

China's 1994 Fiscal Reform: An Initial Assessment

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By most conventional measures, China's economic reform has been astonishingly successful. As shown by Table 1, in the period between 1978 and 1996, real gross domestic product (GDP) grew on average by nearly 10%, which was comparable to the "miraculous" growth records of the East Asian economies. Ironically, during this period of prosperity, the Chinese government had to struggle to raise enough revenue to sustain itself, because the growth of state revenue lagged far behind that of GDP. In the 18 years between 1978 and 1996, the ratio of total government revenue to GDP fell from almost 31% to less than 11%, a drop of 20%. The situation was particularly bad for the central government, whose share of total government revenue suffered a substantial loss, falling from around two-thirds on the eve of reform to one-third in 1993. In real terms, the economy grew sixfold during this period, but total government revenue only doubled, and central government revenue barely held constant at 1978 levels.

The massive decline of the government's extractive capacity greatly enfeebled its ability to exercise macro control (Wang and Hu, 1994; West and Wong, 1995; Wang, 1996a). To arrest the free fall of the "two ratios", namely, the ratio of government revenue to GDP and the ratio of central to general government revenue, China introduced a new fiscal reform at the beginning of 1994. The goal of the reform was not new at all. In the previous decade, the Chinese government had tried many forms of fiscal contracting to increase the "two ratios" but failed with each (Oksenberg and Tong, 1991; Wang, 1996b). By 1993, it had become abundantly clear to central decision-makers that marginal modifications of the old system would never bring about the result they had been longing for. To achieve the old goal, they needed a new approach---institutional overhaul. The 1994 reform was an attempt to replace the old discretion-based system of revenue-sharing with a

new rule-based system of revenue-sharing. The new system was called the tax-assignment system (fenshuizhi).

This article examines to what extent the new system has overcome the institutional drawbacks of the old system. As the following pages will show, while the 1994 reform represented a notable move away from the old bargaining system, the new system was not quite a true rule-based system yet. Some key discretionary powers were still left for the central as well as provincial governments, which allowed them to continue acting opportunistically, although to a lesser degree. Consequently, the initial results of the reform were at best mixed. Unless these discretionary powers are removed, it is not certain whether, in the long run, the current system will fare much better than the previous ones.

The New Institutional Design

The 1994 reform involved the following changes (Ning, 1994; Herschler, 1995).

First, it fundamentally changed the way revenues were shared between the central and provincial governments. Rather than a negotiated percentage or amount of locally collected revenues being remitted to the central government, now taxes were divided into three distinct categories: central, local, and shared. Central taxes would go into the central coffer, and local taxes into local budgets. As for shared taxes, they were to be divided between the central and provincial governments according to some established formulas. For instance, 75% of the revenue from the value added tax (VAT) belonged to the central government and the remaining 25% to the provincial governments. The sharing ratios were fixed and applied to all the provinces, not subject to negotiation. The rule-based method was expected to reduce bargaining costs.

Second, the tax structure was simplified and tax rates were standardized. For instance, a universal tax rate of 33% was imposed on all enterprises whether they were state-owned, collective, private, or foreign-funded. By improving transparency, these two measures were expected to help monitor the behavior of both tax payers and tax collectors and plug important loopholes in tax collection (Wong, 1995).

Thirdly, local governments were no longer allowed to grant tax breaks. The discretion to grant privileges of "reduced taxes and tax exemption" had

been a big loophole in the old system. Local governments had often used it to channel budgetary funds into extrabudgetary funds, thus reducing the revenues to be shared with the center. Now the central government re-claimed this authority. For any tax exemption to be effective, it now had to obtain approval by the State Council. Subnational governments' discretionary power in this area became much more limited than before.

Fourth, and most importantly, tax administration was centralized. Instead of entrusting local tax offices with the task of collecting virtually all taxes, the center established its own revenue collection agency, namely, the national tax service. Now there were two parallel systems of tax administration with separated chains of command: a national system to collect central taxes and a local system to collect local taxes. Shared taxes were collected by the national system first, but the proceeds from these taxes would be split between the central and subnational governments according to the formulas mentioned above.

The separation of the national tax service from the local tax service was crucial for rule enforcement. In the past, when tax collection lay solely within the purview of subnational governments, they had often abused the upward-sharing mechanism by strategically lowering their tax effort or recategorizing revenues in ways that the center could not share, thus reducing their remittance to the center. Replacing upward-sharing with downward-sharing, the new system was designed to deprive subnational governments of their ability to play such a game against the center.

