

Intergovernmental fiscal relations in China:

An Assessment

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Abstract

Unclear division of governmental functions; problematic design and operation of the fiscal transfer system; mismatch between revenues and expenditures; and lack of fiscal transparency, disciplines, and accountability; are but the few of the problems local governments in China are encountering since it joined the decentralization bandwagon. This paper therefore attempts to explain the surrounding societal circumstances and motivations leading to the said predicaments and explores what the concerned sectors are doing to solve said dilemmas. By offering an empirical-based incites and tracing the process of decentralization, this paper offers a clear line of perspective on intergovernmental fiscal dynamics among China's various governmental entities and levels. While this paper refrains in categorically pointing which way forward, it fulfilled its objective to provide key signpost for future reforms.

Introduction

Restructuring of intergovernmental fiscal relations has been a very important issue in developing and transitional countries in recent decades, with an important focus on decentralization and its effects on the quality of governance (Andrews *et al.*, 2007; Fjeldstad, 2001). All but two of the seventy-five developing and transitional economies with populations greater than five million announced having engaged in transferring powers to local governments (Dillinger, 1994). They did this in varying ways and with varying performance. Constitutional restrictions, political realities, capacities of central and local governments, and an array of specific contextual factors deny any one-size-fits-all solution (Bird, 2000). Yet despite the contextual differences, quality of intergovernmental fiscal system invariably and significantly affects the capacities of both central and local governments and the quality of governance.

Since China entered its reform and opening up stage in the late 1970s, its intergovernmental fiscal relations have experienced fundamental changes, with a major purpose to accommodate its transition from a centrally planned economy to a free market economy and its simultaneous transition from a closed economy to an open economy. New demands, problems, and challenges, accompanied with new concepts and ideas of good governance, have quite complicated the reform of the intergovernmental fiscal relations and made it a persistent and thorny problem to reshape public finance in China. While decentralization was often recognized as a principal drive of the annually inflation-excluded 9% economic growth in China in the past three decades, normalized intergovernmental fiscal relations are still far in place.

This paper discusses the evolution of intergovernmental fiscal relations in China since the late 1970s and its effects on the behavior of local governments and the quality of local governance.¹ Section 1 analyzes the basic context of China's design and enforcement of its intergovernmental fiscal rules and policies. China's institutional environments set many restrictions on the applicability of established fiscal principles recommended by classic textbooks. Section 2 offers an overview of the major reforms of intergovernmental fiscal relations in China. The focus is on the revenue side, which experienced significant reforms and is still in need of a sound and stable institutional framework. Section 3 looks at the changing service delivery profile and the devolution of governmental functions. The tendency is obvious that local governments have, more or less, involuntarily and hesitantly become the major providers of public services. Section 4 discusses the vertical fiscal imbalance, the fiscal transfer system, and the strategic responses of local governments in balancing their fiscal strength and service functions. Some concluding remarks are offered at the end.

1. An overview of the settings of intergovernmental fiscal relations in China

Functions of governments are not equally suited for all levels of governments (Oates, 1972). Standard economic theories divide economic functions between central and local governments by assigning macroeconomic stabilization and distribution of wealth functions to the former, while assigning efficient allocation of resources to local governments when the preferences for goods and services vary from jurisdiction to jurisdiction. On the basis of a sound division of government functions comes the fundamental fiscal principle of the match between collection of revenues and disbursement of expenditures (Voorhees, 2005). Different levels of governments should have "matched" revenues and spending responsibilities. The application of these principles gets complicated in China as a country with five levels of governments and huge local variations. Further, complexity is created as intergovernmental fiscal relations bear important political implications in China on national integrity and political stability.

Since the late 1970s, the Chinese Communist Party has gradually abandoned its ideology-driven goals and became pragmatic, adopting the East Asia Developmental State Model. A basic mission in adjusting its intergovernmental fiscal relations was to serve the development and growth of the economy, which became a major pillar to justify the political legitimacy of the regime. Like many other reforming countries, decentralization was adopted in China in compliance with some basic economic arguments. First, decentralization offers opportunities for more informed and more accountable local governments in offering public services that better fit local preferences and tend to promote economic efficiency. Second, decentralization creates local competition. Decentralization essentially awards local governments a position to claim ownership of local economic growth. When resources are mobile, this prevents predatory behavior and encourages local institutional innovations that may

maximize local comparative advantages (Tiebout, 1956). Third, decentralization leads to hard-budget constraints on local governments which may become more self-disciplined and fiscally responsible. In line with the basic direction of marketization, decentralization is also expected to assign more economic decision making powers to the markets.

All these arguments in favor of decentralization have to be effective when certain conditions are met, the most important among which, are local democracy, transparency and subsequent accountability in fiscal process, and law-based and appropriate local-central division of fiscal powers and responsibilities. While these conditions were only gradually and, to different extent, effectively introduced into the fiscal system of China, and while the Chinese economy experienced three decades of unprecedented fast growth, the effects of decentralization may quite deviate from the accepted predictions. In fact, this made it extremely difficult for China to have a long-term and consistent framework of fiscal reform.

Reinventing intergovernmental fiscal relations in China faces some fundamental challenges. First, intergovernmental relations are hardly institutionalized based on constitutional principles, assigning over much discretionary power to central or high level governments. While the unitary system may introduce some federal elements, for example the so-called market-preserving federalism (Montinola *et al.*, 1995), lack of inner stabilizing mechanisms and constraints on unilateral and perverse actions still preclude the formation of stable predictions and cooperative games. This is obviously reflected by the ever-changing framework of revenue sharing between central and local governments. Second, fiscal accountability has hardly been appropriately established. This issue is embedded in the fundamental need of building democracy and necessary check and balance between governmental branches, between different levels of governments, and between governments and citizens. Both local and central governments face limited external control in fiscal decision making, including that from the People's Congresses at all levels, as China's parliaments. A recent example was the newly announced economic rejuvenation package in November 2008, with a total investment of RMB 4,000 billion. There was hardly any engagement of National People's Congress in making and approving this plan. Hard-budget constraints have hardly been fully in effect, while bailout is pervasive.² Third, and related to the second point, there is a lack of transparency in the intergovernmental fiscal system, which makes the understanding and evaluation of the impacts of fiscal policies difficult, and makes accountability to the public unavailable. Finally, public finance, like other areas of public administration in China, has been in a transition, strained simultaneously by various reform pressures and path dependence effects (Jing, 2007). Sound specification of central-local roles, appropriate service areas and methods, design of revenue-sharing and transfer mechanisms, and other relevant aspects of public finance, all faces a challenge to guarantee unified national policies and sufficient local flexibility, and to serve vested interests and long-term strategies at the same time.

