

Part II

ECONOMIC REFORMS IN CHINA

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China's Economic Reform and Fiscal Management: A View from Central-Local Relations

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1. INTRODUCTION

The purpose of this chapter is to trace China's fiscal developments in the post-Mao period (hereinafter, the reform era) and to identify the problems faced by the nation. Of the many fiscal problems that have occurred during the period, this chapter views the emerging coalition between local governments and state enterprises as the most important. It strives to show how and why this occurred, and discusses the prospects of the latest tax reform of 1994 that will purportedly offer a fundamental remedy to the present highly discretionary and contract-governed situation.

The sequence of reasoning that led us to this view can be spelled out as follows: Soviet-style socialism has put a priority on industrialization, and other sectors are mobilized to play supporting roles in this grand design. Thus, the prices of raw materials and wages are made artificially low. Staple foods are maintained at low prices so that real wages are not undermined by high costs of living. The costs of industrialization are essentially paid by laborers and sectors that provide raw materials. The sector that bears the highest burden is often agriculture.

On the fiscal side, the old system works by tapping revenues from

heavily-protected state enterprises; the prices of their inputs, including labor, are set very low, whereas the prices of their products are determined monopolistically. Remittances from these enterprises are the basic source of government revenue, and they are supplemented by archaic turnover taxes with complicated rate structures. In a sense, however, there is an aspect in which this system can meet the needs of poor regions. If a part of the resources mobilized through the process of industrialization are circulated back to the people and the economic sectors that have suffered under the process, the system might be able to encourage them to supply more labor and to produce more raw materials.

In reality, however, this virtuous circle has never prevailed. Instead, ironically for socialist planners, productive incentives have been lost on both the input-supply and output-production sides; the former from ill compensations, and the latter from indulgence in lucrative profits. Reforms in socialistic economic management, therefore, were long overdue even before the collapse of the Berlin Wall.

This story applies more or less to China, which suffered, in addition to the aforementioned problems, from the economic disruptions that continued for an entire decade under the Cultural Revolution (1966-76). Agricultural reforms were launched first and reforms were later extended to the rest of economic activities. However, the reforms have not been free; new and even more intrinsic problems of socialism have taken place. The prices of foods and raw materials have increased, and triggered rises in wages. These price increases have been transmitted to state enterprises, probably like a ripple at first, but later like a tidal wave. State enterprises, which were once the cash reservoirs of the government, have stalled miserably.

The government, which at one time was able to save face by transferring part of its revenues to backward regions, can no longer afford to do so. Provinces have now been left on their own fiscally, and must mobilize resources from their jurisdictions. This contradiction of market socialism is rising to the surface. Local governments must still rely on the profits of state enterprises as the source of revenues. Therefore, an effective strategy for local governments is to enter a coalition with the enterprises; in exchange for the protection and preferential treatments offered by local governments, the enterprises agree to continue to support the local governments by contributing to either on- or off-budgets, or to both. At this stage local governments play a dual role: on the one hand they protect their local partners against the central government, and on the other they assume the role of the old patriarchs of enterprises. Far from being extinct, command economies continue to survive at the lower levels of government.

It is from this point of view that we would like to look at fiscal man-

agement in China during the reform era. In fact, the reasoning above is not entirely new. We are aware of an already solid accumulation of research on the issue. World Bank (1990), Agarwala (1992) and IMF (1994) give important overall information on Chinese fiscal policies. The institutional background of reforms is offered by Cong Shuhai (1994), Ishi (1994), Oksenberg and Tong (1991) and Wong (1992). Wong (1991, 1992) also provides us with a good evaluation of a series of Chinese economic reforms. Recently, a whole volume (Jia Hao and Lin Zhimin eds., 1994) has been devoted to central-local relations in China. The contributors to the book are all Chinese political scientists and economists, and through them access to the contemporary Chinese scene has been made easier. Theoretical presentations have even begun to appear. Jun Ma (1995) studies the lack of credibility of the central government's tax policies, and asserts that the policies are prone to inconsistency over time.