Central Concessions

The adoption of the tax-assignment system in 1994 marked a paradigm shift in China's fiscal reform, which would undoubtedly affect the interests of every province in some way or another. Conflict of interests thus was unavoidable in the course of such a radical change. In order to ensure a relatively smooth transition to the new system, the center had to convince the provinces that their interests would not be too adversely affected by the reform. But empty promises counted for nothing in realpolitik. To mitigate possible provincial resistance, the center had to bribe the provinces by making some "side payments." Indeed, the 1994 reform package included a number of important concessions to the provinces.

Since strictly following the new rules would certainly lower the revenue income of every province, the first central concession was to guarantee that the level of each province's revenue after 1993 would not be lower than that in 1993.¹ For this purpose, each province's net loss in accepting the new system was calculated,² and the center promised to compensate the province for what it would have to sacrifice for the adoption of the new system. Of course, no province would be happy with merely maintaining its 1993 level of income. Thus, the center had to make another concession: starting from 1994, the central compensation to the provinces would increase by 30% of the average growth rate of total VAT and consumption tax (a central tax) collection in the nation as a whole (State Planning Commission, 1994). In other words, every year after 1993, a province was supposed to receive a central compensation amounting to:

$$C_t = R_0 \times (1 + 0.3 \times G_t)^t$$

where C_t is the central compensation in year t ; R_0 is the compensation baseline or the calculated net loss of the province; G_t is the average growth rate of VAT and consumption tax in the nation as a whole in year t ; t represents the first, second, third...year after the introduction of the new system.³

The third concession was to allow a two-year "transitional period" (1994-1995) in which tax breaks and tax exemptions authorized by governments at the provincial level in the years prior to the introduction of the new system would continue to be effective, and lower corporate income tax rates (27% and 18% respectively) would be applicable to some enterprises with low profitability (Chung, 1995).

Finally, the center made a pledge that, once its share of total government revenues reached 60%, at least one-third of its revenue would be used as fiscal transfer to narrow regional disparities between rich and poor provinces.

The center, of course, did not make these costly concessions of its own accord. However, it knew very well that, without such "side payments," the new system might not be able to obtain much support from the provinces. Therefore, the concessions were a necessary price to pay for the founding of the new system. The first two concessions were obviously geared to the needs

of rich provinces. Since those rich provinces had a vested interest in the status quo (large retained revenues) and were capable of blocking the institutional change, the center had no choice but to guarantee their vested interest from being damaged, at least for the time being. Otherwise, the reform might never have a chance to get off the ground at all. The third concession was a lure for all the provinces, both rich and poor, and the last concession was a response to the pressing needs of poor provinces. Although individual poor provinces were not as resourceful as their rich counterparts in economic and political arenas, collectively they were large in number. Their support for the new system, therefore, was also indispensable.

There was a catch in these concessions, though. The compensations were set in nominal terms. Given the high inflation rates in the reform era, the real value of the compensations would gradually decrease. In the old system, the center had borne (in real terms) the consequence of unforeseen increases in inflation rate--diminishing value of locally-remitted revenue. Now it was subnational governments that were to bear the inflation risk in central compensations. This "catch" was by no means insignificant, because, as time went by, the role of the "transitional" elements would wane. The system thus would presumably function increasingly according to the new rules discussed above (Wong, 1995).

Unfinished Business

While the 1994 reform marked a great step forward in rationalizing China's fiscal system, institutions installed in 1994 were far from perfect. To be sure, compared to the old system, the rules of the game were much clearer, enforcement mechanisms much more reliable, and discretionary powers of both the central and subnational governments much smaller than before. All these changes were expected to produce positive results in the performance of China's fiscal system. But there were still many institutional defects left un-addressed.

The most obvious defect was vestiges of the old system. For example, the revenue-sharing contracts negotiated under the old system were allowed to remain effective. The provinces were still supposed to remit a certain amount or proportion of their locally-collected revenues to the central government, or receive a certain amount of subsidies from the central government,

according to the deals cut with Beijing before 1993. As a result, transfer arrangements between the center and provinces were extremely complicated: the center and provinces first collected taxes and divided revenues according to new rules; then the center returned revenue compensations to the provinces according to the formulas discussed above; and finally, the provinces handed over remittances to the center or received subsidies from the center according to the old revenue-sharing contracts. In the end, no one knew what constituted real central revenue or local revenue.

Another defect was fatal: there were no constitutional constraints on the behavior of the center. Given the center's bad reputation for frequent revision of revenue-sharing methods during the previous years, subnational governments had little reason to believe that the center would become more credible under the new system.⁴ Anticipating *ex post* opportunism *ex ante*, subnational governments had two choices, either to respond to opportunism in kind or to devise institutions that could force the center to comply with the rules of game after the fact (North and Weingast, 1989). The second choice of course was much more desirable than the first one. If the center and the provinces could work out a constitutional arrangement that placed explicit limits on the center's ability to unilaterally alter the rules governing its relationship with the provinces, the regions might become less likely to react strategically. And thereby the revenue collection would be higher than in the non-commitment case. As a result, both the center and the regions would be better off under the commitment regime (Ma, 1995). In other words, restrictions on the *ex post* behavior of the center would significantly improve the efficiency of the new fiscal system, which would in turn help solve the center's financial problems. However, no mechanism that could restrict the center's discretionary power was established. Subnational governments thus might have to make the first choice, which would hurt the interests of both sides.