2. The two major stages in reforming intergovernmental fiscal relations

China's transition from a socialist planned economy seriously shaped the reform of its intergovernmental fiscal relations, offering a unique starting point. Between 1950–1978, the fiscal regime was highly centralized. First, revenue and expenditure plans were made by the central government. Under such a system called *tong shou tong zhi* (unified revenue collection and budget appropriation), local governments were de facto implementors of central plans, with no independent budgets and little discretionary fiscal power. Revenues were collected and managed in a centralized way. In accordance with this, local governments had little economic decision power. Investment projects had to be approved by the central government. Second, the highly centralized fiscal system was supported by the existence of a very large State Owned Enterprise (SOE) system. Before 1978, major fiscal revenues were based on the profits of industrial SOEs. China's heavy industrialization strategy mandated the low prices of agricultural products and raw materials, making it possible for the state to harvest profits by selling highly-priced industrial products. During 1960s and 1970s about 60% of the fiscal revenues were from SOE profits, while tax revenues only accounted for 30–40%.³ Relatively industrialized provinces contributed most of the fiscal revenues, for example, in 1970, Shanghai, a municipality with only 1.3% of the population of China, created fiscal revenues of RMB 9.844 billion, accounting for 14.85% of the national total. Within such revenues, 70% were from SOE profits, and 89.98% of the revenues were remitted to the central government. Consequently, fiscal expenditures of Shanghai in 1970 were RMB 1.021 billion, only 1.57% of the national total.⁴ The ownership of the state over SOEs, which may be directly managed by central or local governments, afforded the central government the control of major sources of fiscal revenues.

Such a correspondence between fiscal system and enterprise system deprived both incentives and accountability of local governments in seeking local economic growth and contributed, among many other factors, to the slow economic growth in the 1960s and 1970s, a golden period for other developing countries in East Asian. Since the early 1980s, major adjustments to the fiscal and enterprise systems were introduced, and 1994 was generally recognized as the watershed for the two major stages.

1) *Stage one (1978–1993): Contract-based revenue sharing system*

Since the launch of economic reforms in 1978, highly centralized fiscal system became a major barrier to China's adoption of the East Asian Developmental State Model. In 1980, 1985 and 1988, the fiscal regime experienced some significant adjustments, besides frequent minor and partial adjustments. The basic feature of these reforms was that central government and provincial governments, on a one-to-one basis, negotiated and signed revenue-sharing fiscal contracts, under a principle that provinces should be responsible for balancing their budgets. Such negotiation and

establishment of fiscal contracts would extend until the grassroots level governments were reached.

The 1980 reform reclassified the revenue sources to be fixed central revenues, fixed local revenues, and shared revenues. While fiscal responsibility and accountability of local governments were recognized, the new scheme reflected the tax bases of the planned economy that was about to change. Fixed central revenues were profits of centrally owned SOEs and custom tariffs. Fixed local revenues were profits of locally owned SOEs, agricultural taxes, salt taxes, etc. Shared revenues included profits of SOEs jointly owned by central and local governments, and important taxes like industrial and commercial taxes. To create more incentives for local governments, such division was finally subject to the local-central sharing of the total fiscal revenues. For example, some provinces like Guangdong and Fujian would remit a lump sum of fiscal revenue and retain the extra revenues. No doubt, frequent changes had to be introduced regarding the amount of the lump sum and its growth rate, due to the reform of the enterprise system, the rise of new economic elements, the fast growth of economy, and changing revenue structure. Central government and local governments were trapped in an endless game of bargaining.

The 1985 reform was mainly a response to the newly established income tax for the enterprises. Due to the rise of non-public economy since the late 1970s, profits from SOEs continued to shrink in its importance and profit remittance became increasingly conflicting with the operation of the market. In 1983 and 1984, two reforms were launched to replace profit remittance to income taxation. Between 1985 and 1990, profits only accounted for 2% of fiscal revenues, and were almost totally removed in 1994. Vested interests were recognized in the 1985 reform, which stipulated that income taxes of central SOEs belonged to fixed central revenues, and those of the local SOEs belonged to fixed local revenues. While in general division of revenues began to be dependent on tax categories, revenue sharing retained the 1980 scheme that offered central government a lump sum remittance subject to an annual growth rate.

The 1988 reform stabilized the fiscal contracting system by finalizing six basic schemes of contracting arrangements. They include: (a) remitting a share of the local revenues; (b) remitting a share of local revenues in the base year and the total remittance increases at a predetermined rate in the subsequent years; (c) remitting a fixed amount of the revenues to the central government; (d) remitting a fixed amount in the base year and the total remittance increases at a predetermined rate in subsequent years; (e) receiving a fixed amount of subsidy from the central government; and (f) receiving a fixed amount of subsidy in the base year and the total subsidy increases at a predetermined rate in subsequent years. Table 1 summarizes the contracting schemes adopted during 1985 and 1993.