Given these contributions, the goal of this chapter is to present our own point of view as persuasively as possible and to offer our assessment of the latest reform package, provisional as it may be. The remainder of the chapter is constructed as follows. The second section gives an overview of fiscal developments during the reform era. The third turns to the institutional background of central and local fiscal relations. The fourth delineates the outcomes of fiscal decentralization. The fifth is our tentative evaluation of the 1994 reform package. The last gives a conclusion to the chapter.

2. AN OVERVIEW OF FISCAL DEVELOPMENTS IN THE REFORM ERA

In this section we will draw an overall picture of Chinese public finance in the reform era. Although our discussion is restricted to the levels of government in aggregate, and to the central and local governments, the picture we draw seems to convey some stylized facts about the country's fiscal situation. (Provincial fiscal status will be touched upon in Section 4.) We will begin by treating the government at large and will examine its revenue-raising capacity to show that economic reform has put China's fiscal house into deep trouble. Secondly, we will study the shares of revenues and expenditures between the center and localities. Thirdly, we will show how the fiscal integrity of the central government has been weakened and that both the central and local governments have been working hard to find extrabudgetary revenues to manage their houses.

Tables 1 through 3 depict the government's fiscal extractive capacity. Table 1 reports revenues and expenditures relative to the GDP. Before interpreting the numbers, a caveat is due. Two anomalies can be found

in Chinese fiscal statistics: first, the government borrowing is included in revenue; and second, subsidies to loss-generating state enterprises are deducted from revenue. Table 1 has corrected these peculiarities by deleting government borrowing from and adding subsidies to state-enterprises to revenue. The resulting numbers are startling; the government's revenue has shrunk drastically during the reform era. In 1992 the government as a whole was able to raise only 16% of GDP as revenue, just half as much as the corresponding figure at the beginning of the reform era. Expenditures have also been in sharp decline. In the overall picture, though, the decline of revenue has been sharper, and fiscal deficits have become almost chronic.

Table 2 shows revenue sources by industry; again, fiscal revenues from each industry are calculated as a proportion of GDP. The first column shows the revenue collected from manufacturing industries, and they are divided further into light and heavy industries. The table indicates that the main reason for the declining government's revenue is the loss of revenues from manufacturing industries. In particular, the decline of revenues from heavy industry seems staggering.

Table 3 turns to revenue sources by management type, i.e., state enterprises, collectives and individuals. The result is again very clear, and points to the fact that the main culprit behind declining government rev-

Table 1 Revenues and Expenditures to GDP

(%)

Year	Revenues to GDP	Expenditures to GDP	Fiscal deficits to GDP
1978	31.24	30.96	0.28
1979	26.71	31.86	-5.15
1980	23.32	27.13	-3.81
1981	21.29	23.35	-2.06
1982	20.07	22.25	-2.18
1983	20.21	22.33	-2.12
1984	20.56	22.32	-1.76
1985	20.83	21.63	-0.80
1986	25.26	27.41	-2.15
1987	22.78	24.98	-2.20
1988	19.92	22.40	-2.48
1989	20.40	22.75	-2.35
1990	19.89	22.80	-2.91
1991	18.13	21.42	-3.29
1992	16.35	20.13	-3.77

Source: Guojia Tongji ju (National Statistical Bureau) ed., 1993, *Statistical Yearbook of China*, Zhongguo Tongji Chubanshe.

Table 2 Revenues to GDP Ratios by Industry

Year	Manufacturing industries	Light industries	Heavy industries	Agri-culture	Commerce	Trans- portation	Construction	Other sectors	Total
1978	23.55	9.37	14.18	0.88	3.82	2.27	0.05	0.67	31.25
1979	21.74	8.61	13.14	0.80	1.29	2.12	0.01	1.63	27.59
1980	20.07	8.41	11.67	0.74	0.37	1.57	0.02	1.50	24.28
1981	18.69	8.64	10.05	0.81	0.07	1.31	-0.02	1.96	22.82
1982	18.22	8.19	10.03	0.95	-0.81	0.99	0.03	2.30	21.69
1983	18.57	7.37	11.20	1.17	-1.72	1.23	0.20	2.13	21.58
1984	16.87	6.51	10.37	0.88	-0.18	1.80	0.09	2.21	21.68
1985	14.01	5.77	8.24	1.02	1.68	1.54	0.09	3.54	21.89
1986	13.08	5.26	7.82	0.83	3.42	1.27	0.25	4.48	23.33
1987	10.94	4.59	6.35	0.80	3.28	1.04	0.24	4.66	20.95
1988	8.99	3.96	5.03	0.86	3.32	0.95	0.25	4.30	18.67
1989	8.38	3.86	4.52	0.89	3.63	0.90	0.28	4.35	18.43
1990	7.72	3.95	3.76	0.71	4.10	1.31	0.25	4.65	18.73
1991	7.38	3.53	3.85	0.66	4.21	0.78	0.24	4.62	17.89

