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Comment on "Assessing China's 1994 Fiscal Reforms: An Intermediate Report"

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ASSESSING CHINA'S 1994 FISCAL REFORMS: AN INTERMEDIATE REPORT

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ABSTRACT. To boost the fiscal revenue, i.e., government revenue over GDP and central government revenue over government total revenue, China conducted the 1994 fiscal reforms. According to some observers, the results of the initial reforms were mixed. This study reveals, contrary to most examinations of previous studies, the 1994 fiscal reforms have been an enormous success in achieving the original policy purposes, although remaining problems still present a daunting task for the Chinese government. This paper examines the factors triggering the 1994 fiscal reforms, reveals the contents and accomplishments of the reforms, explores unfinished tasks and ultimately proposes some policy implications.

INTRODUCTION

By any standards, China's 1994 fiscal reform is not a whimsical action triggered by impractical theory or policy considerations. Rather, the reform was derived from a converging force that came from a number of directions. Looking at the issue from a general perspective, the reform was an adjustment of the relationships between central and local governments, between government and enterprises, and between the state and citizens. This effort was an ongoing process along the line of the grand policy "Reform and Opening to the Outside" stipulated in the Third Plenum of the Eleventh Central Committee in December 1978. The primary purpose of the 1994 fiscal reform was to increase the ratio of government revenue over GDP and the ratio of central government revenue over total government revenue. In short, the 1994 fiscal reform targeted at

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strengthening the capacity of central government in its macro economic management and coordination.

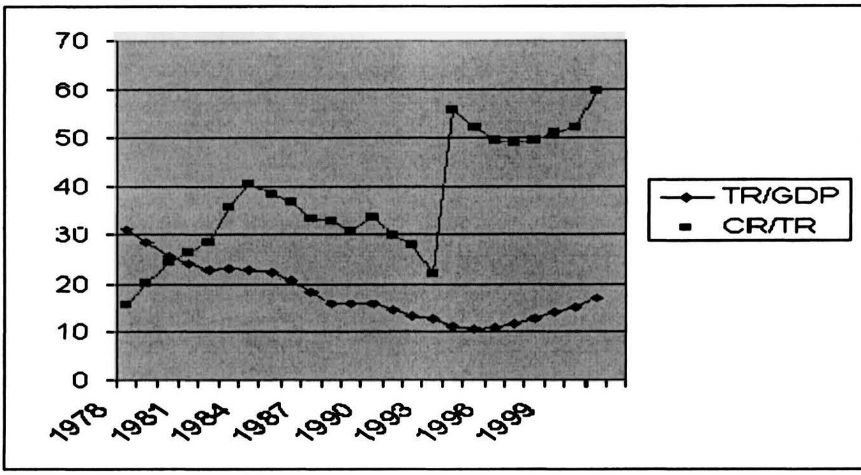
The initial responses of China's 1994 fiscal reforms were indeed mixed, at best. Most Chinese scholars and practitioners alike kept a cautiously optimistic stance about the fiscal reform design, arguing it was a rational approach targeted at solving a number of policy concerns. Looking at the outcomes of the reforms, however, these scholars and practitioners might feel dismayed since the reforms failed to bring about the expected results. Some local Chinese officials complained that the reforms were a selfish action or a trick played by the central government, putting the local government at an even more difficult fiscal plight.[3] Western scholars in Chinese studies presented a balanced view of the reforms on the surface, but a sense of suspicion exists regarding whether the reform could generate the anticipated outcome (Wang, 1997; Herschler, 1995). Nevertheless, most of these studies were completed within the first few years of the reform effort. After entering the new millennium, the scholarly attention paid to China's 1994 fiscal reforms gradually diminished. Given the significant impact of 1994 reforms to the current fiscal system in China, and its vital historical link between the past and the future, the author believes that assessing the reform in an intermediate phase is warranted. This study revisits the issue of China's 1994 fiscal reform. The next section examines the factors triggering the 1994 fiscal reforms; Section III reveals the contents of the reforms; Section IV shows the accomplishment of the 1994 fiscal reform; and Section V explores the unfinished tasks and the last section proposes some policy recommendations. By and large, the author expects to have different findings compared with previous studies, and these findings should have important policy implications.

FACTORS TRIGGERING THE 1994 FISCAL REFORMS

While many factors co-existed in driving the 1994 fiscal reforms, the primary reason was the decreasing central fiscal capacity demonstrated in two ratios from 1985 to 1992: (1) total government revenue over GDP (TR/GDP); and (2) central government revenue over total government revenue (CR/TR) (see Figure 1).

If we use the comparable prices of GDP from Table 1, which deducted the influence of inflation, we can calculate the average annual GDP growth rate in the fifteen-year period between 1978 and

FIGURE 1
"Two ratios" between 1978 and 2001



1993 to be 9.66%. Likewise, we can also calculate the average annual growth rate of government revenue in the fifteen-year period from 1978 to 1993 to be 3.20%. In this fifteen-year period, while real GDP increased 3.99 times, the real government revenue increased only 1.60 times (both numbers accounted for inflation). These numbers are revealing. They inform us that while the GDP growth in this period is astonishing, comparable to the growth records of the East Asian economies, the fiscal capacity of the Chinese government was behind the full potential of the GDP increase.