The first stage of China's fiscal reform was characterized by decentralization which effectively delegated fiscal powers to local governments under a process of fast marketization and economic growth. While local governments didn't have the authority to decide the tax categories, tax rates, and tax bases, they did get the authority to collect all the taxes and retain a substantial portion according to the

Table 1 Central-provincial fiscal arrangements and marginal retention rates

Provinces	1985-87		1988-93	
	Sharing Scheme	Fiscal Decentralization	Sharing Scheme	Fiscal Decentralization
Beijing	a	49.55	b	100.00
Tianjin	a	39.45	a	46.55
Shanghai	a	23.54	c	100.00
Hebei	a	69.00	b	100.00
Shanxi (a)	a	97.50	a	87.55
Liaoning	a	51.08	b	100.00
Heilongjiang	c	100.00	c	100.00
Jiangsu	a	40.00	b	100.00
Zhejiang	a	55.00	b	100.00
Anhui	a	80.10	a	77.50
Shandong	a	59.00	c	100.00
Henan	a	80.00	b	100.00
Hunan	a	88.00	d	100.00
Hubei	a	100.00	a	100.00
Sichuan	a	100.00	a	100.00
Shanxi (b)	e	100.00	e	100.00
Jilin	e	100.00	e	100.00
Jiangxi	e	100.00	e	100.00
Gansu	e	100.00	e	100.00
Inner Mongolia	f	100.00	e	100.00
Xinjiang	f	100.00	e	100.00
Guangxi	f	100.00	e	100.00
Ningxia	f	100.00	e	100.00
Yunnan	f	100.00	e	100.00
Guizhou	f	100.00	e	100.00
Qinghai	f	100.00	e	100.00
Guangdong	c	100.00	e	100.00
Fujian	e	100.00	e	100.00

Source: Lin, *et al.* (2000).

Note: (1) Fiscal decentralization is measured by the marginal retention rate of locally collected budgetary revenues by provincial governments.

(2) Shanxi (a) Province has a provincial capital of Taiyuan, while Shanxi (b) Province has a provincial capital of Xi'an.

fiscal contracts. Table 1 shows that provinces enjoyed a very high rate of retention for revenues beyond the fixed amount set in the contracts. Local governments also made significant use of extra-budgetary revenues to bypass the budgetary system that was relatively easily supervised by the central government. The contracting system created strong incentives for local governments to seek growth by allowing them to assume a role of the owner of local growth, through which low-level local governments and economy merged like a multi-purpose corporation, labeled as local state corporatism by Oi (1992). Such fiscal arrangement suffered from many problems. The sharing scheme and the sharing ratio were both based on one-to-one negotiation and lacked consistent standards, transparency, and stability, failing to achieve equalization across local areas and to reflect the actual efforts and results of

local economic development. Local governments were proactive in promoting local economy and ignored their service responsibilities. The contracting system was quite unfavorable to the central government as it set caps for local remittances and as local governments could easily manipulate tax collection or resort to extra-budgetary arrangements. These problems could hardly be solved by further adjustments to existing contracting system.

2) *Stage two (1994–present): Tax-assignment revenue sharing system*

In 1992, Chinese Communist Party had its 14th National Congress, which defined the final goal of economic reform as the establishment of a socialist market economy. Creating a pro-market fiscal system required further reform and normalization of the taxation system. This looked even urgent when in the early 1990s the contract-based fiscal system had vastly reduced the government's extractive capacity to such an extent that government's macro control in general and central government's control in particular were harmed (Wang, 1997). Table 2 shows that from 1978 to 1993, the ratio of government revenues to GDP decreased significantly from 31% to 12%. Meanwhile, the ratio of central to general government revenues decreased from its peak of 41% in 1984 to the bottom of 22% in 1993.⁵ Despite the fast growth of economy, central government faced embarrassing fiscal constraints and it was not rare that Minister of Finance, even the Prime Minister, solicited from governors of rich provinces fiscal aid and donation.

Table 2 The two ratios of China's fiscal system 1978–2007

Year	GDP (RMB billion)	Ratio 1	Ratio 2	Year	GDP (RMB billion)	Ratio 1	Ratio 2
1978	364.52	0.31	0.16	1993	3533.4	0.12	0.22
1979	406.26	0.28	0.20	1994	4819.79	0.11	0.56
1980	454.56	0.26	0.25	1995	6079.37	0.10	0.52
1981	489.16	0.24	0.26	1996	7117.66	0.10	0.49
1982	532.36	0.23	0.29	1997	7897.3	0.11	0.49
1983	596.27	0.23	0.36	1998	8440.23	0.12	0.50
1984	720.81	0.23	0.41	1999	8967.71	0.13	0.51
1985	901.6	0.22	0.38	2000	9921.46	0.14	0.52
1986	1027.52	0.21	0.37	2001	10965.52	0.15	0.52
1987	1205.86	0.18	0.33	2002	12033.27	0.16	0.55
1988	1504.28	0.16	0.33	2003	13582.28	0.16	0.55
1989	1699.23	0.16	0.31	2004	15987.83	0.17	0.55
1990	1866.78	0.16	0.34	2005	18386.79	0.17	0.52
1991	2178.15	0.14	0.30	2006	21087.1	0.18	0.53
1992	2692.35	0.13	0.28	2007	249530	0.21	0.54

Source: China Statistical Yearbook 2007, 1996 and Ministry of Finance (2008)

Note: Ratio 1 = government revenues/GDP; Ratio 2 = central revenues/general governmental revenues.

The 1994 tax-assignment reform had a recentralization focus. Revenue sharing was set to be strictly based on a new classification of taxes as central, local and shared taxes rather than based on a negotiated lump-sum of revenues remitted to the central government. Important, stable, and easily collectable taxes belonged to the central government, leaving minor, unstable, and hard to collect taxes to local governments. In fact, the fixed revenues assigned to local governments only accounted for about 12% of the total governmental revenues before the reform. The most important tax, the industrial value added tax (VAT), was shared between the central and local at a 75:25 ratio. This reform was directly supported by the simultaneous reform of the enterprise taxes, which introduced VAT as a major source of industrial taxation.

Fixed Central Revenues: Customs Duties; VAT and Consumption Tax collected by the Customs; Domestic Consumption Tax, Income Tax of Central Enterprises; Income Tax of Local Banks and Nonbank Financial Institutions; Revenues remitted by Railway Department, Headquarters of State-owned Banks and Insurance Companies; Profits remitted by Central Enterprises.

Fixed Local Revenues: Business Tax; Income Tax of Local Enterprises; Profits remitted by Local Enterprises; Individual Income Tax; City and Township Land Use Tax; Fixed Assets Investment Orientation Regulation Tax; City Maintenance and Construction Tax; House Property Tax; Urban Real Estate Tax; Vehicle and Vessel Usage Tax; Stamp Tax; Slaughter Tax; Agriculture Tax and Animal Husbandry Tax; Farmland Occupation Tax; Deed Tax; Inheritance and Donation Tax; Land Appreciation Tax.