Source: Same as in Table 1.

Table 3 Revenues to GDP by Management Types

(%)

Year	State enterprises	Collectives	Individual management	Others	Total
1978	27.14	3.97	0.14	—	31.25
1979	23.10	3.48	0.13	—	26.71
1980	19.90	3.27	0.14	0.00	23.32
1981	17.97	3.13	0.19	0.00	21.28
1982	17.07	3.17	0.68	0.00	20.92
1983	16.76	3.36	0.62	0.19	20.93
1984	16.70	3.65	0.59	0.23	21.18
1985	15.76	4.69	0.88	0.21	21.54
1986	17.38	3.83	0.93	0.42	22.55
1987	14.72	3.69	0.93	0.67	20.01
1988	12.77	3.36	1.05	0.51	17.69
1989	12.31	3.31	1.17	0.74	17.53
1990	12.44	3.08	1.30	0.90	17.73
1991	11.46	2.90	1.71	0.92	16.99

Source: Same as in Table 1.

enue has been the weakening financial positions of state enterprises. Over a little more than a decade of economic reform the state enterprises have lost more than half of their revenue-raising capacity as measured by the proportion of revenues to GDP.

We would like to proceed to central and local fiscal relations. Tables 4 and 5 show their relative positions. Since the central government has not been alone in shouldering the sharp decline in revenue, the decline of revenue per se does not imply that the central government has borne more of the loss than its local counterparts. Here, the interpretation of the reported figures of fiscal statistics is important: Table 4 merely reports the official Chinese statistics, whereas Table 5 provides the estimates of IMF (1994) and has corrected statistical abnormalities such as the ones alluded to above. While the share of revenues going to the center does not show a declining trend in Table 4, the revised estimates of the IMF clearly manifests such a trend. On the expenditure side, however, the outcome of reform is clear; in relative terms, localities have come to take on heavier responsibilities for the services they are offering to their people.

The fiscal integrity of the central government is shown in Table 6, which depicts the ratio of expenditures to revenues for both the central

Table 4 Shares of Revenues and Expenditures by Central and Local Governments

Year	Revenue share (%)		Expenditure share (%)	
	Central governments	Local government	Central governments	Local governments
1981	20.63	79.37	54.01	45.99
1982	23.00	77.00	49.87	50.13
1983	29.78	70.22	49.71	50.29
1984	34.92	65.08	47.77	52.23
1985	37.93	62.07	45.35	54.65
1986	40.56	59.44	41.28	58.72
1987	38.24	61.76	42.14	57.86
1988	39.78	60.22	39.18	60.82
1989	37.50	62.50	36.35	63.65
1990	41.29	58.71	39.77	60.23
1991	38.76	61.24	39.80	60.20
1992	39.71	60.29	41.41	58.59

Source: Same as in Table 1.

Table 5 IMF Estimates of Shares of Revenues of the Central Government

(%)

Year	Before transfers	After transfers
1983	45.0	—
1984	46.8	—
1985	49.3	—
1986	45.1	—
1987	42.9	—
1988	43.5	—
1989	43.6	40.2
1990	45.2	42.3
1991	39.8	38.0
1992	36.3	35.3

Source: Constructed from Table 11 of IMF (1994).

and local governments. A fact which is well worth pointing out here is that the fiscal houses of the central as well as local governments are in trouble. In a sense, the situation that the two levels of governments find themselves locked into is not a zero-sum, but a minus-sum one. Table 6 offers us a very interesting result that has appeared out of this situation;

Table 6 Expenditure-to-Revenue Ratios of the Central and Local Governments

(%)

Year	Central government	Local governments
1981	268.00	59.30
1982	222.48	66.81
1983	172.72	74.10
1984	140.84	82.64
1985	118.17	87.03
1986	104.97	101.86
1987	113.92	96.82
1988	101.43	104.03
1989	99.97	105.03
1990	100.36	106.93
1991	108.43	103.83
1992	110.23	102.71

Source: Same as in Table 1.