The unfortunate result of the decline of the government's extractive capacity is also vividly demonstrated in Table 1, which exhibits government revenue as a percentage of GDP, as well as the ratios of central and local government revenue to total revenue. From Table 1, we see a straight linear declining trend of government revenue as a percentage of GDP (%), the share of government revenue from close to one third (31.2%) in 1978 all the way down to about one eighth (12.6%) in 1993. Another disquieting trend is the share of central government revenue over the total government revenue, which declines from 40.5% in 1984 to 22.0% in 1993.

TABLE 1
Government Revenue as a Percentage of GDP, and the Ratios of Central and Local Government Revenue to Total Revenue: 1978-2002

Year	GDP At Current Prices	Government Revenues					
				Central Government		Local Government	
		At Current Prices	As % of GDP	Yuans (Billions)	% of Total Revenue	Yuans (billions)	% of Total Revenue
1978	362.41	113.23	31.2		15.5		84.5
1979	403.82	114.64	28.4		20.2		79.8
1980	451.78	115.99	25.7		24.5		75.5
1981	486.24	117.58	24.2		26.5		73.5
1982	529.47	121.23	22.9		28.6		71.4
1983	593.45	136.70	23.0		35.8		64.2
1984	717.10	164.29	22.9		40.5		59.5
1985	896.44	200.48	22.4		38.4		61.6
1986	1020.22	212.20	20.8		36.7		63.3
1987	1196.25	219.94	18.4		33.5		66.5
1988	1492.83	235.72	15.8		32.9		67.1
1989	1690.92	266.49	15.8		30.9		69.1
1990	1854.79	293.71	15.8		33.8		66.2
1991	2161.78	314.95	14.6		29.8		70.2
1992	2663.81	348.34	13.1		28.1		71.9
1993	3463.44	434.90	12.6	95.75	22.0	339.14	78.0
1994	4675.94	5218.10	11.2	290.65	55.7	231.16	44.3
1995	5847.81	624.22	10.7	325.66	52.2	298.56	47.8
1996	6788.46	740.80	10.9	366.11	49.4	374.69	50.6
1997	7446.26	8651.14	11.6	422.69	48.9	442.42	51.1
1998	7834.52	987.60	12.6	489.20	49.5	498.40	50.5
1999	8206.75	1144.41	13.9	584.92	51.1	559.49	48.9
2000	8940.36	1339.52	15.0	698.92	52.2	640.61	47.8
2001	9593.33	1638.60	17.1	858.27	59.6	780.33	40.4
2002*	10239.8	1891.4	18.5	1102.0	58.3	789.4	41.7
2003**	11669.4	2169.1	18.6	1246.5	57.5	922.6	42.5

Notes: * Xiang, 2003; ** Jin, 2004.

Sources: National Bureau of Statistics of China, China Statistical Yearbook 2001. Beijing: China Statistics Press, 2001 and 2002.

These figures not only reveal a shrinking share of total government revenue as a percentage of GDP, but also indicate a declining percentage of central government revenue over total revenue. The decline of these two ratios is by no means trivial. Compared to other nations, the ratio of China's government revenue over GDP is fairly low. In the United States, tax revenue absorbs over 30 percent of GDP, while the government share of GDP in most developed countries is even higher [e.g., shares in 1992: USA: 32.2; Japan: 34.4; UK: 38.8; Canada: 43.1; Western Germany: 45.3; France: 46.1; Sweden: 60.0. Source: OECD, Statistics for Member Countries (June-July 1994)]. The average ratios between central and local revenue receipts in the 1980s were—US is 2.5:1, India 2.8:1, England 5:1, and in China the ratio was 0.43:1 (Herschler, 1995).

To be sure, there is a sound rationale for government to be involved in the activities of economic development and to take a fair share of GDP. In modern society, government is accountable for a number of functions. According to Musgrave and Musgrave (1989), modern governments' major functions include allocation, distribution and stabilization. To realize these functions for the benefit of the whole society, fiscal instruments are inevitably crucial. The low share of Chinese government revenue not only worries Chinese policy makers, but also has become a big concern of scholars throughout the globe (Lin, 2000). Bahl and Wallich (1992) concluded that public service levels are not adequate in all parts of China and the infrastructure gap might become a key problem in the future. Stiglitz (1998) believed that the Chinese government revenue share over GDP is too small compared with other nations and is a big barrier in China's accomplishment in its blueprint of economic development. Wang (1997) regarded the massive decline of the government's extractive capacity as an enfeeblement of China's ability to exercise macro control to an alarming extent. With the declining share of government revenue over GDP, especially the declining ratio of central government revenue over total revenue, many Chinese scholars worried about the growing regional disparity as well as the general low level of public service providing capacity (Xin, 1998; Xu, 1998; Yang & Wei, 1996).

Then, what are the underlying contributors to the decline in government budgetary revenue in China? Lin (2000) identified three primary reasons (lowered corporate tax rates, small tax base, and tax evasions) that lead to the shrinking share of government revenue over GDP. Wang (1997) argued it was imperative to plug in the five major loopholes (tax evasion, tax reductions and exemptions, tax arrears, extra-budgetary funds and extra-extra-budgetary funds) in order to arrest the two ratios from further decline. While their arguments are meaningful and are accountable for at least part of the underlying causes, the fundamental problem should be examined at a deeper level. My argument is along the line of reform designers, who regard the institutional arrangement of China's previous fiscal system as the root of flaw that resulted in the decline of the two ratios. With this in mind, we now briefly examine the fiscal relationship between the center and locality before the 1994 reform.