Yet another unsolved basic issue in inter-governmental finance was the division of expenditure responsibilities. "The design of inter-governmental fiscal policy should always begin with the expenditure side" (Bahl and Wallich, 1995: 327). However, whenever there was fiscal reform in China, attention was always focused on revenue division. The 1994 reform was no exception. There was still no law that assigned specific expenditure responsibilities to different levels of government. When it was possible for

the center to change expenditure responsibilities at will, clear revenue division made little sense. For the central government would have strong incentive to reap advantages from the ambiguity by shifting its expenditure responsibilities downward. The lack of precise definition of expenditure responsibilities thus made it inevitable for the central and subnational governments to be involved in constant disputes over who was responsible for what.

If China is to move away from this bargaining form of inter-governmental relations, it is imperative to assign expenditure responsibilities distinctly and explicitly to the central and provincial governments. And such assignments should be protected by law. Precision and fixity will create greater certainty and predictability, which in turn will motivate local governments to make their best effort to collect local taxes and the central government to collect central and shared taxes (Marshall, 1983; Milgrom and Robert, 1990).

Strictly speaking, what China's 1994 fiscal reform introduced was not a real tax assignment system. While there were taxes designated as "local taxes," the central government still dictated the rates and the base of all taxes, including local taxes. Subnational governments had no control over the rates and the base of their assigned taxes and hence could not determine autonomously the aggregate size of their budgets. Thus, they remained vulnerable to centrally determined changes in the tax base and tax rates. Since the introduction of the 1994 reform, many Chinese officials and scholars have called for independent taxing power for subnational governments. They complained that the revenues from the assigned local taxes fell far short of local expenditure needs. And they demanded formal autonomy for subnational governments to make changes concerning the local tax base, to adjust local tax rates, and even to levy new local taxes on their own respective residents (Yang and Jia, 1994; Wang and Zhou, 1994; Xiang, 1994).

Indeed, it makes perfect sense for the center to confer a certain degree of autonomous taxing power on subnational governments, as long as such power does not distort the allocation of resources in the economy or fragment the common market (Agarwala, 1992; Wong, 1995; Ma, 1995). The devolution of taxing power could enhance the efficiency of the whole fiscal system, because decentralized decision-making would better suit the preferences of local

residents and make the incentives of subnational governments compatible with the center's, thus reducing enforcement costs.

Of course, it is not possible for every locality to produce sufficient revenue for itself. Therefore, there is always the need for some form of transfer between the center and provinces to fill vertical and horizontal fiscal gaps. The 1994 reform, however, did not adequately address this issue. Fiscal transfers played at best a minimal role in the new system design. And there were no formally established rules to determine which provinces would receive transfers and how much they would receive. Decision-making about transfers was still conducted in an ad hoc fashion.

Developing a formula-based system of inter-governmental transfer is an urgent task not only in the economic sense but also in the political sense.⁵ Given the growing regional disparities (Hu, Wang, and Kang, 1996), there is a strong demand for fiscal equalization in favor of poor regions. The central government is obligated to increase transfers to these regions. The current baseline-figure method (jishufa) in determining budgetary allocation to the provinces favors provinces that have greater revenue-generating capacity, namely, rich provinces. This method, however, has become increasingly unacceptable to poor provinces (Yang, 1994; Yang and Jia 1994). To give poor provinces incentives to stick to the tax-assignment system, the center may have to replace the baseline-figure method with a formula-based factor-analysis method (yinshufa) in determining central transfers. Otherwise, without adequate income from own-revenues, shared taxes, and transfers to meet their expenditure responsibilities, poor provinces may soon lose their confidence in the current system, which could threaten the prospects of overall economic reform.

Finally, the 1994 reform did not touch extrabudgetary funds (Wang, 1995). Right before announcing its decision to introduce the tax-assignment system, in July 1993, the central government had redefined the concept of extrabudgetary funds to exclude funds retained by state-owned enterprises. But, even according to this new, and much narrower, definition, extrabudgetary revenues still amounted to 186.3 billion yuan in 1994, equivalent to 35.68% of total budgetary revenue, or 4% of GDP, for that year (Xu and He, 1995; Ding, 1996; Li and Liu, 1997). Such an important source of government resources was utterly beyond central budgetary control. Obviously, until extrabudgetary funds are incorporated into the formal system of budgetary accounting,

subnational governments will continue to possess great discretionary power over an enormous amount of fiscal resources, which is ominous for the future of the new fiscal system.