Table 7 Proportions of Extrabudgetary to On-Budget Revenues and Expenditures

(%)

Year	Total		Central government		Local governments	
	Extra-budgetary to on-budget revenues	Extra-budgetary to on-budget expenditures	Extra-budgetary to on-budget revenues	Extra-budgetary to on-budget expenditures	Extra-budgetary to on-budget revenues	Extra-budgetary to on-budget expenditures
1982	71.42	63.69	104.72	39.48	61.47	87.77
1983	77.48	67.77	96.75	46.75	69.30	88.54
1984	79.13	72.09	89.71	56.89	73.45	85.98
1985	81.98	74.54	89.86	67.19	77.16	80.64
1986	76.86	67.72	78.17	66.61	75.97	68.50
1987	85.64	75.18	91.41	71.87	82.07	77.59
1988	89.83	79.26	86.77	79.49	91.86	79.12
1989	90.19	82.33	97.00	88.30	86.11	78.93
1990	81.77	78.42	78.46	75.59	84.09	80.28
1991	89.82	81.09	98.67	83.24	84.22	79.67

Source: Same as in Table 1.

the center has continuously lost its function of allocating resources. In 1981 it was able to allocate more than twice as much as the revenue it collected with its own hands. More recently, it has even had difficulty making ends meet with its own revenues.

The other side of this coin is that localities have come to be more on their own. Thus, the real problem of China's fiscal management has not been confined to the impoverishment of governments, but lies in the fact that the fiscal integrity of the central government has been loosened. The pain of the loss of revenues could be equally shared by the center and localities, but decaying fiscal integrity has the potential to lead the country to wasteful regional protectionism. Its economic and political impacts would be much more far-reaching than a mere decline in overall revenues.

Table 7 shows the fiscal management inside the two houses. Off-budget revenues and expenditures, which are called extrabudgetary (*yusuan wai*) in China, are compared with the on-budget counterparts. The results are surprising: in both revenues and expenditures the volumes of extrabudgetary items have grown nearly to the size of the on-budget numbers. Moreover, this applies equally to the central and local governments, implying that China's fiscal management has become fuzzier and fuzzier and that revenues have been collected not through taxes, but under other arrangements that are often very susceptible to negotiations and compromises.

This is an overview of the developments of Chinese fiscal management over a decade of economic reform. The losses of revenues are indeed startling, but another fact we would like to stress equally is that localities are now becoming more independent fiscally. Both the central and local governments are looking for and developing means through which they can collect revenues by their own hands, most probably from state enterprises, without clearly setting up taxation rules.

3. THE INSTITUTIONAL BACKGROUND OF CENTRAL-LOCAL FISCAL RELATIONS

The purpose of this section is to review the institutional background of central and local relations in China. As we extend our perspective to the early days of the establishment of the communist regime, we can observe several important swings over the years between fiscal centralization and decentralization. However, as an overall picture, it can be said that the Chinese fiscal system is tilting more toward decentralization than to the other pole.

An important factor that has persistently been behind the changes in central and local fiscal relations in China is movement in the political world. In fact, Chinese economic policies have never been independent of political changes, and this seems to apply exactly to the developments in central-local fiscal relations. China went through the period of nation

building in the early 1950s and the following period of the Great Leap Forward, an ambitious, but too fast and too disorganized social experiment. The turmoil of the Cultural Revolution disrupted the economy for a decade, and since the end of the 1970s the country has been employing a policy of market socialism. Central-local fiscal relations have not been disconnected from these political developments, or to put it more correctly, intergovernmental relations should be viewed as a mirror of political developments.