Shared Revenues:

- a. Domestic VAT: 75% for central government and 25% for local governments;
- b. Resource Tax: the part for the central government is the tax paid by offshore oil enterprises, and the rest is for local governments;
- c. Security Transaction Tax: Split by half between central and local governments

In order to enforce the new arrangement, tax administration was also centralized. National tax bureaus were established in most provinces,⁶ representing the central government in collecting both central and shared taxes. Meanwhile, local tax bureaus were kept and were in charge of collecting local taxes. Along with this change, fiscal disciplines were better enforced since local governments were restricted in offering tax breaks or exemption. In fact, they lost the incentive to do so. It also became increasingly difficult for them to intervene in the collection of central and shared taxes.

The 1994 tax-assignment reform seriously broke the previous structure of revenue distribution between the central and local governments and effectively reversed the decade-long trends of a “weak state” and a “weak central government”. Between 1993 and 2007, ratio 1 increased from 12% to 21%, while ratio 2 increased from 22%

to 54% (See Table 2). In fact, ratio 1 only stopped to increase in 1997 and experienced slow and continuous increase after that, while ratio 2 had an abrupt jump to 56% in 1994 and then fluctuated roughly between 50% and 55%.

The 1994 reform recognized the dominant role of the central government in the intergovernmental fiscal system. Despite the sacrifice of local governments, fiscal federalism was not established and central government didn't give up its authority in making unilateral adjustments. This looks unavoidable considering the fast changing Chinese economy and the subsequent fiscal uncertainty. In 2002, corporate income tax became a shared revenue without differentiating central and local enterprises. Individual income tax also changed from a fixed local revenue to a shared revenue. The sharing ratio of these two income taxes, which grew to be stable and principal taxes since 1993,⁷ was set to be 50 : 50 between central and local governments in 2002, and 60 : 40 in 2003 and the following years.

Fiscal disciplines were also strengthened by reforming the banking system. In 1983 China separated the central bank and professional banks and required professional banks to match their deposits and loans. Yet professional banks were essentially unlimitedly guaranteed by the central bank, whose local branches were under dual leadership of their superordinate branches and the local governments. The integration between the central bank and the local governments made the banks the milking cows of local governments that forced the banks to loan to money-losing SOEs and collective enterprises, in order to avoid their bankruptcy and to collect VAT that could continue to be collected if these enterprises were still "producing". In 1998, the central bank was restructured and its provincial branches were replaced by 9 regional branches, with a purpose to split their direct connection to local governments. The commercialization reform of professional banks also made banks cautious in making loan decisions. This further created hard budget constraints on local governments.

3. Changing profile of service delivery

While fiscal reforms since 1978 featured decentralization and recentralization regarding revenue sharing, governmental functions (spending responsibilities) had a continuous devolution to local governments.⁸ Table 3 shows that the share of local expenditures in total government expenditures continued to increase from its lowest point in 1981 (45%) to its highest point in 2007 (76.9%). Local governments were in effect responsible for the provision of most public service.

Devolution of service delivery responsibilities were driven by several factors. First, marketization reform gradually deprived the social service functions of SOEs and other working units including governmental agencies to their employees. These service responsibilities were transferred, incompletely, to local governments. Second, as China was experiencing a fast process of urbanization and industrialization, the high rocketing new demands on services in principle became local responsibilities. Third, the fiscal decentralization before 1994 essentially required local governments to be fiscally self-sufficient except for those receiving subsidies from the

Table 3 Central and local shares in revenues and expenditures, 1978–2007

(%)

Year	Revenues		Expenditures		Year	Revenues		Expenditures	
	Central	Local	Central	Local		Central	Local	Central	Local
1978	15.5	84.5	47.4	52.6	1993	22.0	78.0	28.3	71.7
1979	20.2	79.8	51.1	48.9	1994	55.7	44.3	30.3	69.7
1980	24.5	75.5	54.3	45.7	1995	52.2	47.8	29.2	70.8
1981	26.5	73.5	55.0	45.0	1996	49.4	50.6	27.1	72.9
1982	28.6	71.4	53.0	47.0	1997	48.9	51.1	27.4	72.6
1983	35.8	64.2	53.9	46.1	1998	49.5	50.5	28.9	71.1
1984	40.5	59.5	52.5	47.5	1999	51.1	48.9	31.5	68.5
1985	38.4	61.6	39.7	60.3	2000	52.2	47.8	34.7	65.3
1986	36.7	63.3	37.9	62.1	2001	52.4	47.6	30.5	69.5
1987	33.5	66.5	37.4	62.6	2002	55.0	45.0	30.7	69.3
1988	32.9	67.1	33.9	66.1	2003	54.6	45.4	30.1	69.9
1989	30.9	69.1	31.5	68.5	2004	54.9	45.1	27.7	72.3
1990	33.8	66.2	32.6	67.4	2005	52.3	47.7	25.9	74.1
1991	29.8	70.2	32.2	67.8	2006	52.8	47.2	24.7	75.3
1992	28.1	71.9	31.3	68.7	2007	54.1	45.9	23.1	76.9

Source: China Statistical Yearbook 2007 and Ministry of Finance (2008)

central government. Medical services, housing, 9-year obligatory education, old-age pension, and unemployment insurance gradually became mainly local responsibilities. There was a trend of “racing to the bottom”, with service responsibilities to be further devolved from provincial to municipal, county, and street governments.

After 1994, the trend of devolution remained, yet the tax-assignment reform suddenly created a serious reliance of local governments on fiscal transfer from the central government. The 1994 tax-assignment reform specified in principle areas of spending responsibilities for central and local governments. The central government was responsible for national security, operational expenditures of central and diplomatic agencies, adjustment of the structure of national economy, coordination of local developments, regulation of the macro-economy and the provision of public services directly managed by the central government. Local governments were responsible for the operational expenditures of local agencies and relevant economic and social expenditures at local levels. While the definition of responsibilities remained unclear, in reality there was a lot of overlap. Central agencies reserved vast discretion in approving local service programs and offering grants, leading to intensive lobbying efforts of local governments on central ministries in Beijing. Table 4 shows major areas of expenditures of central and local governments in 2006. Since the 1980s investment expenditures have continuously decreased in importance compared to consumption and transfer expenditures, which are more inclined to be local responsibilities.

