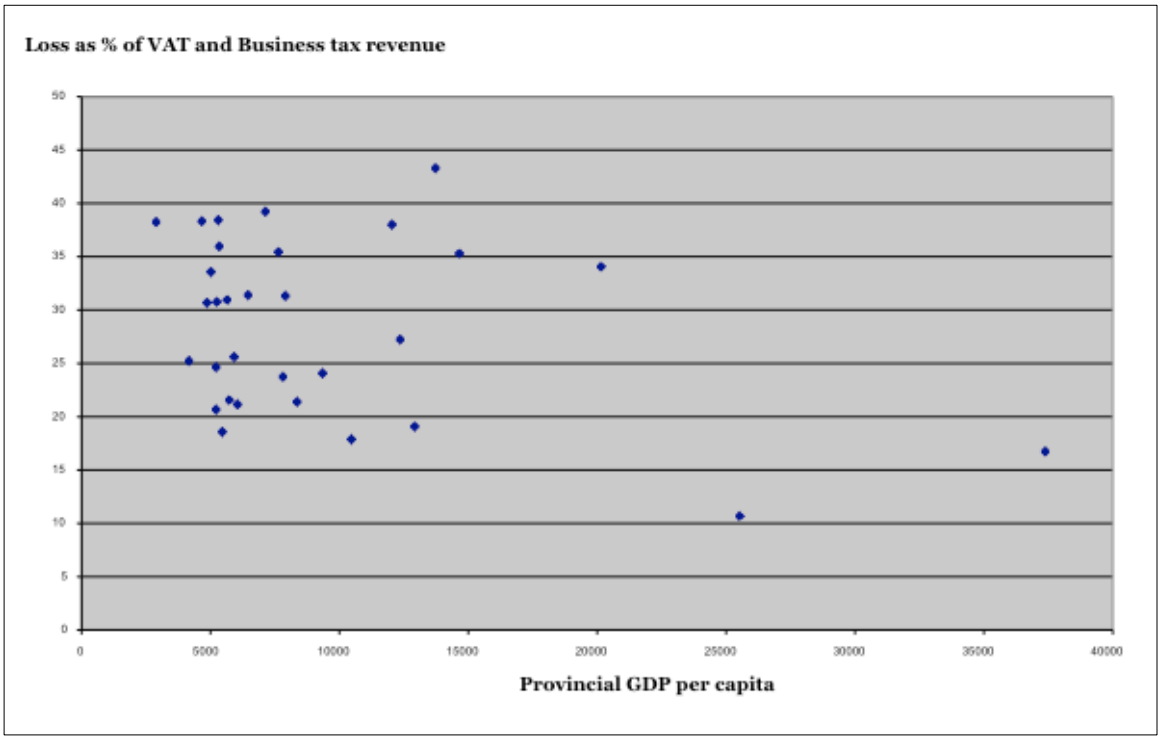
Figure 5 Percentage revenue losses from the C-VAT reforms



Source: Ahmad (2008), Ahmad, Lockwood and Singh (2005).

[11] However, unlike the Australian case, it is not likely that 100 percent of the VAT in China would need to be allocated to finance the equalization system.

Figure 6. Final stage of the VAT reform—provincial losses



Source: Ahmad, Lockwood and Singh (2005); Ahmad (2008).

2. The Corporate Income Tax

The principles underlying the reform of the income tax were understood at the outset in the 1994 reform—creating a level playing field for all firms irrespective of the sources of financing.[12] But it was clear that the implementation would have to be gradual, and there was a need for maintaining incentives for foreign investment, in particular. The 2007 legislation created this level playing field by introducing a uniform tax rate of 25 percent for all enterprises, and removing most of the exemptions and incentives that were available to foreign investors. Unified and clear rules govern the remaining incentives that are available to all investors provided they fulfill the criteria. This simplifies the legislation and administration, and provides greater transparency to the investors (Li 2007).

The new tax rate is close to the effective tax rate for the foreign enterprises, and does not increase the taxation of foreign enterprises or investors. However, the reform reduced the effective tax rate on domestic enterprises and generated a windfall for Chinese companies, including the state owned enterprises.

In general, the lower corporate tax rate should not be a problem, as it permits firms to take rational decisions concerning investments, and creates the incentives for greater efficiency in decision-making. The issue of "excessive" SOE profits, which could be a transitional

[12] For a full description of the basis of the 1994 reforms, and the longer-term objectives on the tax side, see Xu and Lin (1995).

consequence, should not be addressed through a "mandatory" transfer, which would become a tax in disguise and thus negate the spirit of the 2007 legislation.

The appropriate mechanism to deal with "excessive profits" may well be a more active involvement by the management boards of the enterprises that would determine the extent of reinvestment, retained profits, and dividends to the owners (central or local governments) on a case-by-case basis. The more flexible arrangements regarding dividend transfers would supplement a simple sharing arrangement of the CIT between different levels of government. This mechanism would protect the interests of all the concerned parties: firms, central and local governments.

3. Personal income tax

As incomes rise in China, the personal income tax (PIT) will become a more significant source for revenues, as it is in the more advanced countries. Much of the gap in the potential revenue raising capacities between China and other developed countries will be closed through the more effective design and implementation of the PIT. This tax is also a key instrument to deal with inequalities in personal incomes—as this has now become a priority for the leadership and the current plan. Finally, the PIT also provides a convenient handle to provide "own-source revenues" to provinces, in the sense of potential setting of their preferred rate within a specified range even if administration continues with the SAT.