**The Performance of the 1994 System:
An Initial Assessment**

Prior to 1994, China had made numerous attempts to amend its central-local fiscal relations, but none of them was able to halt the free fall of "the two ratios," namely, the ratio of central to total government revenue and the ratio of government revenue to gross domestic product (GDP) (see Table 1). The 1994 fiscal reform was the most daring reform China had ever taken. Rather than marginal reparation, it aimed at fundamental institutional changes.

Ideal institutional changes are supposed to reconfigure actors' choice sets and alter their incentive structures so that they will behave in more productive ways. However, the 1994 reform was by no means perfect. Therefore, we may expect some improvements in the performance of China's fiscal system, but it is unlikely that the new system will fully achieve the goals its designers had hoped to achieve.

Table 2 confirms this expectation. Total government revenue has increased at a much faster pace. Before 1993, the annual increase of total government revenue had normally been in the range of 20 to 30 billion yuan range, but the 1994 increase was 85 billion yuan, which grew to 122 billion yuan by 1996. After 1993, the annual increase soon climbed to 70 to 110 billion yuan. The central share of total government revenue also appears to be on the rise, going up from one-third to around one half.

When viewed in relation to GDP, however, the annual increase of total government revenue becomes rather disappointing. Even after the 1994 reform, revenue growth still lagged behind economic growth, and the elasticity of revenue to GDP was still lower than unity (Table 3). As a result, the ratio of total government revenue to GDP has largely continued the falling trend of the 1980s. The only exception was 1996 (see the second column of Table 1).

It is also unclear whether the rising central share of total government revenue was real or illusory. Given the complexity of the 1994 system, one may come up with three different definitions of central share. The first is

central collection of taxes. As Table 4 shows, the proportion of central collection has increased from lower than 30% to around 50%, which, by any measure, is a great improvement. The second definition includes not only central collection, but also that part of locally collected revenues that subnational governments are obligated to remit to the central coffer. If we use this definition, the central government's share reached around two-thirds of total government revenue, comparable to the level of many countries in the world. However, the center could not use such combined funds at will, because it had to compensate, through refunds, the provinces' losses in agreeing to accept the new system. Such refunds were in a sense the provinces' entitlements. The center was not free to decide whether to withhold or reduce the refunds. It had to make such refunds to the provinces if it did not want the system to be derailed. Subtracting the refunds that the center was obligated to transfer to the provinces, the central share accounted for only 20% to 30% of total government revenue, which was lower than the level of 1993 and before (see Table 1).

No matter which definition is adopted, one thing seems unmistakable. That is, the central share has been falling since 1994. Is this a transient phenomenon or an evil omen? It is still too early to tell. Indeed, there were some factors that might have contributed to the temporary reduction of central revenue income in 1995 and 1996. Examples were a sharp upsurge of export rebate, the decrease of customs duties, and the gradual phasing out of two central sources of income: Energy and Transportation Funds, and Budgetary Adjustment Funds (Han, 1996; State Information Center, 1996). Will the central share rebound after such ephemeral factors fade out? Not very likely in the short term, I believe.

As shown by the right column of Table 5, it was the large central tax refunds that substantially lowered the center's disposable revenue. Why did the center end up paying such a large amount of refunds to the provinces? The answer is clear from looking at Table 6. In the first nine months of 1993, there was nothing unusual in the pattern of local revenue collection. But as soon as local governments learned, in late September and early October, that the center had decided to use 1993 instead of 1992 as the base year for the new fiscal system,⁶ they all rushed into a collection fever. The local collection in October was 63.3% higher than that in the same month of 1992. In the next two months, local revenue continued to grow at an unprecedentedly

high speed (87.5% in November and 119.8% in December, respectively). Especially, those rich provinces that had usually been sluggish in tax collection suddenly became very enthusiastic in improving their tax efforts (see Table 7). Some local governments collected arrears of taxes, some urged local banks to make loans to enterprises so that they would be able to pay such arrears; some even collected 1994 taxes in advance. In the end, the local collection of 1993 taxes was 28.3% higher than the budgeted amount, and 39.9% higher than the previous year (Ma and Sun, 1994). There is only one explanation for local governments' extraordinary zest: they wanted to collect as much revenue as possible to raise the baseline of their retained revenue so that the center would have to pay them large refunds after the new system was established.⁷

By using 1993 as the base year, the central government was able to lure local governments to reveal their true taxable capacities.⁸ But this achievement came at a high price: the center had to pay the provinces a huge amount of tax refunds, which reduced the center's revenue by a big margin.⁹ Fortunately, the remnants of the old system, namely, the central tax refund and local remittance, tended to gradually lose their importance in the new system. In 1995, the center fixed the total amount of local remittance for all provinces (Ma and Sun, 1996). Thus, as total revenue grew, the center would become less dependent on local remittance (see Table 5). Another good sign was that while local collection still increased faster than the center's, the growth gap nevertheless was narrowing (see Table 8). It is possible, in five years or so, for the center's financial situation to experience some improvement.