Table 4 Main items of budgetary expenditures of central and local governments in 2006
(RMB 100 million)

Item	Budgetary Expenditures		
	Total	Central	Local
Expenditure for Capital Construction	4390.38	1483.52	2906.86
Innovation Funds and Science & Technology Promotion Funds	1744.56	432.19	1312.37
Additional Appropriation for Enterprises' Circulating Capital	16.58	15.65	0.93
Geological Prospecting Expenses	141.82	37.95	103.87
Expenditure for Supporting Agriculture Production	2161.35	194.39	1966.96
Interest Payment for the Domestic and Foreign Debts	975.39	975.39	
Investment expenditures	9430.08	3139.09	6290.99
Urban Maintenance and Construction Expenditure	1698.69		1698.69
Operating Expenses of Department of Industry, Transportation and Commerce	581.25	135.13	446.12
Operating Expenses for Culture, Education, Science and Health Care	7425.98	719.07	6706.91
Expenditure for Government Administration	3355.81	461.07	2894.74
Expenditure for Public Security Agency, Procuratorial Agency, Court and Judicial Agency	2174.23	98.68	2075.55
Expenditure for Armed Police Troops	388.03	335.38	52.65
Expenditure for Foreign Affairs	109.01	95.40	13.61
Expenditure for Supporting Undeveloped Areas	220.10	4.18	215.92
Operating Expenses in Other Departments	1461.60	111.46	1350.14
Other Expenditures	3721.90	510.77	3211.13
Expenditure on Education Surcharge	388.64		388.64
Expenditure by Using the Vehicle Purchase Tax	656.36	445.03	211.33
Consumption expenditures	25160.98	5863.51	19297.47
Pensions and Relief Funds for Social Welfare	907.68	5.61	902.07
Social Security Subsidiary Expenses	2123.90	241.20	1882.70
Expenditure for External Assistance	82.37	82.37	
Expenditure for Price Subsidies	1387.52	550.22	837.30
Expenditure for Retired Persons in Administrative Department	1330.20	109.40	1220.80
Transfer expenditures	5831.67	988.8	4842.87
Expenditure for National Defense	2979.38	2947.34	32.04
Total	40422.73	9991.40	30431.33

Source: China Statistical Yearbook 2007

4. Local governments in stress

By looking at the vertical fiscal imbalance,⁹ the collapse of China's planned economy since 1978 was accompanied by continuous fiscal centralization. Vertical imbalance decreased from 31.9% in 1978 to 1.3% in 1985, then remained at a very low level until 1993, in which it increased to 6.3% as a response to the anticipated 1994 tax-

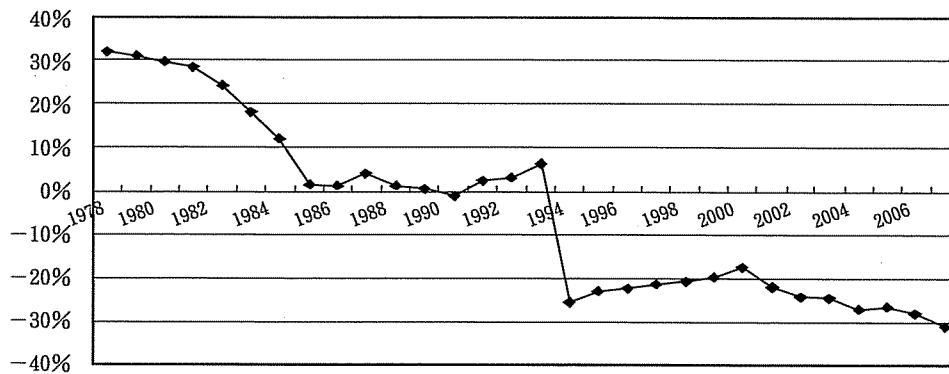


Figure 1 Vertical fiscal imbalance 1978-2007

assignment reform. Since 1994, vertical imbalance had an abrupt change in favor of the central government and in most of the time except in two years (1999, 2000) the rates of imbalance were kept below -20% , reaching the unprecedented -31% in 2007.

The dual trend of fiscal centralization and service devolution created serious reliance of local governments on central transfer. Fiscal transfer only appeared in the 1980s when rights and obligations of local governments as independent fiscal bodies were recognized. Before 1994, fiscal transfer was featured by bottom-up remittance of revenues from provinces to the central government. While reliance on local governments was finally removed after 1994, the new problem was how the central government could effectively transfer back about half of its revenues and serve multiple goals including macro-stabilization, regional balancing, and local development. Just like the vagueness in dividing spending responsibilities, fiscal transfer in China lacks clear legal and administrative guidelines and binding formulas.

Current fiscal transfer in China includes three parts that have relatively equal importance in recent years. First was the tax return (*shui shou fan huan*). The 1994 tax-assignment reform recognized the vested interests of the provinces and guaranteed that fiscal revenues of the provinces would not get worse after 1993. Accordingly, a formula of central transfer, $C_t = R_0 (1 + 0.3G_t)^t$, was worked out that fully compensated the net revenue loss of provinces between 1993 and 1994 and gave the provinces a 30% share of the average growth rate of value added tax and consumption tax of the nation. C_t is the central compensation in year t , R_0 is the net revenue loss of the provinces between 1993 and 1994, G_t is the average growth rate of VAT and consumption tax of the nation in year t , and t is the first, second, and subsequent years after 1993 (Wang, 1997).¹⁰ This baseline method hardly had any effect in reducing local differences. But according to this formula, as time went by, although local governments got increasing transfer from the central government, such transfer had to continuously decrease as a portion of the revenues beyond the 1993 baseline.