Appropriately, the PIT is no longer a local tax, as it was in 1994. However, converting the PIT into a shared tax, with no control for the local governments over the rate structure at the margin, converts the provincial shares into the equivalent of another transfer from the center, and not an "own-source" tax as defined above—in the sense that the local government has neither control over the rates or base of the tax. This reduces incentives for the local government to assist the SAT, e.g., in providing information.

With a piggy-backing arrangement for the PIT, where there is an additional room for setting the provincial rate (say up to 5 percentage points) above the central PIT rate and collected by SAT,[13] the tax would constitute effective own-revenues of the provincial government. Moreover, there is a greater incentive for a local government to assist with the administration and provision of information to maximize its resources. Further, a ratings agency could examine the effectiveness with which the local income tax base is being utilized, and the rates adopted at the margin by the local government in meeting its obligations.

A piggy-backed PIT sharing arrangement would have similar effects on the regional allocation of resources as the straightforward sharing arrangement. Indeed, a standardized approach to revenue capacities would not "correct" for the effectiveness with which the local revenue base is utilize—so as not to penalize the more efficient local governments. Indeed, with the standardized approach, incorporated in the Chinese equalization

[13] In some unitary countries, the tax base is determined by the center, and the range for provincial tax "piggy-back" is also legislated at the center. The payments due to the local government could be made directly to the local Treasury Single Account (TSA), or routed through the central TSA.

framework, there are incentives for local governments to enhance the use of their revenue assignments. The difficulty is that the local governments have few, if any, own-source revenues assigned, so the incentive in the transfers system is not currently effectively utilized.

4. Property tax experiments

Property tax experiments are being initiated at the large city level (Shanghai and Chongqing). The main focus appears to be to put a brake on spiraling property valuations and speculation more than raising revenues or providing a tax-handle to the local government. In Shanghai, the base is the assessed value, which is now calculated based on the related market prices. Shanghai Government established a standardized property information management system that apparently includes information on the cadaster and market values.[14] In Chongqing, the base is apparently historical trading prices. A shift to the market-valuation may be possible in the future.

If there is eventually a constituency for a modern property tax at the municipal (third tier of local governments), considerable work will be needed to establish a cadaster, mechanisms for valuation, establishment of a rate structure and administration, as well as the recording of property transactions and updates of valuation. The current experiments in Shanghai and Chongqing should provide a useful basis for further expansion.

This reform could usefully be linked to a rationalization of "executive" levels of government that could be held responsible for the delivery of their assigned services—with clearly assigned spending and own-source revenues. Thus, if there were three levels of government, the property (or land) tax could be assigned to the third tier—roughly corresponding to municipalities or counties.

Transfer design

The "political economy" innovation of the 1994 reforms lay in the linkages between the tax reforms and the transfers that helped to "persuade" provinces to cooperate in a significant shift in the power to collect taxes. There were different components (as shown in Table 1)—including the "lump-sum" for 1993 level allocations; that would gradually become insignificant over time; revenue-sharing to provide resources to the provinces that generate revenues, as well as a greater focus on equalization that would benefit provinces with higher spending costs and needs as well as more meager revenue bases. Special purpose transfers were also instituted, and the infrastructure deficiencies in the interior and poorer provinces were targeted. As mentioned above, a "revenue-returned" component was also introduced, designed to decline over time, but principally to ensure that there would be no abrupt shift in the pattern of investment that might adversely affect growth prospects or employment opportunities.

Table 3 shows the shifting patterns of the transfer system over time. We see that the objectives of the 1994 reforms have been largely met. In particular, the revenue returned that formed almost three quarters of the transfers in 1996, was down to 17.3 percent by 2009. The equalization transfers that were 10 percent in 1996, now form almost 40 percent.

[14] Communication from the Ministry of Finance, PRC, February 28, 2011.

Central government earmarked transfers that jumped from 18 percent in 1996 to almost 50 percent, with the government's emphasis on meeting infrastructure gaps in the interior, have fallen to 43 percent by the end of the decade.

The effects of the transfer system can be seen in relation to the spending and revenue patterns in the provinces—Figure 7 shows the picture based on the most recent data available for 2008. While there are clearly significant differences in per capita income across Chinese provinces, with Shanghai, Beijing and Tianjin forming the "outliers" so to speak (above Y 50,000 per capita), and the other Eastern provinces forming the "second" tier (mainly between Y 30,000 to Y 40,000 per capita) and the interior provinces (mainly below Y 20,000 per capita). Shanghai and Beijing are also outliers in terms of revenues, and correspondingly in terms of equivalent spending. If these are excluded, the provinces with the highest per-capita spending are Tibet, Qinghai, Inner Mongolia, Ningxia and Xingiang, and all others are clustered within similar ranges.