As we know, China's economy was a centrally controlled planed system in the Mao era (1949-1976). At that time governments at various levels not only owned the corresponding enterprises, but also were involved in enterprise management from plan, production, purchase and sale, as well as in fixing prices of materials and final products. The relationship between central and local governments is much like a pendulum swinging between trends in centralization and decentralization, reflecting the domestic management needs of political control at the top versus regional economic development at the bottom locality (Straussman & Zhang, 2001). The fiscal division of power fluctuated along the different periods of PRC's history and became an enduring topic of research and real politics. The centralized fiscal system featured in Mao's era was inconsistent with the market-oriented reforms beginning in 1978. At least three factors caused the changes in China's fiscal system. The first is the rapid growth of non-state-owned enterprises: township and village enterprises, joint ventures, and private businesses. Second, accompanied by the growth of local political power, it is natural for local governments to require a commensurate decision-making power in the fiscal aspect. Third, only a decentralized fiscal system could stimulate local government in collecting revenue and promoting economic growth (Lin & Liu, 2000). The overall economic reform embarked on in the late 1970s was oriented toward the benefit of lower sub-national governments by means of "playing to the provinces" (Shirk, 1993). In the process, the center has lost, at least partially, its capacity to control the government below it (Wang, 1994). The central-local balance of power has undergone an unprecedented and irreversible tilt toward the province, and even to the levels beneath the provinces (Zhang, 2002).

At least four types/phases of fiscal arrangement can be distinguished from 1979 to 1993 (Lin, 2000). They are: Allow State Enterprises to Keep Some Profits (fang quan rang li); Substitute Taxes for Profit (li gai shui); the Contract Responsibility System (bao gan zhi) and the Tax Plus Profit system (li shui fen liu). A consequence of these fiscal reform efforts was the decline of "two ratios." How did this happen? An open secret is the conspiracy between local governments and enterprises at the expense of the central coffer. Before 1994, revenue and/or tax were collected by the local governments first and then submitted to the central government. Afterwards, the central government returned a share (according to a formula agreed upon by both sides) to the local governments. Most local governments frequently failed to realize its full potential in collecting all the possible money and then submitting the revenue to the center. Rather, they play games with the central government. The local governments would rather collect much less money from enterprises in each jurisdiction and ask these enterprises to contribute (in various format) part of the money to the local governments' extra-budgetary accounts or let these enterprises "voluntarily" provide local public services, which are the responsibility of the local governments, such as paving roads or building bridges or tunnels. Local governments often offer incentives to allure new enterprises in each territory by granting tax exemptions and deductions. These maneuvers and tricks have benefited both the local governments and the enterprises, but have caused a heavy loss for the central treasury.

The above theory of conspiracy between local governments and enterprises had found a widespread market before the 1994 fiscal reforms. Although the practice was pervasive, empirical evidence was hard to collect. Fortunately, the 1994 fiscal reforms provided a golden opportunity to test the "Conspiracy Theory." A case in point was the revenue base. To ensure that every province would agree to and implement the 1994 fiscal reform policies, the interests of provinces could not be jeopardized. At least the previous provincial fiscal revenue level should be guaranteed. Initially, 1992 had been selected as the base year by the standing Committee of the Politburo. However, due to high pressure from coastal provinces, especially Guangdong, the center decided to use 1993 instead as the base year. When local governments realized this in late September of 1993, there was a collection fever over the country. For the remaining three months in 1993, local fiscal performance rocketed. "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, and some even collected 1994 taxes in advance" (Wang, 1997: 811). 1993 local tax collection was 28.3% higher than the budgeted number and 39.9% higher than 1992 (Wang, 1997). This story suggests that local governments do have the capacity to collect more taxes but lacked the interest to do so in previous years. How to harness and constrain the fiscal power of locality to benefit both the central and local coffers became the central concern of new institutional design in the upcoming fiscal reform.

MAJOR CONTENTS OF THE 1994 FISCAL REFORM

What is China's 1994 fiscal reform? In short, this is an umbrella term accommodating a wide range of files and contents. To different observers and commentators, the 1994 reform may have various connotations. The reform efforts were widely called "fiscal reform," "tax reform," "tax-assignment reform or "tax-sharing reform." This confusion may derive from a number of reform regulations enacted by the end of 1993 which relate to fiscal and tax systems. Accord to Jia (2000), within the first one hundred days of 1994, there were about 80 documents issued by fiscal or tax authorities as well as the State Council. Each added complementary regulations or adjustments to solve the imminent and prominent problems of tax related policy concerns. The chief official document, we believe, is Decisions on Implementing Tax-sharing Fiscal Management System, issued by the State Council (1993). The file was issued on December 15 of 1993, to be carried out immediately from the first day of 1994. In short, the 1994 fiscal reform contains the following major contents.

Tax Division

Unlike the pre-1994 fiscal system where—the revenue amount was usually negotiated between the center and each province on a one-by-one basis, the new design unified the tax division and formed three parts: central tax, local tax and shared tax (see Table 2). By doing so, tax obligation was expected to be transparent, with a greatly reduced or eliminated transaction cost, and horizon equality realized among the provinces or province-level units.