However, only under one condition could this happen. That is, the ratio of total government to GDP must stop falling. Otherwise, even if the central share of total government revenue may increase, the ratio of central revenue to GDP would decline further. Why has the ratio of total government revenue to GDP continued to fall under the new fiscal system? Very simple, the government lost a huge amount of revenues.

There were five major "holes" in the system. The first was tax evasion. Because tax evasion was pervasive, the Chinese government conducted a nationwide tax inspection every year. Table 9 gives the figures for uncovered tax revenues during these annual inspections in the last decade. These figures, of course, represent only the tip of the ice-berg. It is estimated

that China can collect only 50% to 75% of its taxes (Ding, 1996; Liu, 1996a). In other words, tax evasion costs China more than 200 billion yuan a year (An & Liang, 1996).

To a large extent, tax evasion was possible because local governments were not serious in enforcing certain tax laws. The collection of personal income tax is a telling example. When this tax was categorized as a shared tax under the old system, it had grown very slowly. However, as soon as the tax was re-classified as a local tax in 1994, the revenue from this source soared (see Table 10). The case of personal income tax suggests that local governments' tax effort may be a key factor in understanding the pervasiveness of tax evasion. This factor also explains why in 1994 over two-thirds of tax evasion instances involved VAT, a tax from which local governments received only 30% of collection (Xinhua, March 22, 1995).

The second "hole" was unauthorized tax reductions and exemptions. In principle, under the new system, local governments had no right to grant tax breaks and exemptions without the approval of the central government. But some local governments continued past practices. In 1994, Wuhan Municipal Tax Bureau, for instance, circulated within the city a document called "120 Provisions," which permitted local enterprises to enjoy reduced tax rates or even outright tax exemptions. If fully implemented, such local policies could result in a loss of 200 million yuan in annual tax revenue in the city (Herschler, 1995). Wuhan of course was not alone in circumventing the new rules. It was estimated that authorized and unauthorized preferential tax policies together cost the government at least 150 billion yuan of annual revenue (Yu, 1995; Cong, 1996).

The third "hole" in the new system was arrears of taxes. In October 1994, overdue taxes reached 30.1 billion yuan (see Table 11), which alarmed the central government. In that month, it gave orders for all arrears of taxes to be collected. The situation improved somewhat in the next three months. By January 1995, overdue taxes went down to 9.7 billion yuan. Then the central government set a target for all the local governments: to collect at least 80% of arrears of taxes by the end of the year. This plan, however, fell through. When 1995 drew to a close, the total amount of arrears of taxes had returned to the level of late 1994. By the end of 1996, arrears of taxes reached a new height, amounting to 35.7 billion yuan. It is interesting to note that over 80% of unpaid taxes involved consumption tax (a central tax)

and VAT (a shared tax) from which local governments were entitled to get only 30% of what was collected (Liu, 1995b). Obviously, the local tax bureaus enjoyed the priority in tax collection over the branches of the national tax bureau. This indicates that local governments still could manipulate not only the collection of local taxes, but also the collection of central and shared taxes.

The next "hole" in China's current fiscal system was extrabudgetary funds. Since the 1994 reform did not touch extrabudgetary funds, it remained as easy as before for local governments to convert budgetary funds into extrabudgetary funds. Extrabudgetary funds amounted to more than 380 billion yuan by the end of 1996, double what they had been in 1994 (Zhao, 1996).¹⁰

In addition to extrabudgetary funds, so-called "extra-extrabudgetary funds" have been growing in recent years. Derived from ad hoc charges, unauthorized fees, forced "contributions," and the like, such funds constitute what Chinese call "little pots of gold (xiaojinku) for the various government agencies that own them. And they are subject to no budgetary control whatsoever. Consequently, no official statistics about such funds are available. By rough estimate, they amounted to 60 to 200 billion yuan in 1996 (Ding, 1996; Xu & He, 1996; Li & Liu, 1997)

These five "holes" were different in nature. The first three and the last one were illegal. It was against the law for individuals and enterprises to evade taxes and to be in arrears with tax payment; it was also against the law for local governments to grant tax breaks and exemptions, and to levy fees and charges, without authorization. Under the new fiscal system, rules about these illegal activities are unambiguous. Therefore, in order to plug these "holes," what the central government needs to do is not to introduce new rules but to show resolve in enforcing existing rules. Unfortunately, so far the central government has failed to show such resolve. It is almost unheard of for violators of tax law, such as Wuhan local officials who were responsible for making the illegal "120 Provisions," to be sentenced to prison. Without forceful enforcement, no matter how good the rules are in themselves, they are meaningless.