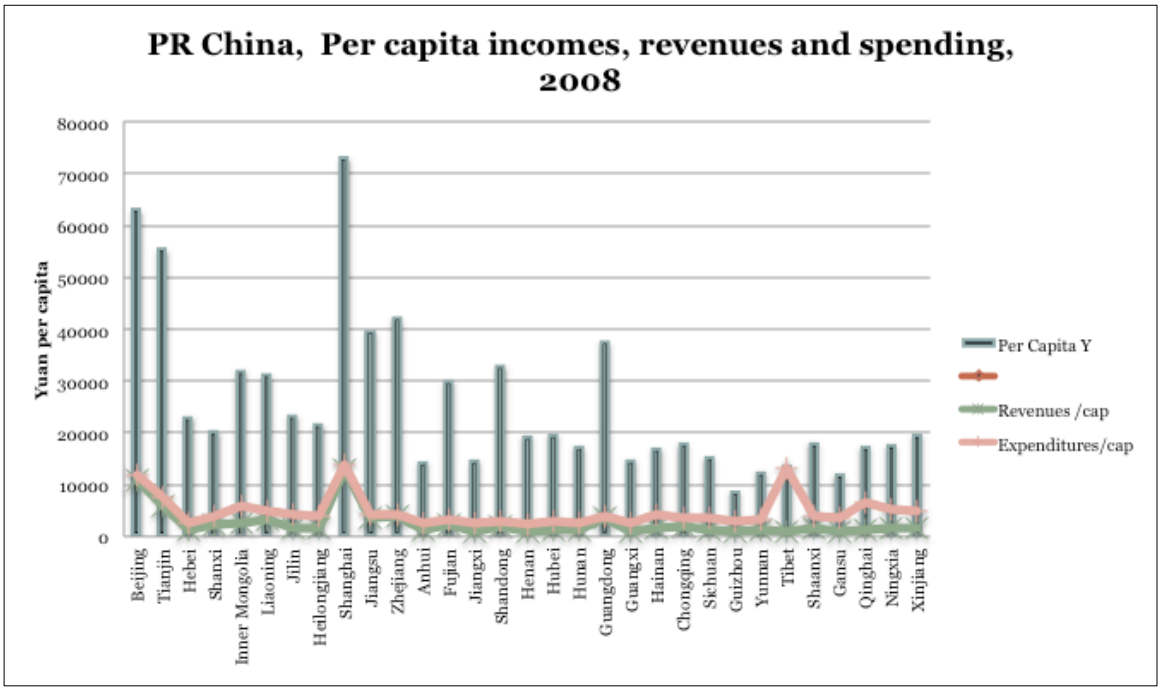
One might say that the special purpose transfers effectively address deficiencies in "backward" provinces like Tibet and border regions. The rest of the transfer system, together with revenue sharing, does indeed result in fairly similar levels of spending across the remaining provinces. This may be contrasted with Figure 3 for 2000, when the pattern of public spending in the provinces was distinctly unequal, even if the outliers (Shanghai, Beijing, Tianjin and Tibet) were to be excluded.

Table 3 Shifting pattern of transfers

	1996	%	2001	%	2008	%	2009	%
Total	271.6	100	517.6	100	2294.6	100	2862.1	100
as % of local gov expenditures	*46.9%*		*39.4%*		*38.0%*		*39.1%*	
Tax Return	194.9	71.8	233.5	45.1	428.2	18.7	494.2	17.3
General transfer	27.9	10.3	28.1	5.4	869.6	37.9	1132.0	39.6
Earmarked transfer	48.8	18.0	256	49.5	996.7	43.4	1235.9	43.2

Source: China Statistical Yearbook, various years

Figure 7



Source: China Statistical Yearbook, 2010

Within-province differences in public spending and provision of services, largely based on rural and urban areas, may be significantly greater than across-province differences, that are being addressed through the revenue-sharing and transfer mechanisms between the center and the provinces. A greater role for the equalization system as the revenue returns are phased out, should allow it to more effectively address differentials in revenue capacities and costs of service provision—more effectively than a system that is now operating more or less on an equal per-capita basis. The greater rebalancing of resource flows should reduce the incentives for out-migration from the more backward, and largely agricultural areas to the industrialized coastal regions.

An alternate would be to introduce an equalization system at the sub-provincial level—e.g., at the third tier. This could be organized by the center directly, as in Indonesia, or by the provinces themselves, under the guidance of the State Council. However, the complexity of managing a transfer system from Beijing directly to the third tier should not be underestimated.

Governance structures

An advantage of the unitary structure of the Chinese legal framework, the center is able to establish rules and norm, although as we saw in the case of the 1994 tax reforms, considerable care is taken by the center in addressing the interests and concerns of the provinces. Although it is in principle feasible for the center to abruptly "instruct" the subnational entities to function in a given manner, this is almost never the case, and there is considerable thought given to the consequences of specific measures, and some experimentation is normally initiated (as with the property tax experiments in Shanghai and

Chongqing). But in other cases, regional experimentation is not possible—as when system-wide reforms were attempted in 1994. Budget reforms fall into both categories—where experimentation is possible and where it is not.

A difficult reform was the transition to an international standard for the budget classification—the use of the IMF's Government Financial Statistics Manual (GFS 2001) for the economic classification and the UN's COFOG for the functional classification. This involved issues relating to budget coverage, as well as having implications for budgeting, accounting and reporting and introduces greater transparency in public transactions. As is evident, this reform could not be introduced in a piece-meal fashion, as it would lead to considerable confusion and nonsensical information. The Ministry of Finance implemented the GFS 2001, in 2007. This now forms the basis for governments at different levels to budget and report fiscal revenue and expenditure statistics. [15]

The coverage of government has been gradually extended, to conform to the logic of the GFS2001 to cover all inflows and outlays that are government in nature, including social insurance spending. According to Ministry of Finance rules issued in 2010, with effect from 2011, all off-budget funds will be shown in budgets "for strict management, the item "off-budget" is going to disappear in Chinese government budgeting." [16] The critical issue is whether this tighter arrangement will be fully implemented.