TABLE 2
Tax Shares of 1994 Tax Reform

Central Taxes	- Tariffs - Consumption tax and Value-added tax collected by customs - Consumption tax - Income tax of central enterprises - Income tax from financial enterprises which have obtained business license from the People's bank of China - Tax on revenues turned in by railways, banks and insurance companies - Offshore oil resource taxes
Local Taxes	- Business tax (exclude that turned in by banks, railways and insurance companies) - Income tax from local enterprises - Personal income tax - Urban land use tax - Adjustment tax on fixed asset investment direction - Urban maintain and construction tax (exclude that turned in by banks, railways and insurance companies) - Real Estate duty - Tax on vehicle and boat license - Stamp duty - Laughter tax - Agricultural and husbandry tax - Agricultural tax levied on special products - Occupation tax on cultivated land - Contract tax - Inheritance and gifts tax - Land appreciation tax - Income tax on rented state land
Shared Taxes	- Value-added tax: central government (75%) and local government (25%) - Stock transactions gains tax: central government (50%) and local government (50%) - Resource tax other than offshore oil resource tax: mostly to local government

Sources: The State Council (1993).

Fiscal Administration

Pre-1994, there was no branch of State Tax Service (STS) at sub-national governments thus the central treasury relied on local fiscal departments to collect and submit revenues first, and then a portion was returned to the locality. As we have shown in section 2, local governments usually utilized this mechanism to play games with the center to the benefit of the locality. The 1994 fiscal reform established central government's own branch tax bureaus within local governments, creating two parallel line tax systems: a national system for central taxes and a local system for local taxes. Shared taxes were collected by the local branches of STS first, and then the proceeds were split between the center and sub-national governments according to the agreed upon formula. The downward-sharing mechanism is essential in preventing the previous local abuses. As we will see later, the sharing direction is by no means insignificant.

Tax Rates Standardized and Tax Types Simplified

Before 1994, the tax rates and types were very complicated. First, different enterprise ownerships [state, collective, private enterprises, township and village enterprises (TVE), foreign-invested enterprises (FIEs), foreign enterprises (FEs)] enjoyed different tax rates. Special Economic Zones (SEZ) and some coastal cities had preferential tax policies. Many local governments also enacted a number of preferential tax policies to attract investment for local economic development. Additionally, different industries might have different available tax treatment. The 1994 fiscal reform unified the enterprise income tax rates to be 33%, regardless of state, collective, TVE, or private ownerships. For joint ventures, the initial plan was that the unification income tax rates would be implemented for a longer term, when the current agreement of preferential tax policies phased out. However, the Asian financial crisis had postponed the implementation of such a plan (Lin, 2001). For tax types, the old 32 tax types (except tariff and agricultural taxes) would be reduced to 18 (Xu & Zhang, 2001). One of the motivations behind the segregated tax rates was to curb the growth of private enterprises and to meet the government's special economic policies (Lin, 2001). The logic of 1994 fiscal reform is obvious-the tax burden among different types of enterprises should be equal. With the anticipated entry of WTO, the joint ventures also should stand on the same footing as the domestic enterprises.

Tax Exemptions and Deductions

Pre-1994, local governments frequently used tax exemptions and deductions to attract new investment and also to conspire with enterprises by granting tax breaks. The net effect was the weakened central coffer and decreased local budgetary revenues. As explained in Section II, the central government is the loser in this game of conspiracy, while the local government is the winner with more money to use at its own discretion. From the perspective of the central government, there is an efficiency loss of taxable revenue. From the view of the society in general, the consequence of conspiracy behavior is more extra-budgetary fund and even extra-extra-budgetary fund collected by the local governments, leading to redundant industry and economic construction and increased cases of corruption (Holzer & Zhang, 2004). The 1994 fiscal reform provided tax exemption and a reduction of authority back to the central government, explicitly regulating that no further tax holidays or breaks can be granted by any local governments. But for the consistency of policy implementation and the credibility of local governments, the previously contracted tax exemptions and deductions would be implemented until the end of 1995.

The aforementioned four aspects are only part of the important 1994 fiscal reform design. The 1994 fiscal reform was not a minor effort in tinkering with the old fiscal system, but rather a comprehensive overhaul for shuffling the entirety of the institutional arrangement between the center and the locality associated with a division of tax jurisdiction and authority. The 1994 fiscal reform also targeted an equal tax-burden effort for different business ownership or types. Facing a dilemma of increasing pressure of rising demand for the thirsting expenditure of providing public service, while seeing a shrinking piece of pie in central revenue year by year, the central government made a grand resolution to fight back. A clear goal of China's 1994 fiscal reform was to make the government revenue cake bigger, with a larger share going to the central government (The State Council, 1993). The next section examines whether such expectations can be accomplished.

THE ACCOMPLISHMENT OF THE 1994 FISCAL REFORM

Almost ten years have passed since the introduction of China's 1994 fiscal reform and it appears to be an appropriate time now to assess the intermediate effect of the institutional design of the reforms.

An unavoidable grand question to ask is whether the fiscal reform has brought about the effects the reformers expected. To be more specific, whether the government revenue has increased as a percentage of GDP (the first ratio) and whether the central government revenue increased over the total government revenue (the second ratio)?