The second part of fiscal transfer was the general transfer (*cai li xing zhuan yi zhi fu*) including general purpose transfer, transfer to minority autonomous regions,

wage adjustment transfer, rural tax and fee reform transfer, yearly balancing transfer, and county and township institutional reform transfer. The central government provided these transfers according to established policies, and local governments lacked discretion in the use of the transferred money except in the first two. The third part was special-purpose grant (*zhuan xiang zhuan yi zhi fu*) that was under the discretion of the central government according to the demands of socioeconomic development. Special purpose grants existed in all the spending items in Table 4 and are often subject to the discretion of responsible central ministries. These grants often required local governments to provide matching funds.

In general, affluent provinces have a higher rate of contribution to central government and a less reliance on central transfer. Table 5 shows such information of 4 provinces and one district in 2006. Shanghai only needed the central government to cover an expenditure gap of 12.22% in its total expenditures. It was 14.6% for Guangdong and 17.71% for Jiangsu, two highly industrialized provinces. It was 62.86% for Guizhou, an inland subsidy-receiving agricultural province. Like the revenue sharing system, fiscal transfer within the provinces is under the discretion of provincial governments and has a lot of local variation. Table 5 shows the revenue remittance of Yangpu District, a municipality level local government in Shanghai, to Shanghai and the central government and its own expenditures.

Table 5 Revenue sharing and expenditures for selected areas in 2006¹¹

(RMB 100 million)

	Yangpu District	Shanghai	Guangdong	Jiangsu	Guizhou
District budgetary revenues	29.80				
Provincial budgetary revenues	15.41	1576.1	2179.5	1656.7	226.8
Central budgetary revenues	25.51	3157	2937.5	1547.3	222.1
Budgetary expenditures	48.8	1795.6	2553.3	2013.3	610.6
Upward Contribution	58%	67%	57%	48%	49%
Upward dependence	38.92%	12.22%	14.6%	17.71%	62.86%

Current fiscal transfer mechanisms at all levels suffer from many defects. Mandatory transfer like tax return accounts for a large portion and favors affluent provinces. Transfer decisions lack basic standards, procedural control and transparency, and the transferred money lacks performance measurement and accountability. The effectiveness of fiscal transfer in fulfilling the gap between local revenues and expenditures is still limited, and many transfer decisions were not finally implemented. According to National Audit Office, in 2005 there was totally RMB 773.36 billion transfer payment from the central government, yet only RMB 344.43 billion (44.5%) got into the budgetary plans of local governments, making it impossible for local People's Congress or other agencies to impose necessary supervision.¹²

Facing expanding service demands, local governments adopted some basic strategies that significantly impacted the practice and quality of local governance.

1) *Revenue maximization*

The 1994 tax-assignment reform changed the context of central-local game, despite the fact that maximization of local revenues continued to be a major focus of local officials, whose evaluation and promotion were still largely based on local economic and fiscal performance. Local governments gradually shifted their priority to profit-making private or foreign funded enterprises with national competence rather than money-losing SOEs. This created the foundation for a large scale privatization of small and middle size SOEs in the late 1990s (Cao *et al.*, 1999).

In practice, almost no province has its expenditure gap fully or adequately covered by the central government. This remains true for low level local governments depending on provincial governments for transfer payment. Since the 1980s, extra-budgetary revenues (*yu suan wai shou ru*), including all kinds of fees, charges, levies and funds, were began to be collected by local governments and their agencies to complement their budgetary revenues. These revenues were not under central supervision and were not shared, creating a clear inclination of local governments to shift tax revenues to extra-budgetary revenues, for example by giving tax breaks to the enterprises while collecting fees from them. Popularity of extra budgetary revenues was also related to the weak capacity of the taxation system in raising revenues. Central agencies also began to seriously rely on extra-budgetary revenues in the 1980s. Before 1993, extra-budgetary revenues already surpassed the budgetary revenues. In 1992, in the central revenues and local revenues, extra-budgetary revenues accounted for 64% and 46%, respectively (see Table 6).

In 1993, the central government began to limit the use of extra-budgetary revenues, which lacked basic fiscal disciplines and supervision regarding their scope and standards, as a preparation for the 1994 tax reform. Table 6 shows that since 1993 the central extra-budgetary revenues decreased sharply and continued to remain at a low level. In comparison, local governments quickly restored its reliance on extra-budgetary revenues. In 2005, extra-budgetary revenues accounted for 2.4% and 25.4% of central and local revenues, respectively. Basic categories of extra-budgetary revenues include all kinds of fees imposed by administrative agencies and public service units, government fund revenues, township fundraising revenues, revenues from SOEs, etc. Beyond extra-budgetary revenues, local governments still have some other revenues sources called extra-institutional revenues (*zhi du wais hou ru*), for example some illegal or nonlegal fees and charges or revenues from agencies' affiliated enterprises. While there is no any kind of formal statistical record for these revenues, many believe that they have a very substantial amount (Cong, 2002).

A major revenue source with rising importance for local governments is land sale revenue, which was assigned to local governments in the 1994 reform.¹³ According to official data, between 1990 and 1999, the cumulated revenues were RMB 400 billion, yet they increased fast and reached an annual amount of RMB 913 billion in 2007.¹⁴ Revenues of land sale have been called the "second finance" (*di er cai zheng*) and its importance has surpassed the extra-budgetary revenues. Such high reliance

Table 6 Extra-budgetary revenues of central and local governments 1990–2005
(RMB 100 million)

Year	Budgetary revenues			Year	Extra-budgetary revenues		
	Total	Central	Local		Total	Central	Local
1990	2937.10	992.42	1944.68	1990	2708.64	1073.28	1635.36
1991	3149.48	938.25	2211.23	1991	3243.30	1381.10	1862.20
1992	3483.37	979.51	2503.86	1992	3854.92	1707.73	2147.19
1993	4348.95	957.51	3391.44	1993	1432.54	245.90	1186.64
1994	5218.10	2906.50	2311.60	1994	1862.53	283.32	1579.21
1995	6242.20	3256.62	2985.58	1995	2406.50	317.57	2088.93
1996	7407.99	3661.07	3746.92	1996	3893.34	947.66	2945.68
1997	8651.14	4226.92	4424.22	1997	2826.00	145.08	2680.92
1998	9875.95	4892.00	4983.95	1998	3082.29	164.15	2918.14
1999	11444.08	5849.21	5594.87	1999	3385.17	230.45	3154.72
2000	13395.23	6989.17	6406.06	2000	3826.43	247.63	3578.79
2001	16386.04	8582.74	7803.30	2001	4300.00	347.00	3953.00
2002	18903.64	10388.64	8515.00	2002	4479.00	440.00	4039.00
2003	21715.25	11865.27	9849.98	2003	4566.80	379.37	4187.43
2004	26396.47	14503.10	11893.37	2004	4699.18	350.69	4348.49
2005	31649.29	16548.53	15100.76	2005	5544.16	402.58	5141.58

Source: China Statistical Yearbook 2007

on land financing led to some serious negative effects:

- Accelerating appropriation of agricultural land for commercial and industrial use;
- Inappropriate shift of the use of revenues from rural to urban development;
- Lack of transparency and enormous corruption;
- High-rocketing land price and real estate price;
- Serious detriment to the interests of local residents who were relocated.