But could agencies at different levels of government get around these strictures, say by establishing "private" activities, such as taxi services with government vehicles, or "restaurants" with publicly financed canteens that have been reported at all levels of government? This becomes more difficult, of course, with a parallel reform—this is the establishment of treasury single accounts (TSA) at all levels of government. Under this reform, all revenues and expenses must pass through the TSA—this provides an electronic trail of all fund movements, and it would be difficult to "disguise" transactions as "private".[17]

According to the communication from the Ministry of Finance, "by the end of 2010, the (TSA) reform has been fully implemented in all the departments of the Chinese central government, 36 provinces (autonomous regions, municipalities directly under central government, and cities specially designated in the state plan), 327 prefectures (cities), and more than 2500 counties (districts). So, more than 12,500 basic budget units belonging to the central government and more than 0.35 million local budget units are covered."[18]

A consequence of the tighter budget system and TSA reforms is that the flexibility enjoyed by local governments (Hussain and Stern, 2008) will be considerably reduced, if not eliminated. Of course, if this tightening of the budget framework is accompanied by greater flexibility in terms of raising own-revenues—e.g., along the lines discussed above—this

[15] Communication from the Ministry of Finance, February 28, 2011.
[16] Communication from Ministry of Finance, February 28, 2011.
[17] The establishment of a TSA is necessary as part of increased transparency, but is clearly not sufficient to sufficient to eliminate "handling fees" in dealing with local and foreign contracts. This would require closer coordination between the audit and tax bureaux.
[18] Ministry of Finance, op cit.

would engender greater transparency and accountability in public operations at the local level.

Local government risks, Investment financing, UDICs

Local governments are not allowed to borrow, under the existing budget law, and any debt has to be formally incurred by the center for on-lending to local governments. Yet local governments have accumulated around 30 percent of GDP in off-budget liabilities (Liu, 2010), indicative of the flexibility that the off-budget operations provided local operations.

Local governments have been using land-based transactions to generate funds. In particular, land-leasing and bank loans securitized on land and property—accounting for 80-90 percent of infrastructure spending. This has significantly added to the pressure on land prices and scarcity.

In addition, the Ministry of Finance issued bonds for local governments as part of the fiscal stimulus amounting to $17bn, 2008; $62bn, 2009; $14bn Q1 2010 (Liu 2010). The questions arises as to who will eventually pay for these and whether the liabilities have been factored into the local government's medium-term budget envelopes, given that their ability to generate autonomous own-revenues is quite limited.

Urban Development Investment Corporations (UDICs) are springing all over country.[19] In principle these are not an unwelcome phenomenon, but fall into a grey area with an incomplete budget framework law. Some of these are well managed, but perhaps not all.[20] In addition to loans, the UDICs were financed by public instruments, include State bonds on-lent to the local governments, land use rights as capital injection; transfer of assets; extra-budgetary municipal fees and charges as well as tax credits. There are also instances of on-lending from international agencies, issuance of corporate bonds and stocks.

It is clear that the strength of the UDICs is the close linkage with local governments and establishment of local priorities, as well as their implicit guarantee and backing. But that is also the main weakness, as the local government legal and budget framework is not consistent with handling the long-term risks and liabilities that might be generated.

Credit ratings agencies are being engaged to evaluate the performance of the UDICs in ten provinces. Yet, systemic risks and liabilities could be created if some of the investments begin to go sour, and may have an impact on the stability of the financial system--even if there are no explicit guarantees.

Indeed, as seen in the 2011 crisis in Europe, and in the tequila crisis Mexico in the 1990s, private sector liabilities that affect the banking system can be quickly transformed into public liabilities, even if the public sector initially does not have deficits or an apparently unsustainable fiscal position. It is important to realize that the fiscal position can become

[19] World Bank, *The Urban Development Investment Corporations in Chongqing*, Technical Assistance Report.
[20] IMF, China2010—Article IV Consultation Staff Report, p.27.

adverse very quickly—and this puts great weight on the need to establish information and coordination mechanisms.

It was pointed out in 2003 that there is a need for the MOF, PBC and CBRC to build a comprehensive database on local debts and a risk register (see Ahmad et al, 2003). This indeed seems to have been implemented, and the PBC's recent "Regional Financial Operations Report" suggest that loans to the LGFVs have increased significantly since 2008, with the numbers of LGFVs increasing 25% to 10,000 and the total amount of LGFV debt to around Y14 trillion or around 36% of GDP.

Regulators are reported to be preparing to shift Y2 trillion of the loans from the books of 3800 LGFVs to asset management companies. Some part of the loans may have to be written off by the banks, and increased provisioning introduced for other categories. While these measures are sensible to address the stock of local government debt, it is not clear that these will stem further accretions in the future.

Legal framework for subnational debt and liabilities

Local governments are prohibited from borrowing directly. Yet, there has been a loophole permitting borrowing for the operations of UDICs, ostensibly to link borrowing to capital spending. Indeed, this creates an incentive for unrestricted physical capital investment in infrastructure, but with little focus on the sustainability of the spending. This could generate macroeconomic problems in the future.

As in other parts of the world, municipal bond markets would be a useful mechanism to channel savings of households, pension funds, and state owned enterprises that are permitted by their respective boards, into productive avenues of investment. But this would require amending the current prohibition of local government borrowing. Also critical are the presence of hard budget constraints, involving clarity in spending assignments and access to "own-source" revenues at the margin, as well as the provision of information to the market.

Amendments to the budget law are needed to make the process more transparent and accountable, and better linked to local priorities and sustainability. It should also help to generate a more balanced growth perspective, avoiding the current exclusive emphasis on physical infrastructure. Thus would also focus on the operations and maintenance aspects of physical investment as well as the human capital and manpower needs to sustain the investment, thus ensuring a better linkage with the budget process and local priorities.

Ratings for local governments would need to be introduced. As is seen from Box 1, which lists the criteria used by Standard and Poor's, these cover a range of interlocking issues. It is possible to implement this reform in an asymmetric manner, once the revised legislation has been promulgated. For instance, it is likely that Shanghai, Beijing and other large cities may be able to qualify to issuing local bonds before others. This source of finance, together with own-source revenues, may help to unlock the difficult political economy constraints e.g., to additional tax reforms and pensions pooling. For macroeconomic management purposes, a register of liabilities at the local level, in addition to actual debt incurred, should be provided

to the MOF, PBC and CBRC so that they might monitor potential problems in a proactive manner.