To answer these two specific questions, we need to examine table 1 carefully. In the period from 1993 to 1998, the first ratio (government revenue over GDP) decreased in the first two years (from 12.6% in 1993 to 10.7% in 1995) and then slightly increased in the next three years (from 10.7% in 1995 to 12.6 in 1998). These unimpressive records probably serve as the basis for many early unsatisfactory observers and commentators who concluded that the 1994 fiscal reform is not a success, or at least not a big one (Herschler, 1995; Lin, 2000; Wang, 1997). For the second ratio, central government revenue over government revenue, the effect was immediately shown. The ratio of central government revenue over government revenue jumped forward from 22.0% in 1993 to 55.7% in 1994, and then declined to 49.5% in 1998. The leap of the second ratio is more like a two-sided coin depending upon the interpretation, rather than the absolute truth. On the optimistic side, the increased ratio was close to the expectation number (60%) that reform designers had desired; on the pessimistic side, the increased share of the central government revenue was no more than nominal, as will be discussed later.

Nevertheless, the policy designers of the1994 fiscal reform were not short-sighted. Their focus aimed at a long-term institutional rational-approach. As the Vice-Director of the State Tax Bureau noted in 1995, "The policy changes of the central government follow the principle of incremental philosophy. What concerns the central government is the reform of institutional mechanism, not the gain or loss in the short run" (Xu & Zhang, 2001). Its effect would emerge in a longer scope. The share of the total government revenue over GDP increased from 12.6% in 1993 to 18.5% in 2002. While the average GDP growth rate was 8.96% (excluding the influence of inflation) from 1993 to 2001, the average growth rate of total government revenue, excluding the influence of inflation, was 13.2% in the same period, which surpasses the GDP growth rate an average of 4.24 % each year. Using 1993 as the base year, the average growth rate of central revenue was 26.2% from 1993 to 2001, while the growth rate of average local revenue was 6.46%. The change from 1993 to 1994 may have been too sudden to be indicative. Thus a better reference point was to use 1994 as base year. By doing so, the growth rate of central revenue was 14.23% from 1994 to 2001, while the local revenue growth rate was 16.44% in the same period.[2] These numbers are meaningful and indicative. First, average total government revenue growth rate far surpassed average growth rate of GDP from 1993 to 2001, suggesting a consistent behavior of great efforts in collecting tax revenues by the government. Second, using 1994 as the base year, we found an amazing average growth rate of both central government revenue (14.23%) and local government revenue (16.44%) from 1994 to 2001, suggesting that tax collectors at both central and local levels worked hard to achieve the policy goals. These two groups of numbers (the average GDP growth rate and the average growth rate of total government revenue) are reminiscent of the counterparts from 1978 to 1993, whenever the GDP growth rate was 9.66% while the growth rate of total government revenue was only 3.2%.

Although many converging factors were at work in driving the first ratio (the government revenue over GDP) up from 12.6% in 1993 to 18.5% in 2002, we have to acknowledge that the primary source of this success was the institutional design of the 1994 fiscal reforms. The high growth rates of both central government revenue and local government revenue from 1994 to 2001 reveal that incentives of both the center and the locality were consistently boosted. The central government's share as a percentage of total revenue from 22.0% in 1993 increased to 59.6% in 2001, suggesting a promising prospect in approaching the original policy objectives (60% for the second ratio). Although some may argue that the increase of the central governmental revenue is only nominal, not much revenue would be left after deducing of the center's refund to provinces and fiscal transfer to poor provinces (Lee, 2000; Wang, 1997), it is at least politically significant even if it is nominal. Before 1994, the central government had to rely on local government to submit revenue. Now local governments must rely on central government to return revenue or fiscal transfer. This change from bottom-up to top-down suggests a leader–follower game which is beneficial in strengthening the macro coordination and control capacity of the central government (Hu, 1996; Xu & Zhang, 2001).

The chief accomplishment of the 1994 fiscal reforms was the consistent and rapid growth of government revenue. However, this achievement should not overshadow the reform results in other aspects. As an institutional overhaul of 1994 fiscal reforms, the real effect surpassed the expectations of some reform designers (Xu & Zhang, 2001). In addition to the government revenue surge, the performance of 1994 fiscal reform was mainly manifested in the adjustment of the following three pairs of relationship. They are: government-enterprise, central-local governments and State-citizen. The traditional relationship before 1994 between government and enterprises was more featured by administrative instruments than by economic means. Governments at different levels frequently negotiated with enterprises for the profits to be submitted. The contract responsibility system was a product of such a mechanism. But even after quota was mutually agreed, government often changed the rules of the game in its favor. This situation also caused the conspiracy of local governments with enterprise at a loss to the central treasury. Uncertainty, unpredictability and arbitrariness were the characteristics of the old system. Since 1994, the government-enterprise relationship has been much more rule-based. Enterprises, irrespective of their size, types and ownership, pay taxes to the governments according to the corresponding tax law, rules and regulations. Tax burdens were unified at 33% income tax rate for every enterprise. Tax types were simplified from the previous 32 types to the current 18. Now, the norm is certainty and predictability for the relationship between government and enterprise.

For the relationship between central and local governments, the 1994 fiscal reform had greatly enhanced the transparency and normality of fiscal allocation. In the previous years since 1978, central-local fiscal relation was subjected to frequent negotiation, in which mechanism lacks either transparency or equity among the peer provinces. As evidence shows, the center had been willing and capable to regulate the provincial fiscal autonomy according to central preference (Chung, 1995). The 1994 fiscal reforms tried to rationalize the division of fiscal authority between center and locality, making the relationship more rule-based.