It is admittedly very difficult for a general scholar of public finance to unveil developments in central and local fiscal relations in China, and almost impossible to understand real developments behind the scenes. The following description owes much to the preceding contributions: Cong Shuhai (1994), Oksenberg and Tong (1991), World Bank (1990) and Wong (1992). Among them, the chronology and the complicated contents of various intergovernmental arrangements are especially indebted to Cong Shuhai.

3.1 Before the Post-Mao Reform

In the early 1950s, the goal of the Chinese government was to establish its administrative control over the nation, and in fiscal affairs this implied streamlining the state's revenues and expenditures. *Tongshou-tongzhi* (unified revenues and expenditures) was the policy that was employed by the center. However, as the stormy days of nation construction came gradually to calm, the defects of this policy became visible. That is, the connection between the taxes collected by localities and local expenditures became so weak that localities began to conceive of revenues and expenditures as two different things. Accordingly, they lost their interest in mobilizing resources or in making the best use of them, since they were only administrative agents of the center.

The decade of the 1950s, until the end of first five-year plan (1953-57) saw the construction of institutions for central-local fiscal relations. In 1951 the General Administration Council (*zeng wu yuan*), the predecessor of the State Council (*guo wu yuan*), gave directions concerning central-local fiscal relations. The nation was administratively divided into three tiers: the center, the greater administrative regions (*da xingzeng qu*) and provinces (*sheng*), including some municipalities. The extents of the administrative responsibilities of central and local governments were delineated, and the revenues were classified into three types: central, local and common (meaning revenues shared by the center and the localities). Though revenues were classified and some were left to the localities, a system was set up for the center to scrutinize the budgets of local governments, which were only given meager revenue sources of their

own. The 1954 reform abolished the greater administrative regions and in their place introduced the present tiers of local governments: provinces and prefectures-cities (*xiang-shi*).

On the eve of the Great Leap Forward, massive decentralization policies were carried out. Responding to the directions of Mao, the center devolved wide-ranging control of state enterprises to local management. As a result, the number of enterprises under the control of the center shrank from 9,300 in 1957 to less than 1,200 in 1958 (Zhao, 1994). On the fiscal side, this implied the major increase in the local revenue. In Shanghai, which was the home of 480 of the national total of 536 state enterprises, a large number changed hands from the center to the municipality in 1958. This boosted Shanghai's revenues to 8.51 billion yuan, raising its share of national revenue to 17.47% (Lin, 1994).

In addition, a portion of the income of the centrally-controlled state enterprises was made available to the local governments under whose jurisdictions they operated. Perhaps an even more noteworthy development was that once the revenue sources and the rate of sharing of the income of the enterprises under state control were determined the "contracts" were deemed to be effective for the succeeding five years.

The reform of 1958 was formally framed under the direction of the State Council which was stipulated in September that year. The direction was put into execution from 1959 and fiscal decentralization was pushed further on both the revenue and expenditure sides. The new central-local fiscal arrangement was dubbed "total sharing and one-year-effective-arrangement" (*zonghe fencheng, yinian yiding*), implying first that the revenues of local governments would be shared between the center and the local governments to ensure that the budgets of local governments would be balanced, and second that this revenue sharing would be subject to annual examinations by the center.

Along with the failure of Great Leap Forward, a backlash toward re-centralization occurred in 1961. This time, while the framework of the aforementioned "total sharing and one-year-effective-arrangement" continued to be observed, some of the revenues from the local state enterprises were transferred directly to the center, and the expenditures for basic construction (*jiben jianshe zhichu*) were put under the management of the center. Local incentives for tax collection were further suppressed by a central decision that the revenue surpluses of local governments would no longer be at their disposal, but would be absorbed into the budget for basic construction, which was reclassified as a totally central program.

China went into the turmoil of the Cultural Revolution starting in 1966. Along with the revolution China turned again to fiscal decentralization. However, this shift of policy seemed to have started a few years

prior to its outset, and “after the wide-ranging purge of the political establishment at all levels of government, with neither market nor central planners to coordinate the economy, Mao sought to minimize the need for coordination by means of *zili gengsheng* (self-reliance)” (Zhao, 1994, p.28).