Box 1 Standard and Poor's Ratings Criteria for Sub-National Governments

- Economic growth:
  - Outlook
  - Degree of diversification

- Intergovernmental fiscal relations:
  - Clarity in Expenditure responsibilities
  - Taxing powers - control over revenue bases and rates
  - Transfers Design and System—extent of Equalization – system
  - Borrowing legal framework and regulations

- Sub National budget system:
  - Medium-term budget planning framework
  - Clarity of regulations on fiscal management, accounting and reporting
  - Effectiveness of cash management
  - Independent and external audits

- Budgetary performance, debt burden and contingent liabilities:
  - Sound operating balances and sustainable debt structure and level
  - Recognition of contingent liabilities including from government-owned enterprises

III. Elements of a new Fiscal Reform Strategy

The 1994 reforms and the changes were aimed at consolidating the role of the central government in a modern economy, and considerable success has been achieved in this regard. The issue of spending assignments was "postponed" as the role of the SOEs was still to be clarified, and the restructuring has proceeded apace in this regard. The issues involved have less to do with central-provincial assignments, with the exception of pensions, but between provinces and lower levels of government.

In addition, new own-source revenues are needed at appropriate provincial and sub-provincial levels. The main elements of the intergovernmental transfer system exist already—both for special purpose central transfers as well as equalization transfers. However, it needs to be determined whether the central government will make transfers directly to all "responsible" levels of government.

As discussed above, the **critical short-term issue is to address the issue of sub-national risks and debts**. The progress on budget and treasury management needs to be consolidated in a new budget law that also tackles the issue of sub-national debt. This should be transparently determined, along with proper risk assessments of the local governments' investments and operations. The latter in turn requires clarity on spending responsibilities and own-source revenues—thus the reforms are clearly interlinked. It is also important to be cognizant that the private sector liabilities, especially related to property transactions, can be quickly translated into public-sector difficulties. There is thus a premium on establishing a mechanism for the coordination and management of risks across local governments—this has to be at the center, since no one local government will have the ability to monitor or handle the potential difficulties. Some of the building blocks for the short-term, including the new budget law and coordination mechanisms, as well as potential own-taxes (including the piggy-back on the personal income tax, property tax and green tax) are described as part of the overall strategy below.

Key elements of the new medium-term strategy, building on both the 1994 reforms as well as the short-term reforms concerning debt and risk management, are discussed below.

1. Spending assignments

In relation to central-provincial spending assignments, the decentralization process has not only been maintained, it has grown stronger during the last decade in all areas, except social policy (see Table 4). In the latter case, the externalities associated with providing for the aged have not only intertemporal but also spatial implications, and it is appropriate for the central government to play a bigger role, as we discuss below (see also Ahmad, Li and Richardson, 2001).

With respect to "local" spending (which refers to all sub-central levels), the share has increased from 69 percent in 2000 to 80 percent overall—with significant increases in education and health case, as well as transportation. Even in the case of social spending (pensions and unemployment benefits, for example) the share remains above 90 percent, although the center has appropriately begun to play a larger role.

At the provincial level, for the main spending areas: social safety nets, education and health care, the highest spending in each case is for Shanghai and Beijing (see Figure 8)—reflecting their higher resources, as well as cost of provision for an ageing population (with the highest dependency ratios in the country). The higher per capita spending in Tibet, and also the poorer provinces (like Qinghai) reflects need factors and also likely higher cost of provision, and suggests an appropriate design of the special program and equalization transfer system, as discussed above.

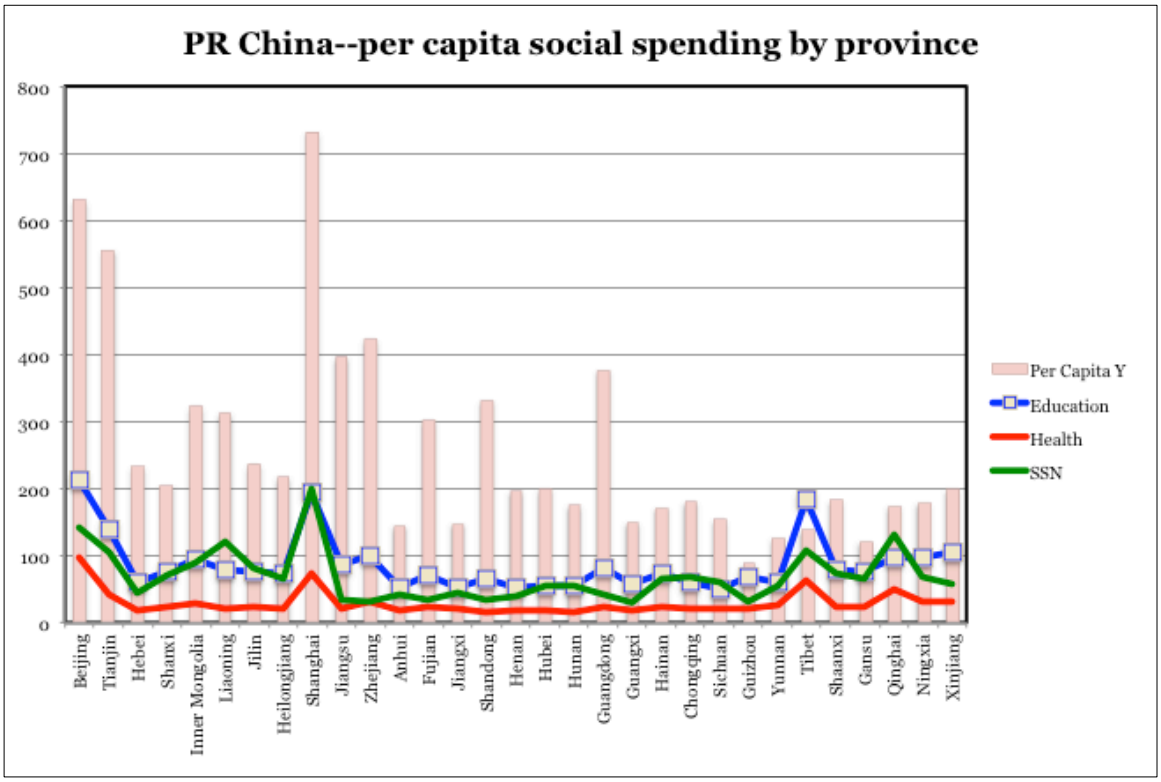
Table 4 China: Changing subnational share in spending, 2000-2009