As for the relationship between the State and citizen, the focus was also on the rule of law. The amended Act of Personal Income Tax of PRC was promulgated in October 31 of 1993, to be effective on January 1, 1994. For wages and salary, there are nine grades of progressive tax rates from 5% to 45%. For individual owned business, the income tax follows five grades of progressive tax rates from 5% to 35% (Jia, 2000). Some of the previous illegitimate regulations were abolished (Xu & Zhang, 2001). The outcome of adjusting the relationship between the State and citizen was not so illuminative, and the impact had to wait an even longer term.

There are other accomplishments such as the containment of the rocketing inflation rates from late 1992 and the reduction of tax burden for enterprises demonstrated from empirical study (Xu & Zhang, 2001). The 1994 fiscal reform, as with any other reform crusade, was not perfect. With this point in mind, we now turn to the unfinished business.

REMAINING PROBLEMS OF CHINESE FISCAL REFORMS

The 1994 fiscal reform was a big remedial operation targeted to the problems of the old system. An action of such large scale cannot be expected to be perfect. It is nevertheless an ongoing process to complement the institutional design and to solve the newly emerging problems. "Trial and error" and "touching the stone to cross the river" that had guided Chinese reforms since 1978 were also in some sense applicable to the field of Chinese fiscal reform. Yet, pragmatic pressure and theoretical concerns had raised many questions that were not well addressed by the 1994 reform design or implementation. The following is only a simplified sketch of the problems to be dealt with by the policy makers and administrators.

First, although the central government's share as a percentage of total revenue increased from 22.0% in 1993 to 59.6% in 2001, there were widespread concerns that the central government's disposable revenue was too low (Lee, 2000; Wang, 1997). Indeed, as discussed above, this is a "two-edged sword" depending upon how we view and interpret the issue. If the central revenue is defined as central collection plus local remittance and then minus central refunds and subsidies to the provinces, the percentage of central government's revenue was fairly low (26.0% in 1994, 30.2% in 1995, 20.9% in 1996 and 22.0% in 1997) (Wang, 1997). According to the data from

Lee (2000), there was also a slight decline of net central government revenue over national fiscal revenue from 1992 to 1998 (Table 3).

Second, the division of fiscal authority between the center and the locality should be first conducted on the analysis of expenditure need at each level of government. However, the 1994 fiscal reform, similar to previous efforts, focused on the side of revenue first, leaving the question of "who should be responsible for what" blurred. This ambiguity created the problem of ad hoc directives from the center to require local expenditure. These un-funded mandates frequently turned out to be an extra burden to the locality, a phenomenon popularly called "center hosted banquet but paid from local pocket."

Third, the 1994 reforms had kept too many vestiges of the old system, such as the four concessions of the center to the locality. These vestiges served well to smooth the transition from the old system to the new one, but also complicated the implementation of the reform design and therefore postponed the effect.

Fourth, a rational approach of reform should clearly demarcate the boundary of fiscal authority between the center and the locality.

TABLE 3
Net Central Government Revenue over National Fiscal Revenue
(In billion RMB Yuans)

Year	Central Fiscal Revenue after Intergovernmental Transfers		
	National	Net	Net /National
1992	141.16	423.00	33.37%
1993	148.81	513.22	28.99%
1994	161.64	605.55	26.69%
1995	194.42	711.98	27.31%
1996	244.16	857.28	28.48%
1997	262.48	957.46	27.41%
1998	267.85	1,064.57	25.16%

Notes: Net Central Fiscal Revenue = Central Fiscal Revenue - Transfers from center to localities + Transfers from Localities to center. To follow the definition of fiscal revenue in the International Monetary Fund's Government Finance Statistics, China's fiscal revenues are adjusted by including all the negative revenues such as subsidies to loss-making state-owned enterprises and export rebates.
Sources: Lee (2000).

Unfortunately, the 1994 reforms did not prohibit the center's arbitrary behavior. Given the long time earned reputation of not abiding by the rules by the center (Chung, 1995; Herschler, 1995), there was no reason for the sub-national government not to act opportunistically. For example, Wuhan City Tax Bureau circulated an "internal document" with 120 provisions that authorized tax exemptions or deductions for local enterprises, suggesting that some local governments continued to play games with the center (Herschler, 1995).

Fifth, the central government claimed virtually all the tax authority in the 1994 fiscal reform. In addition to the tax exemption and deduction rights no longer available to the locality, sub-national governments still have no rights in deciding tax rate, determining tax base or levying new taxes. The formally enfeebled local government thus has to continue to seek the informal ways for increasing revenue, instruments such as collecting extra-budgetary fund and extra-extra-budgetary fund are sometimes illegitimate, but often a possible choice for the local governments.

Sixth, inter-government transfer is not rational or typical according to the international practice. Current government transfer in China includes two parts. The first is the refund to each province to ensure the revenue of the previous year is guaranteed. The second part is the fiscal transfer from the center to poor provinces (or province level units) to reduce the gap between rich and poor provinces. Critics believe that the refund enlarged rather than decreased the gap between rich and poor provinces, and the second part fiscal transfer lacks a clear formula for deciding "who gets what."

Seventh, since the tax-sharing system between the center and the provinces is far from complete, the tax-sharing system between local governments (government levels lower than the province level) and provinces leaves much to be desired (Yan, 2001; Yu, 1998; Zhang, 2000).