Specially, local governments have built keen stake on the development of real estate industry and made itself a hostage of real estate price. Local governments' land interest was gradually intensified especially after the conclusion of housing reform around 2000, which essentially shed government's housing responsibilities and created the commercial housing market. The fast increase of land sale revenue since 2004 was a direct result of the bubble-blowing real estate industry, which crazily rising prices and expansion faced almost no real regulation from local governments. Due to the binding of interests and the formation of local political-industrial complex, China's real estate market responded very slowly to the sub-prime mortgage crisis in the US and the world-wide economic crisis in late 2008, showing a strange coexistence of hot price and cold transaction.

Table 7 Land sale revenues 1999–2007¹⁵

(RMB billion)

Year	1999	2000	2001	2002	2003	2004	2005	2006	2007
Revenues	11.4	34.6	49.2	96.9	293.8	589.4	550.5	760	913

Competition for central transfer is also very important for local governments, as special-purpose grants are under central government's discretion. These grants are characterized by too many items, too large size, and messy management. According to an audit report by Ministry of Finance, a total of 37 central agencies were involved in distributing special-purpose grants in 2004.¹⁶ According to National Audit Office,¹⁷ in 2005, there were 239 projects supported by special-purpose grants. Among them, 41 projects with a total value of RMB 15.6 billion had some level of overlap; 64 projects with a total value of RMB 70.6 billion had no management guidelines or had them publicized. In order to get these discretionary grants, local governments make incandescent efforts to lobby central agencies in Beijing. "Access ministries, access money" (*pao bu, qian jin*) has become an underlying rule, which reflects both the effect of centralized fiscal power and the mismanagement of the intergovernmental fiscal relations. Undoubtedly, this leads to astonishing transaction cost, leakage, and rent-seeking.

2) *Devolution and divesture of spending responsibilities*

Devolution of governmental functions began under the fiscal contracting system and spread across the whole chain of governments in China. The race to devolve responsibilities peaked after the 1994 reform. Many important social services, whose effective provision needs risk-pooling with a large base, were devolved, inappropriately, to low level governments. For example, risk-pooling for old-age pension and medical care at the provincial level was only a quite recent development on trial, which had long been a responsibility for municipal or county governments. Currently, low-level local governments, including municipal governments, county governments, and township governments, are responsible for providing most of the services, yet are hardly adequately supported by transfer from the provincial governments, making themselves most strained by the current regime. Despite the legal prohibition on borrowing debts, many low-level local governments have cumulated many debts and are essentially bankrupt.

Devolution without matched funding and local democracy invariably led to divesture or cut of services. Local governments frequently failed to provide sufficient services either due to their fiscal incapability or due to the unwillingness to shift money to "unproductive" areas. This is most obvious for township and county governments that have the least revenue capabilities but the most service responsibilities. For poor areas, fiscal expenditures are mainly used to pay the wages of governmental employees, satirized as "dining finance" (*chi fan cai zheng*). This was especially true for township governments in 2006 when major agriculture-related taxes, which were the most important direct revenues of township governments, were finally abolished in China and when the promised central transfer was either

insufficient or retained by high-level governments.

County governments are doing no better. Using pension as one example. Till now, pension system has not been established in most rural areas. Since 1999, migrating workers from rural areas began to participate in basic pension plans, yet in 2006 only about 12 million people were covered, accounting for about 10% of the total. Urban nonpublic sectors also have a relatively low coverage, despite their major contribution to the growth of new employments. Despite this, China's pension deficit increased from RMB 7 billion in 1997 to 50 billion in 2002 (Fu *et al.*, 2006). A World Bank report estimates that in 2050, the annual pension deficit will be RMB 524 billion, with an accumulated debt of RMB 9,514 billion (about 8.5% of GDP) (Wang *et al.*, 2000). Money in the funded individual accounts was also largely diverted to the PAYGO system, resulting in pervasive notional individual accounts. Bailout from higher level governments seems unavoidable. Medical care, obligatory education, public health, and many other services share the same dilemma. In recent years, the central government has got more involved in funding and supervising service provision in these areas with nation-wide spillover effect, such as repealing tuition for the 9-year obligatory education in rural areas by offering central subsidies.

3) *Privatization and civil society engagement*

For governments under fiscal constraints, the tenets of New Public Management suggest privatization of services that can be effectively and efficiently provided by the market, or contracting out services to enhance efficiency and quality through a combination of public provision and private delivery. Facing unsatisfied demands, a lot of services have been partially privatized or deregulated, for example public utilities in urban areas like water supply, garbage collection, infrastructure construction, and road cleaning. Governments also retreated from low-end services, mostly manual work, and they faced technical and institutional barriers to producing high value-added services like finance, insurance, legal services and IT. These services are basically procured from outside. While China's privatization of services is mainly driven by governmental downsizing and growing demands, efficiency concern is also salient for local governments constrained by insufficient resources. According to the recent research, from 2002 to 2004, "outsourcing accounted for about one third of the total governmental services expenditures and demonstrated a trend of continuous growth" (Jing, 2008). Local governments have seriously changed to be pragmatic in meeting the service demands, and alternative service delivery methods are increasingly being considered and adopted.