Most state enterprises were again returned to local management. In terms of the distribution of profits from state enterprises, starting in 1971 local governments were able to retain depreciation funds, with the exceptions of centrally controlled enterprises (Zhao, 1994, p.28). An experiment on new fiscal arrangements between the center and local governments was carried out in the Hebei and Dongbei regions and in Jiangsu in 1973, and it was later extended to the rest of the country. Under the new system, called “fixed rate retention (*guding bili liucheng*)” local governments were given the right to retain a fixed portion of revenues at their disposal. A separate rate was applied to the surplus revenue, that is, on local revenue collected over the contracted amount, in order to give incentives to local governments to collect increased revenues.

Since the new revenue sharing method put aside a certain fraction of local revenue from the outset, it became difficult to balance local budgets. This prompted a return to “total sharing and one-year-effective-arrangement.” However, to promote local tax collection incentives, revenue retention rates were made progressive to localities which increased revenues.

While most of the provinces were returned to the old contract system, Jiangsu was given an opportunity to continue and even strengthen the “fixed rate retention” system. Under the fiscal contract, the province was given the right to retain its entire tax revenue after contributing a fixed portion to the center. Moreover, the retention rate itself was fixed for four years, thus freeing the province from annual negotiations with the central government on its budget.

3.2 The Reform Era

In 1979, after the Third Plenary Session of the 11th Party Central Committee that met in December of 1978, the Communist regime started to heal the wounds that people suffered during the decade of the Cultural Revolution. Market socialism, while succeeding in raising production incentives, especially for hitherto suppressed farmers, did not achieve this success without cost; the prices of staples foods and raw materials for industries went up, and this aggravated the financial conditions of state enterprises. This, in turn, made fiscal management difficult for the state, which until then had depended almost entirely on the revenues raised from state enterprises.

The central government seemed to have no choice at this junction but to appeal to local governments for more fiscal decentralization; on the one hand, it offered more flexible fiscal contracts to localities to allow them to raise more revenues, and on the other used this as an excuse of cutting central transfers and commitments to localities. This desperate change in the central attitude toward local governments was manifested by the fiscal separation policy in 1980, which was called "eating in separate kitchens (*fenzao chifan*)."

Taxes were classified at the source into four categories: central fixed, local fixed, fixed sharing and regional adjustment taxes. The central fixed revenue came mainly from the income of the centrally-controlled state enterprises and tariffs. The local fixed revenue consisted of taxes from local enterprises, salt tax, agricultural tax and industry-commerce income tax. The taxes from central state enterprises allocated to localities were the source of the fixed sharing for the center and localities: 80% of the taxes were distributed to the center, and the rest to localities. Industry and commercial taxes (turnover taxes) were earmarked for adjusting regional revenues.

The division of expenditures between the center and localities was made more explicit than ever, and the localities were granted more room for allocating their revenues. Once the center and local governments reached agreements, fiscal contracts between them were set to be unaltered for the five succeeding years. Within the contracted amount of revenue and during the contract period the localities had a free hand over the allotted revenues.

Along with this contract system, the following three systems were applied to specific provinces and municipalities. The first, the old "total sharing and one-year-effective-arrangement," was applied to such revenue-rich municipalities as Beijing, Tianjin and Shanghai. The second contract system, the "fixed rate retention," was left in place in Jaingsu. The third type of contract, which was called either "lump-sum remittance" (*dinge shangjiao*) or "lump-sum subsidy" (*dinge buzhu*), was most straightforward in devolving fiscal management to localities. The two coastal and rapidly growing provinces of Guangdong and Fujian were granted this contract, under the premise of five-year fixed amounts for remittances and subsidies, respectively.

A noteworthy development in tax reform in the post-Mao era was the introduction of "tax on profit" (*li gai shui*) in 1985. The center aimed at strengthening its revenue from state enterprises by replacing highly discretionary and negotiation-governed remittances with a more transparent rule-governed profit tax. However, local governments were very reluctant in complying with the reform, and somewhat ironically, the center was able to raise the revenue from state enterprises only by authoriz-

ing more straightforward "contract-management responsibility systems" (*chengbao jingying zerenzhi*) to the local governments, who more often than not had ultimate control over the state enterprises.