The fourth "hole," however, was a legitimate one. As long as it is legitimate for local governments to have extrabudgetary funds, it is extremely difficult, if not entirely impossible, for the central government to prevent them from exploiting this loophole. Here, what the government needs to do is

to incorporate extrabudgetary funds into the formal system of budgetary accounting.¹¹

It is very important to close the five "holes," for they are huge in size. Altogether, they drained the state of at least 700 billion yuan of revenues in 1996, which was equivalent to the size of China's total government revenue, or about 10% of GDP that year. Had the government been able to plug these "holes," its revenue would have instantly increased to more than 20% of GDP, a level close to that of many developing countries.

Conclusion

China's 1994 fiscal reform was an attempt to replace the old discretion-based system with a new rule-based system. Under the new fiscal system, the rules of game are much more comprehensive, unambiguous, and transparent; rule enforcement mechanisms are more reliable. By redefining the choice sets of both the central and subnational governments, new institutions greatly limit the space in which they may maneuver. Since what used to be within their discretion has now become unlawful, the costs of defection are higher. Correspondingly, cooperation looks more attractive under the new system than before. Positive changes in China's central-local relationship since 1993 illustrate how important it is to restructure defective institutional arrangements.

However, new institutions are rarely created de novo. Actors behind any institutional changes normally face three types of constraints. First of all, because no one possesses perfect information and obtaining information is very costly, actors themselves may sometimes have difficulty in figuring out their own interests and in calculating their own strategies. Second, and relatedly, because information about the future is seldom or never available, no actor can foresee all the possible consequences of alternative institutional changes. They always need time to learn and adapt. Third, and most importantly, actors may have conflicting interests. Each may want to structure others' choice sets in such a way as to produce social outcomes that give oneself the distributional advantage. Thus, institutional changes can never be a Pareto-superior response to collective goals or benefits. Rather, they tend to be the by-products of conflicts over distributional gains between the actors involved (Knight, 1992). For these reasons, one should not expect

much of a link between the intentionality of actors and institutional outcomes.

In the case of China's 1994 fiscal reform, although both the center and local governments had long been unhappy with the old revenue-sharing system, what they desired to see were different kinds of new institutional rules. Each hoped that new rules would constrain only the behavior of others, but not their own. Due to this and other constraints, it is impossible for the new institutional arrangements to be perfect without going through a long process of trial and error.

This article shows that, despite many positive changes introduced by the 1994 reform, the institutional arrangements between the central and subnational governments in China were still far from optimal: rules concerning some key aspects of the relationship (e.g., expenditure responsibilities) were absent; there were no constitutional constraints that required the center to follow ex post the rules they had agreed to accept ex ante; huge loopholes (e.g., extrabudgetary funds) continued to be a great drain on state revenue; enforcement mechanisms rarely put teeth into laws. These institutional defects explain why the new system has so far not been able to improve the government's revenue buoyancy.

The Chinese central government was very well aware of the negative effects of these institutional defects. In his report at the Fourth Session of the Eighth National People's Congress on March 5, 1996, Liu Zhongli, China's Minister of Finance, made the following statement:

In 1996, we will adjust and improve the new fiscal system while working to stabilize it. This is aimed at further standardizing financial and tax management...[W]e will continue to improve the tax-assignment system. While adopting interim transfer payment methods, we will study the issue of dividing [expenditure] responsibilities between governments at different levels...We should adjust and review preferential policies on tax reduction, exemption, and post-collection tax rebates...We should take effective measures to collect overdue taxes from enterprises and prevent tax arrears from rising again...We should improve the measures for managing extrabudgetary funds. We should resolutely include in our budget all fees that should be placed under

budgetary control...We should tighten the supervision and inspection of law enforcement effort and step up our efforts to combat various illegal acts...We will conduct a general inspection of financial and economic discipline this year, focusing on serious violations of the law and such breaches of discipline as the practice of keeping "two accounts," tax evasion and cheating, the conversion of budgetary funds into extrabudgetary funds, the illegal establishment of "small treasures," and the collection of unwarranted fees...We should sternly deal with problems that we have identified. If they constitute crimes, we should refer them to judicial organs for criminal investigation (Liu, 1996b).

The question is whether the central government has the will and ability to carry out further institutional changes, including constraining its own future actions, that are necessary for establishing central-local fiscal relations on an unambiguous, binding, non-negotiable, and predictable basis.