Eighth, the fiscal reforms of 1994 did not have particular measures to address the issues of extra-budgetary funds (EBFs) and extra-extra-budgetary funds (EEBFs) that had long plagued the central government. Simply stated, EBFs were income collected and expended by government agencies and quasi-governments (such as service institutions). Although these funds are on the budgeted books, they are beyond the reach of fiscal departments of either central or local governments. For the EEBFs which came from ad hoc charges, unauthorized fees, involuntary "contributions" and so forth, they are even not reported to fiscal departments at every level of government (Holzer & Zhang, 2004).

Ninth, it is necessary to coordinate the tax behavior by the local branches of State Tax Bureau (STB) and local tax bureaus. Some enterprises face the problem of multi-head tax management since both the local branches of STB and local tax bureaus are collecting their tax, while in some other domains, "who is in charge of what" is not quite clear (Xu, 1998). As for the tax administrators in the local branches of STB, they have to be loyal to both their bosses at a higher level of STB offices and the local government officials. This double allegiance does not always work together and sometimes presents problems and conflicts.

Tenth, the income tax of SOEs is collected by the separate division of affiliation of central and local governments respectively. The concept of what enterprises belong to what level of governments is a barrier to the establishment of a real modern enterprise system (Xu, 1998). The different affiliations of enterprises also encourage the local protectionism and create a number of problems.

Eleventh, there are wide gaps between different regions and with the tax policies applied to the domestic and international enterprises. This is not conducive to fair competition of enterprise and regions. When the fiscal reform system was introduced in 1994, the government authorized tax refunds to foreign invested enterprises (FIEs) and foreign enterprises (FEs) established before 1994 and located in special economic zones (SEZs). This preferential policy was initially granted for a five-year period, yet later extended to 10 years in some zones. Preferential tax policies expired for 10 of China's 44 SEZs by the end of 1999 and were not renewed. The rest of the SEZs would phase out their preferential treatment by the end of 2003 so that an "even playing field" would be established ("Goodbye to SEZ," 1998).

Twelfth, the significance of the implementation of the rule of law in the area of tax collection cannot be overstated. In the period after the 1994's fiscal reforms, tax evasion, tax arrears and tax cheating were still serious. How to rigorously implement the rule of law not only attracted scholars (Herschler, 1995; Hu, 1996; Jia, 1999; 2000;

Wang, 1997), but was also emphasized by China's financial minister in recent years (Jin, 2004; Xiang, 2001; 2002; 2003).

CONCLUDING REMARKS: POLICY IMPLICATIONS FOR IMPROVING CHINA'S FISCAL SYSTEM

Overall, the power of China's 1994 fiscal reforms has been demonstrated over time. The chief accomplishment is the increase in the government's total revenue over the GDP, making a growing bigger cake of fiscal revenue. This and other achievements are mainly attributable to the institutional redesign of China's central-local relationship, as well as State-enterprise relationship. Viewing the fiscal reforms of 1994 through a longer lens, this author concludes a far more positive assessment than most of the previous studies have shown. The success of the 1994 reforms does not suggest that the main tasks in the financial arena have been completed. Rather, the reform process has raised more questions than it has addressed. At least, twelve aspects of unsolved questions have been identified in the last section. To solve these questions and others that might appear at any moment in the transition era of reform, we have to rely on the rule of law and an alignment to the international standards. Market orientation, democratic means and rational approach could offer important clues for most of the reform efforts.

Regarding the question of central revenue share, what amount is appropriate for the disposable revenue? We need to seek the answer from two sources. First, what is the international standard for the share of central government revenue over the total government revenue? Do other countries have as great of a variance of revenue share between central and local government according to different stages of economic development? And what country is a good model for China to follow, if there is really one? What is the appropriate division of expenditure between central and local government? Only when it is decided what functions should be the responsibility of central government and local government, can we approximately calculate what reasonable percentage of national revenue should go for central government's expenditure. Apparently, China is still far from locating an optimal point to divide the responsibility between central and local governments for offering public service, and between State and society in deciding which part is the domain of the government. Certain public services urgently needed by the society have not been adequately provided by the government, such as environment protection, while in some other areas such as profit making business, government still stretches a hand. Marching on the way toward market economy, China has a lot to learn from matured systems and its own previously learned lessons.

As an authoritarian state, the 1994 reform did not constrain the power of central government, which endangers the efforts in mobilizing local enthusiasm: especially encouraging local governments to take advantage of any policy loopholes. With the frequent reversal of central policies penalizing those who did not take advantage of the center's moves, the lack of a constitutionally-guaranteed framework in marking the power line between center and locality presents a big problem of the local's confidence in the center (Jia & Lin, 1994). A case in point is the issue of taxing legislative power by the local authority. The 1994 fiscal reforms almost do not touch the issue, but simply take the tax exemption and reduction power away from the hands of local government officials. The sub-national governments have so far been lacking the power to decide a tax base, tax rates and to levy new taxes. China is a huge country with a territory bigger than that of the USA and a population accounting for one fifth of the world population. The lack of tax legislative authority provides a power disadvantage to local government in meeting the demand of local public service. More often than not, the local governments have to explore other channels for revenue, such as the EBFs and EEBFs which are sometimes illegitimate. My recommendation is that China should allow provincial and city level government legislative power to decide a local tax base, tax rates and to levy new taxes, though this power should be vested in the local legislature—People's Congress at provincial and city levels.