	Local 2009	**Local 2000**
Total	**80%**	**69%**
Transportation	**77%**	**66%**
Education	**95%**	**89%**
Health care	**98%**	**90%**
Social	**94%**	**99%**

Source: China Statistical Yearbook, 2010.

The variance in aggregate provincial level is far less than at the sub-provincial level and quality of actual provision of services may be far worse. Dollar and Hofman (2008) using World Bank data for 2006 on the investment climate argued that the per capita spending in the richest county was 48 times as high as that in the poorest. It would be interesting to explore how this pattern has changes, e.g., through assessments of different provinces, as practices within provinces may vary considerably. Significant issues may arise in the traditional urban-rural divide, as well as in the provision for the most vulnerable groups of the population.

Figure 8



Source: China Statistical Yearbook, 2010.

2. Telescoping budgetary pressures at the local levels

In the earlier part of this paper, we had noted the increasing budgetary pressure at the local level, particularly in recent years (see Figure 2). This results in telescoping pressures the lowest levels, as central resources tend to stick to the highest tiers of local governments. While the urban areas were able to fall back on indirect borrowing, e.g., through UDICs, effectively unfunded mandates, and inadequate sources of revenues led to pressures at the lowest rural levels for ad hoc fees and charges that were regressive and distortive. And in order to collect such fees and charges, additions to the local bureaucracy were inevitably resorted to. Given political unrest, the central government responded by replacing the fees and charges by an agricultural tax to be accompanied by administrative downsizing—but this tended to be resisted by the local bureaucratic interests (Li 2006).

Despite the tax for fee reform, there was little downsizing and the pressures continued, as did the unrest. The central government reacted by eliminating rural taxes altogether in 2006, and replacing these by central transfers. Three problems arise with this structure—(1) higher-level transfers cannot substitute for the locally generated resources, given the limitations of funds: "the appetite in the localities for central transfers is insatiable… central coffers cannot fill up a bottomless pit" (Li, 2006, p.65). This is also corroborated in an assessment after the agricultural tax was abolished (Tao and Qin, 2007). This is partly due to the incentives for the higher levels to pass through fewer resources than intended at the

local levels, and the timing of central transfers is often not adequately determined even to the provinces. A more difficult issue relates to the incentives for local bureaucracies to divert the central transfers to paying for their salaries and benefits, and not necessarily to the provision of services.

How would it be possible to provide incentives for better local governance, and possible applications of the insights of "yardstick" competition? The first element relates to improved transparency on the flow of funds and the results of the spending—and the current budget and treasury reforms go a long way in doing this. But this is not likely to be sufficient in a country of the size and sophistication of China. It is clearly important to align local incentives through clarity in responsibility for public spending and outcomes and who is responsible. Moreover, some own-source taxation at the margin, however limited, is critical in getting communities and local populations to scrutinize the outcomes of the spending.

3. Rationalizing levels of government and responsibilities

The current 5-level administrative structure poses difficulties in assigning responsibilities and holding officials accountable. Under the aegis of the NDRC, a multi-province experiment to rationalize the levels of government has been initiated (e.g., experimented in Jiangsu). In principle a three-tier arrangement would facilitate:

- Greater clarity in spending assignments—lower levels (existing fourth or fifth levels) could act as "agents" of the third level.
- Possible assignment of "own-source revenues" at the second and third levels of government.

Spending is likely to be higher in rich coastal regions (Shanghai), due to demographics and costs; and in remote and sparsely populated regions with poor infrastructure (Tibet, Qinghai). A U-shape cost curve on the basis of need is seen in the latest figures. However, a significant agenda remains.

Perhaps the most difficult reassignment that remains on the spending side relates to pooling of pension funds. Local pools that have grown in importance and magnitude bestow influence on local officials, who may be suspicious of the manner in which benefits may be administered in neighboring jurisdictions, hence loth to part with control over the resources.

Part of the difficulty lies apparently in the mistrust of lax collections of premia in other cities/regions. Similarly, in the interior provinces with younger demographic profiles, officials are not keen to pay for PAYG pensions in richer coastal areas. Perhaps the mistrust could be assuaged by centralized collections of payroll premia, e.g., by SAT, even if provincial pooling is envisaged—although if there is to be provincial pooling there could easily be pooling at the central level. In addition to the credibility concerns there are issues relating to the likely flow of resources as the younger, perhaps poorer cohorts from the interior finance, on a PAYG basis, the retirement of richer, older cohorts in the coastal region. For this reason, placing this reform within an equalization framework is essential in order to get political acceptability.