Table 1: Selected Fiscal Indices of China, 1978-1996

Year	GDP Growth	GGR/GDP	CGR/GGR	Deficit	Debt/CGR
	%	%	%	(Billion)	%
1978	11.7	30.9	45.8	-1.0	0.0
1979	7.6	27.6	46.8	20.7	5.5
1980	7.9	24.0	51.2	17.0	6.6
1981	4.5	22.8	57.2	9.9	12.1
1982	8.5	21.7	NA	11.3	14.6
1983	10.2	21.6	53.0	12.3	12.3
1984	14.5	20.9	56.0	12.2	10.5
1985	12.9	20.8	52.7	6.8	10.7
1986	8.5	22.2	NA	20.9	14.4
1987	11.1	19.8	48.8	25.0	16.4
1988	11.3	17.6	47.0	34.9	25.5
1989	4.3	17.4	NA	37.4	25.6
1990	3.9	17.9	48.5(45.1)	51.6	27.3
1991	8.0	16.7	45.0(40.3)	66.4	30.8
1992	13.6	15.6	45.6(38.6)	90.5	36.8
1993	13.5	14.7	NA(33.4)	89.9	35.5
1994	11.8	11.6	?	63.8	40.7
1995	10.2	10.7	?	NA	52.8
1996	9.7	10.9	?	54.8	NA

Notes: GDP: Gross domestic product
GGR: General government revenue
CGR: Central government revenue
CGE: Central government expenditure
Figures in parentheses exclude debt incomes.

Source: State Statistical Bureau (1995, 1996), Ma (1995), Liu (1995a) and (1997).

Table 2: Fiscal Indicators, 1992-1996

Year	Total Revenue (bn.)	Growth Index	Central Revenue (%)	Local Revenue (%)	Local Remittance (bn.)	Central Refunds (bn.)
1992	348.34	100.00	28.1	71.9		
1993	434.90	124.85	22.0	78.0		
1994	521.81	149.80	55.7	44.3	57.005	211.800
1995	624.22	179.20	52.2	47.8	60.319	197.650
1996	736.66	211.48	49.5	50.5	60.319	271.628
1997*	839.79	241.08	49.4	50.6	60.319	290.504

Note: *The figures for 1997 are budgeted ones.

Source: State Statistical Bureau (1995) (1996), Liu (1996) and (1997).

Table 3: The Growth Index of Government Revenue and GDP
(1992 as 100, current price)

Year	Revenue	GDP
1992	100.00	100.00
1993	126.85	130.02
1994	149.80	175.02
1995	179.20	216.73
1996	186.77	254.49

Source: State Statistical Bureau (1995), (1996), and Liu (1997).

Table 4: The Central Share of Total Revenue According to Three Definitions
(billion yuan/percentage)

Year	Central Revenue 1	Central Revenue 2	Central Revenue 3
1993	95.751 (22.0%)		
1994	290.650 (55.7%)	347.655 (66.6%)	135.855 (26.0%)
1995	325.662 (52.2%)	384.513 (62.1%)	186.863 (30.2%)
1996	364.907 (49.5%)	425.226 (57.7%)	153.598 (20.9%)
1997*	415.065 (49.4%)	475.384 (56.6%)	184.880 (22.0%)

Note: Central Revenue 1 = Central Collection.
 Central Revenue 2 = Central Collection + Local Remittance.
 Central Revenue 3 = Central Revenue 2 - (Central Refunds + Subsidies).

*The figures for 1997 are budgeted ones.

Source: State Statistical Bureau (1995), (1996), Liu (1996) and (1997).

Table 5: Interdependence between the Central and Local Governments
1994-1996

Year	LR/CR	CT/LI	CT/CR
1994	16.40	47.80	60.92
1995	15.69	40.15	51.40
1996	14.19	42.22	63.88
1997*	12.69	40.62	61.11

Note: LR = Local Remittance to the Center
 CR = Central Revenue 2
 CT = Central Transfers to Local Governments
 LI = Local Collection + CT

*The figures for 1997 are budgeted ones.

Source: State Statistical Bureau (1995), (1996), Liu (1996) and (1997).

Table 6: Monthly Progress Rate of Local Revenue Collection, 1990-1993

(Budgeted Revenue Collection as 100)

Year	1	2	3	4	5	6	7	8	9	10	11	12
1990	7.2	13.4	19.3	28.2	36.1	44.1	53.6	61.5	69.3	79.6	88.4	100.0
1991	6.1	12.2	19.1	27.8	35.9	44.7	53.8	61.6	69.4	79.9	88.8	100.0
1992	6.9	13.0	20.9	30.6	39.0	48.3	58.3	66.9	75.1	85.5	94.0	106.7
1993		12.3	20.3	29.9	38.0	47.2	59.4	65.4	76.0	90.6	104.3	128.3

Source: Ma and Sun (1993, 1994).