Local governments also face the increasing difficulty in directly dealing with social issues and social services, which are growing in number and in complexity. While China's civil society is emerging and civil society organizations (CSOs) are booming, delegation of responsibilities to or authorization of CSOs became important in fulfilling the vacuum of governance. Between 1990 and 2007, CSOs (including social groups, civil nonprofit organizations, and foundations) registered at Ministry of Civil Affairs increased from 10,855 to 386,916,¹⁸ and they received increasing fiscal

support from the governments and helped implement policies.

These developments in effect changed the environment of public service delivery for the governments and created new risks and uncertainties. Yet the boundary spanning behavior of the governments was far from out of control, by putting it on a clientelist basis (*guan xi*). External service providers often get governmental contracts due to their various connections with governmental agencies or their officials. Divested SOEs or public service units are often favored. And CSOs have to find their supervisory government agencies and register at Ministry of Civil Affairs before they can operate. The underlying political rationality of such a clientelist basis lies in its ability to bring about a transformation of service delivery whilst maintaining existing political and administrative regimes. By introducing market and society into public service delivery in a controllable manner, the government equips itself with the leverage to impose public values and purposes on its contractors and to adapt to the risks of the market in a gradual and secure way. Consequently, there is an outburst of quasi-public and quasi-private organizations (Francis, 2001). Both the cons and pros of this path of change are remarkable.

5. Conclusions

China's intergovernmental fiscal relations experienced fundamental adjustments since 1978, in response to the progress of its economic reforms and the purpose of bringing in economic incentives and macro-control. As China largely adopted the East Asia Developmental State Model, the design of the fiscal system had a serious impact on the speed and quality of economic growth, and it is clear that China's restructuring of the intergovernmental fiscal system has been jointly shaped by the modernization momentum and its special institutional context.

In this paper, the post-1978 development of China's intergovernmental fiscal relations is split into two stages according to the revenue-sharing scheme. The first stage (1978–1993, contract-based revenue-sharing system) highlighted decentralization with a major purpose to create local interests, competition, and growth. After the new enterprise system came into being and demonstrated its vitality, and as decentralization led to perverse behavior of local governments, the second stage (1994–present, tax-assignment revenue-sharing system) highlighted recentralization and fiscal disciplines with a major purpose to exert macro-control, even local inequality, and break localism. Despite the achievements following the 1994 reform, problems in the current fiscal system accumulated seriously. The most salient among them are the unclear division of governmental functions, the problematic design and operation of the fiscal transfer system, the lack of fiscal transparency and performance management, and the mismatch between fiscal power and accountability. As China and the world have been experiencing an unprecedented financial and economic crisis since the 1970s, chances may be created in the future for another round of major adjustments.

Notes

- 1 In China there are five levels of governments, including central government (the State Council), provincial government, municipal government, district/county government, and street/township government, with the latter four referred to as local governments. In this paper, the discussion on central-local relation has a focus on central-provincial relation.
- 2 There are many reports on the debt crises of local governments and even universities. A notorious case is Jilin University, which had cumulated debts of about RMB 3 billion in 2007 including outstanding bank loans and other debts. Currently there is no bankruptcy case of local governments or universities. Legally, bankruptcy law in China only covers enterprises.
- 3 Data source: National Statistics Bureau of China. 1986. *China Statistical Yearbook 1985*, Beijing: China Statistics Press.
- 4 Data source: Bureau of Finance of Shanghai. *Fiscal Statistics of Shanghai 1949–1987*. pp. 62–63.
- 5 This decrease was especially unfavorable to the central government due to the decrease of the government revenues as a portion of GDP, since local governments could more effectively offset its negative impact by making use of extra-budgetary revenues. Although Ratio 2 reached its lowest value in 1993, it must be notice that the 6% decrease between 1992 and 1993 was largely due to local governments' response in 1993 to the 1994 reform.
- 6 For example, Shanghai retained its local tax bureau and didn't establish a new state tax bureau, arguably due to its established good record of revenues remittance to the central government.
- 7 For example, individual income tax revenues increased from RMB 7.27 billion to RMB 121.11 billion between 1994 and 2002, accounting for 1.41% and 6.87% of the total tax revenues of 1994 and 2002, respectively. The data are from State Administration of Taxation (2007).
- 8 In this paper governmental functions are equivalent to spending responsibilities, with a focus on public service delivery.
- 9 Vertical fiscal imbalance refers to the difference between the share of local revenues and the share of local expenditures in the national total, see figure 1. We assume that national fiscal revenues and expenditures were balanced across 1978 and 2007 in order to calculate this indicator, although there were slight variations in many years.
- 10 This baseline method stimulated the fever of local governments in collecting taxes and forced them to disclose the true fiscal strength of the local governments. In 1993, the growth rate of local revenues was 35.4%, compared to 13.2% in 1992. Such growth concentrated in the last 3 months of 1993, when local governments got the definite signal from the central government that no delay would be allowed for the tax-assignment reform in 1994.
- 11 Data are from multiple sources including the online statistical yearbook of Shanghai (<http://www.stats-sh.gov.cn/>) and Jiangsu (<http://www.jssb.gov.cn/jssb/sjzl/tjnj/index.htm>), budgetary reports of Guangdong and Guizhou, and the Statistical Yearbook 2007 of Yangpu District.
- 12 Source: the 2005 report of National Audit Office, *The Auditing Results of the Implementation of the 2005 Central Budget*. (http://news.xinhuanet.com/fortune/2006-06/28/content_4762987.htm)
- 13 In China the ownership of land belongs to the state. Local governments can sell the right of land use.

- 14 According to the research by a Peking University professor, in 2006, the conservative estimate of the amount of land sale revenues should exceed RMB 1000 billion.
- 15 Data are from multiple reports by the Ministry of Land Resources.
- 16 Source: the 2005 report of National Audit Office, *The Auditing Results of the Implementation of the 2004 Central Budget*. (<http://www.audit.gov.cn/n1057/n1087/n524092/557308.html>)
- 17 Source: the 2005 report of National Audit Office, *The Auditing Results of the Implementation of the 2005 Central Budget*. (http://news.xinhuanet.com/fortune/2006-06/28/content_4762987.htm)
- 18 Source: Ministry of Civil Affairs, *The 2007 Report on the Development of Social Issues*.

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