The development of individual retirement accounts, or even effective investment of local or provincial pools would be facilitated if there were local bonds and a municipal bond market.

The preconditions for this are quite stringent and not all local governments would qualify. Thus the linkages with budgetary reforms would be quite important.

With the ageing of the population, that will begin to affect the more prosperous and presumably better managed coastal regions, it may be in their longer-term interests to move towards a national pooling of risks and efficiency of management. However, given the nexus of short-term gains and losses and the limited own-source resources that are now available to local governments, ***the pension reform has to be clearly part of a "package" that includes both assignment changes, transfers and access to own-source funding, including credit.***

4. Financing—transfer design

While responsibilities for education and health care are largely devolved to local governments, the key issues relate to effective service delivery within provinces, and whether there should be national standards and whether these should be financed by own- or shared-revenues, supplemented by equalization transfers, or whether there should be special purpose transfers directly to provinces or counties/urban districts. If infrastructure gaps can be identified, an issue that arises is whether the equalization framework, based on spending needs and revenue capacities should be extended to capital transfers within "equalization framework", along the lines of recent theoretical developments and practice in countries such as Spain.

It is clear that the design of spending assignments will need to be linked with the transfer system. The equalization framework is already in place, but the amounts to be transferred, and whether the equalization is at the provincial or county levels, and whether the system will cover both current and capital spending, are the key issues to be determined. Further, the interactions and scope of earmarked transfers and centrally directed spending will also need to be calibrated for specific policy packages.

5. Financing—tax reforms

Despite significant progress in establishing a modern tax system in 1994, and since then, China has still some way to go, especially on income tax reforms, completing the VAT reforms, and possible new initiatives with relation to green/carbon taxes. Most importantly, significant rethinking about options for own-revenues at the subnational level is needed, linked to the budget and accountability reforms that are underway.

Linking taxation and spending, at subnational level, is important in creating the incentives for more efficiency and better accountability. Options for own-source revenues provinces, in addition to simplified shared revenues, could be defined given international best practices. Similarly, non-distortionary options for the third tier could be examined, largely based on more significant moves towards property taxation.

The next stages of tax reforms could focus initially on which instruments have relatively underdeveloped yields, but also examining ease of collection, and effects on production incentives (Ahmad and Stern 1991). To the extent that distributional objectives can be met

through social programs, there is less need to provide special exemptions or preferences for distributional purposes in the tax structure, and the joint tax-transfer system should be examined for welfare and growth enhancing directions.[21]

We summarize the possible options for tax reforms for consideration by the Chinese authorities as follows:

a. The Personal Income Tax (PIT)

Perhaps the greatest potential for additional revenues arises from the PIT, given China's rising incomes. It is desirable to keep the tax law relatively simple, with a reasonable exemption limit, a limited number of rates and top marginal rate synchronized with the CIT.

The PIT could also provide an excellent own-source revenue base for provincial (second tier) governments, if the authorities were to move from the revenue sharing principle to a "piggy-backed arrangement." Under this model, the provinces would be authorized by State Council legislation to levy up to 5 percentage points on the central PIT liability, but the administration would continue to be by the SAT. The current incremental sharing arrangements would be abolished. Taxpayers would use the same base, and file either a single return showing provincial PIT due, or separate returns to central and provincial treasuries.

As the piggy-backed arrangement would favour rich provinces such as Shanghai and Beijing, the equalization framework would need to be recalibrated to reflect the changes over the status quo.

b. Corporate Income Tax (CIT)

The 2007 reforms leading to an integration, standardization and consolidation of the base, are consistent with international best practice, and the tendency of CIT regimes to converge, given the mobility of capital flows. Existing preferences are grandfathered, and new preferences are standardized and simplified. The establishment of a common 25 percent tax rate is also appropriate. Dividend and investment policies should be determined by the respective provincial or central boards of directors of specific companies to address transitional windfall gains for SOEs. Blanket rules for SOEs approximating a reintroduction of higher rates should be avoided.

A simple revenue-sharing arrangement between the center and provinces for the CIT would be appropriate (although, as in the United States, some apportionment will be necessary given the problem of headquarters based filing of returns), replacing the current complex earmarking of incremental incomes. Alternatively, a piggy-backed arrangement, similar to that proposed for the PIT, could be considered. Again, given that richer provinces would likely benefit from either option, a linkage with a recalibration of the equalization framework would be essential.

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[21] An empirical and policy oriented assessment between design of social programs at different levels of government in China, and the appropriate measures for financing through taxation are part of a current research agenda at the Asia Research Center of the LSE.

c. Completing VAT reforms

The recent reforms moving from an investment to a consumption-type VAT were needed to remove the bias against exporters as the exchange rate strengthened. However, this would have led to revenue losses, and the middle-income provinces may have suffered more than others as a result of the current revenue-sharing arrangement on a derivation basis.

The next stage of the VAT reforms is clearly more difficult, as it would replace the local business tax. While the reform would significantly enhance VAT revenues, the losses incurred by provinces would need to be compensated, either by varying the sharing percentages or changes in the overall financing of equalization transfers. [22]

The complexity in dual or multi-level VATs between the center and the provinces, as in India or Brazil should be avoided. China has the makings of an efficient VAT instrument, administered by the SAT, and this should not be dissipated—as there are other instruments that would provide better own-tax handles for the lower levels of government. At most, a modified sharing arrangement could be considered.