Table 7: Growth Rate of Local Revenue in 1993

< 30%	> 30% but < 40%	> 40% but < 50%	> 50%
Beijing*	Shanghai*	Hebei	Jiangsu*
Tianjin*	Anhui	Inner Mongolia	Guangdong*
Shanxi	Jiangxi	Liaoning*	Guangxi
Heilongjiang*	Shandong*	Jilin	Hainan*
Hubei	Henan	Zhejiang*	Yunnan
Guizhou	Hunan	Fujian*	Qinghai
Shaanxi	Gansu	Ningxia	
	Xinjiang*		

Note: Those provinces with * were ones where per capita GDP was higher than the national average.

Source: Hu (1996).

Table 8: Growth Rate of Revenue, 1993-1996 (%)

Year	Total	Central	Local	Difference
1993	24.8	-2.2	39.9	42.1
1994	20.0	8.5	28.2	19.7
1995	19.6	11.5	27.4	15.9
1996	18.0	12.6	26.2	13.6
1997*	14.0	13.7	14.3	0.6

Note: *Budgeted figures for 1996.

Source: State Statistical Bureau (1995) (1996); Liu, Wang, and Li (1996);
Liu (1996) and (1997).

Table 9: Uncovered Tax Revenue, 1985-1996

(billion yuan)

1985-1992	1993	1994	1995	1996
90.1	12.7	20.4	22.7	22.4

Source: Xinhua News Agency, Beijing, July 13, 1993; March 22, 1995;
May 17, 1996; China News Agency, Beijing, May 28, 1997.

Table 10: Growth Index of Personal Income Tax, 1993-1996

(The same period of the last year as 100)

1994	1995	1996 ^a	1996 ^b
154.90	180.25	158.90	151.9

Note: ^aThe first three months of 1996.

^bThe first eight months of 1996

Source: People's Daily, November 22, 1995; Xinhua News Agency, March 29, 1996, April 24, 1996; Wang (1997).

Table 11: Arrears of Taxes, 1993-1996

(billion yuan)

Date	Total	Date	Total
Jan. 1993	11.4	Jan. 1995	9.7
May 1993	19.2	May 1995	18.8
Jan. 1994	5.0	June 1995	17.9
June 1994	16.3	Aug. 1995	21.0
Sept. 1994	28.0	Oct. 1995	23.0
Oct. 1994	30.1	Nov. 1995	28.2
Nov. 1994	27.0	Oct. 1996	35.7

Source: World Journal, June 8, 1993 and August 3, 1994; Peoples' Daily, February 13, 1995 and June 29, 1995; Xinhua News Agency, November 28, 1995 and December 5, 1995; Ming Pao, December 20, 1996.

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Endnotes

¹ Originally, 1992 had been selected as the base year by the Standing Committee of the Politburo. However, due to great pressure from coastal provinces, especially from Guangdong, the center was forced to replace 1992 with 1993 as the base year. A top advisor to Vice Premier Zhu Rongji later admitted that the change represented a major concession to "the Southeastern provinces" (Zhou, et al, 1994).

² The net loss was the difference between two figures. One was the province's actual revenue collection in 1993, and the other was what it would have been able to collect if the new rules had been applied in that year.

³ In August 1994, under growing pressure from some provinces, this rule was changed. Central compensation to a province would grow by 30% of the average growth rate of total VAT and consumption tax (a central tax) collection in that particular province, instead of in the nation as a whole. Even with such a change, the above formula was still applicable. The only difference was that G_t now meant the average growth rate of VAT and consumption tax in the province.

⁴ Some local leaders regarded the new tax-assignment as nothing but the center's new trick to increase its share in total government revenue (Zhang, 1994).

⁵ Since 1995, Ministry of Finance has made some efforts to devise a formula-based transfer system.

⁶ Interview with an official of the Ministry of Public Finance, May 9, 1997.

⁷ Local revenue collections were exactly equal to 100% of the budgets in both 1990 and 1991, which implied that local revenue collections were essentially discretionary.

⁸ An adviser to Zhu Rongji indicated this to me in an interview conducted in August 1994.

⁹ In 1993, in order to prevent provinces from gaining from artificially inflated revenues, the center responded to local strategic behavior with its own strategic moves. In 1994, the center "set targets for revenue growth for each province, with higher targets for those provinces suspected of having padded their 1993 collections. For those provinces that fail to meet their target, the Ministry threatens to reduce correspondingly their base retained

revenue figure...While handing down revenue growth targets to each province in 1994 can be seen as a clever manoeuvre by the central government to deal with the problem of provinces inflating base revenue figures, it has also re-introduced the harmful individual negotiation between province and center that was characteristic of the contract system" (Wong, 1995: 8-9).

¹⁰ Interview with an official of the State Planning Commission, May 8, 1997.

¹¹ In August 1996, the central government overhauled extrabudgetary funds. Thirteen major categories of extrabudgetary funds were re-classified as budgetary funds (Zhao, 1996)