For EBFs and EEBFs, most of them should be converted to the budgetary fund in the management of each level of financial department. The government should have strict laws, rules and regulations to complete the transition within a given period. In doing so, the government revenue can be further boosted and the problems of EBFs and EEBFs eliminated, but a pre-condition is to grant local legislatures the power to enact local tax rules.

Additionally, law enforcement should be strengthened. Otherwise these unimplemented cases become demonstrable samples for others to follow, further weakening the fiscal capacity of government.

In the past, tax evasion, tax arrears and tax cheating frequently came into the lexicon of fiscal management. This situation should be reversed to collect the revenue that the society so urgently needs.

In 2002, total tax revenue was 1,700.4 billion RBM yuan, in China,[1] the biggest contributor being State-Owned Enterprise (536.17 billion yuans, about 32.2% of the total). Other contributors to the revenue were: Stock-Share Companies (435.52 billion yuans), Joint Venture and Foreign Enterprises (348.71 billion yuans), Individual Businesses (100.49 billion yuans), Private Enterprises (94.56 billion yuans) and Collective Enterprises (92.94 billion yuans). Among these contributors, the share of State-Owned Enterprises had decreased from 55.2% in 1998 to 32.2% in 2002. The average revenue growth rate for the Stock-Share Enterprises was 59.5% from 1998 to 2002 (http://chanye.finance.sina.com.cn/cs/2003-05-14/165365.shtml, access on April 24, 2004). These numbers indicate a changing structure of China's enterprises and the sources of the government revenue.

In summary, 1994 fiscal reform in China was only a part of the reform efforts initiated since 1978. Under a broader backdrop of China's transition from traditional planned economy to socialist market economy and from rule by man to rule of law, a lot of changes have been occurring in virtually every corner of the Chinese society. In the process, administrative reforms have consistently adjusted and reoriented the governmental functions and the roles government played in the society. Enterprise reform has witnessed the restructuring of enterprise composition, leading to the rapid growth of non-state owned businesses. Political reform has brought about the changes that resulted in a more democratic way of organizational life. For the relationship between state and citizen, the current reforms represent a paradigm shift from the old state-centered governance toward new citizen-centered governance which would benefit all sectors of Chinese society (Zhang and Zhang, 2001). In this perspective, the fiscal reform is not an isolated arena. Rather, fiscal reforms are driving engines for the change of the other parts of the society, and in the meantime, it is shaped by the ideology of contemporary society. As the current catchwords indicate, the fiscal reforms have to "keep pace with time."

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NOTES

1. This perspective is obtained from an interview with local public finance officials from Hubei province.
2. The growth rate of GDP or government revenues were calculated by the author, all growth rates deducted the influence of inflation.
3. The number of government revenue cited here was different from the revenue reported by Huaicheng Xuang, the Minister of Finance Department

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COMMENTS ON "ASSESSING CHINA'S 1994 FISCAL REFORMS: AN INTERMEDIATE REPORT"

Meili Niu and John R. Bartle*

As a milestone change in intergovernmental fiscal relations, China's 1994 fiscal reform had far-reaching effects on China's fiscal administration. Assessing China's 1994 fiscal reform is therefore a daunting assignment. Most research deals with specific aspects of the reform and lacks a deep exploration of reasons for and influences of the reform. This article is welcome because it fills that gap.

The article begins by demonstrating that the 1994 fiscal reform was the result of converging forces beyond the superficial effort to improve the central government's fiscal capacity. This study argues that the strain of the centralized planned economic system was the underlying cause. The article then examines major provisions of the 1994 fiscal reform. The 1994 fiscal reform is also called "tax-sharing reform" or "tax-assignment reform" because most provisions of the new system are related to the division of tax sources and tax administration authority between the central government and local governments. Four topics are discussed in turn: tax assignment; fiscal administration; tax rates standardization and tax simplification; and tax exemptions and deductions. While there is no easy way to evaluate the effects of the 1994 fiscal reform, this article demonstrates three accomplishments of the reform. First, it led to an increase in total government revenue as a share of the economy and an increase in the central government's share of total government revenue. Second, it improved the relationships between governments and enterprises, the central government and local governments, and the state and the citizen. Third, and most importantly, it furthered the movement toward a more rule-based system. However, the author argues that the 1994 fiscal reform left old problems and created new ones. Twelve problems are discussed which suggest an agenda for future fiscal reforms.

The important contributions of the article are evident in three aspects. First, it presents a deeper understanding of the impact of the tax assignment reforms. Increasing the central government's fiscal capacity was not the most lasting change in the long run; more important was the move towards a rule-based fiscal administration system to accommodate the transition from a planned economy to a market economy. Second, the presentation of twelve remaining problems demonstrates the need for an intermediate assessment on the 1994 fiscal reform and provides policy-makers the direction for future reforms. Third, the author demonstrates that fiscal reform is closely related to other issues, in particular political reform that is shaping the evolution of democratic governance in China.

Although the author argues that the 1994 fiscal reform leaves "who should be responsible for what" unsolved, it does not articulate an alternative approach to the issue. Perhaps this question is not one that should be answered directly, but rather should emerge from the interaction of governments, enterprises and citizens. "Who should be responsible for what" is the critical question that all societies have to answer, and most do so by iterating to a pragmatic balance of institutional arrangements rather than applying a textbook solution.

This article is important reading for scholars of fiscal administration and of Chinese society, as well as for Chinese policy-makers. The timeless nature of the questions it asks also makes it of interest to all scholars of government administration.

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