If revenue-sharing is maintained, a simplified sharing mechanism would be appropriate. Straightforward sharing on derivation basis tends to benefit producing provinces, as the credits and refunds given across provinces tend to be ignored, and there is a danger that more could be given away than actually collected. A statistical sharing on the basis of "consumption" would be closer to the true basis for a VAT.

d. Property taxes

Proper property taxation forms an appropriate own-source base for county (third) level administrations. Again, given that China is a unitary state, the State Council could legislate the appropriate band that could be chosen by a specific county or municipality.

The issues that arise include the level at which the cadaster should be maintained—the provincial (second) tier, or the municipal (third) tier. There are arguments in favour of a uniform practice and historical valuations to be maintained at a higher level to prevent "game" play at the third (municipal) level. However, in cases where transaction values are also maintained, this may be best done at the third level. The current experimentation building up information on transactions (IT system in Shanghai on assessed base, extensions to Chongqing on transaction values) should provide useful experience.

While overall revenues of the property tax are likely to be modest in relation to the total revenue potential in PR China, this base is likely to be quite important for the third tier governments, and also critical in establishing own-source revenues for ratings and debt management purposes.

e. Consideration of agricultural tax (with exemption limit)

While the abolition of the agricultural tax was designed to remove irritants and "exploitation" of small farmers, it does provide windfall gains for larger farmers and those

[22] In Australia, the VAT reform was made feasible by replacing the mechanisms to finance equalization through the budget, by placing the entire amount of the VAT revenues into the equalization pool.

with more valuable properties. Consideration could be given to reintroducing the agricultural tax on more valuable holdings above a minimum threshold, to mimic the income tax rules.

f. Green taxes

Given the need to protect the environment, and to encourage more efficient use of energy, a generalized green or carbon tax could be considered. The revenues generated, which could be substantial, would create resources that could be used partly for industrial restructuring, and to compensate the poorest households as there would be a likely change in relative prices as the new tax is introduced.

A proposal by Ahmad and Stern (2011) for India suggested that the administration of a green tax should be central, as it is important to prevent local governments from 'playing games' with the tax to attract investments, and that a level playing field for this tax is important. A compensation mechanism linked to the special purpose transfer mechanism for firms and households may be easier to design and manage at the central level.

6. Transfer mechanisms

The modern transfer mechanisms are in place in China—both special purpose transfers as well as equalization transfers are used. The revenue-returns are gradually being phased out and more resources are available for the equalization purposes that are clearly beginning to have an impact on regional imbalances. Both tax reforms and redesign of spending assignments will have a further impact on the transfer system, and the balance between special purpose and equalization transfers and a recalibration of the latter will be needed.

However, the existing instruments for transfers and framework are largely suitable. Possible extensions of the equalization framework are towards the third tier of counties and municipalities, and to capital transfers for education and health care in particular. More resources may be available as the revenue-returned is phased out, the VAT reform is completed, or a green tax introduced.

7. Governance—consolidating budget reforms and managing local liabilities and risks

The progress with budget system and treasury reforms will tighten the flexibility available to local governments. We have discussed own-tax revenues above, and a key element in putting local governments on a modern footing is to bring the management of assets and liabilities, especially for pensions, and provisioning for public-related risks of local governments explicitly onto the budget.

The key extension of the budget framework would be to permit local governments to access capital markets provided they meet certain criteria (own-source revenues, and modern management systems for assets and liabilities). The development of municipal bond markets will help to channel growing household, pension and firm level savings into well-defined and productive directions. There may well be asymmetric solutions that evolve, as the more

advanced provinces/municipalities may be able to meet the necessary preconditions much earlier than others. A new budget law should formalize local borrowing, but set out the necessary preconditions in terms of stock and flow criteria, development of own-source revenues (e.g., as being attempted in Shanghai and Chongqing), and sanctions for failing to meet needed criteria.

There also needs to be strengthened MOF/PBC oversight over subnational budgets and local risk generation, as systemic risks can arise from the private sector even if there are no guarantees—as has been seen in Latin America over the past couple of decades, as well as recently in Europe. The current intergovernmental framework could distort local preferences in unsustainable ways, by emphasizing physical infrastructure to the detriment of maintenance spending, or human capital requirements—a proper framework would synchronize current and capital spending.

In conclusion

In conclusion, the 1994 reforms were remarkably successful in stabilizing the economy and laying the foundations for the growth and poverty reduction that have been seen since then. The criticisms that the process was disequalizing (Qiao, Martinez-Vasquez and Xu, 2008) miss the point that the growth could not have been sustained had the equalization framework introduced in 1994 been fully implemented at that time. It would have shifted resources abruptly to regions that would not have been able to use them effectively, and led to a sharp reduction in growth, but with more equal distribution across regions. It is likely that the reduction in poverty would not have been as remarkable as has been seen since 1994.

Now that the infrastructure has been established to move growth generation inland, it is appropriate that the Chinese government is giving greater room for "equalization"—this again builds on an instrument that was introduced in 1994—the system of equalization transfers. As mentioned, some consideration may need to be given to an additional equalization at the third tier of government, as in Indonesia.

The fiscal infrastructure has also been developed to an extent that was not available in 1994—this includes both the SAT and the budget and treasury systems. Here again, work is needed, including on short-term measures to address the potential local government and private sector debt difficulties. A deepening of the tax reforms, as well as the budget management as well as coordination and information mechanisms suggest that there will need to be a continuous building on sound foundations.

As shown in 1994, a deepening of some of the more difficult tax reforms will require the same political economy wisdom that was shown at that time—and necessitates a combination of instruments to ensure that there is political buy-in for the additional measures needed. Although a comprehensive review is needed, in spirit, the 1994 reforms remain the basis for the continued prosperity of China.

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