On the central and local fiscal fronts, too, the tide was clearly toward contracts rather than rule-based revenue sharing methods. In 1987 the lump-sum taxes and subsidies that were hallmarks of newly industrialized Guangdong and Fujian became the standard contract system between the center and local governments in the remaining provinces and municipalities, including Shanghai and other aforementioned revenue-rich municipalities. It is, therefore, no wonder that the system was called "a big fiscal contract" (*caizheng da baogan*).

4. OUTCOMES OF FISCAL CONTRACT SYSTEMS

Our institutional examination of Chinese fiscal management, especially in the post-Mao era, has revealed that the country has been heading toward decentralization. However, this should not be regarded as the center's positive commitment to a decentralized, federal-state-like policy, but as a course of events which was made inevitable when the economy began moving toward market socialism. The sharp drop of revenues called for severe retrenchment for the center, and deals were made between the center and various localities on budget cuts. Slashing appropriations from the center to localities was only made possible by granting more fiscal autonomy to local governments.

The following section looks from the viewpoint of local governments, and tries to extend our examination to the local scene: first, we will touch upon the reactions of localities to policy changes; and second, the resulting economic and political outcomes will be discussed. Overall, we will draw a picture showing that the coalition between the local government and its subordinate state enterprises blocks the center's integral role in the market economy and that the country is drifting without any coherent plan and without integrating institutions toward de facto separate states.

4.1 The Strategic Reactions of Local Governments

A noteworthy fact of the reform period is that it was not the center alone that was plagued with plummeting revenues; local governments were as hard hit with this problem. After all, the two levels of governments were in the same boat in the sense that both were dependent on state enterprises for most of their revenues. Therefore, fiscal decentralization resulted in confrontations between the central and local governments

over limited resources. Local government now found themselves forced to react strategically to raise their own revenues.

What strategies did they employ? Many authors have hinted at an answer. Zhang Amei and Zou Gang (1994) in their paper on foreign trade decentralization, summarize the issue in the following three ways: first, "local governments interpret central policy flexibly to realize and promote their own interests"; second, localities hide benefits at the enterprise level (i.e. Jaingsu Province, that failed to collect enterprise profits to be remitted to the center); third, local governments are sometimes bold enough to simply confront the center. The authors refer to the reform of "tax on profit" as a good example of the last strategy; when the tax was to be introduced, "provincial officials told enterprises that although the center had made this proposal, they could ignore it and continue the profit-contracting system."

A richer and more systematic menu of local reactions to the center is provided by Wang (1994) in his examination of central-local politics in China. Local strategies start from negotiation with the central government for favorable arrangements within the revenue-sharing framework. "The second strategy used by localities to augment their funds is to take a noncooperative position whenever local governments consider central policies detrimental to their interest." A case in point here is again the aborted reform of "tax on profit." The author steps somewhat further than the preceding authors, Zhang Amei and Zou Gang, and concludes that "the successful boycott of the taxes-on-profit reform demonstrates how local powers are now sometimes able to 'veto' central decisions."

"The third local strategy is to hold back as much local funds as possible from central extraction." This strategy consists essentially of allowing state enterprises to retain as much income as possible in their various funds so that profits that would otherwise be collected by the central government stay at localities. In fact, China's procedures for revenue collection from state enterprises abound in "loopholes." World Bank (1990, p.167) gives an outline of the procedures; indeed, there are some salient arrangements that seem to have contributed to the accumulation of collection-exempted funds. The deductibility of amortization on loans on top of interest paid and the retention of depreciations that are more often than not the outcome of negotiations are typical of the arrangements that help local governments evade remittances to the center, not to mention other more straightforward ways such as tax exemptions and grants to local enterprises.

Local governments, however, do not protect local state enterprises out of generosity; they merely look like protectors under the shadow of the central government. When the doors are closed and local governments are left alone with the local enterprises, they seek to recoup some

of the money sitting in the enterprises. Thus, "the fourth strategy used by localities to augment their income is to impose ad-hoc charges on local enterprises." Retained earnings are officially or unofficially collected by local governments, and some of the collections have become an important source of the extrabudgetary accounts.

Thus, the menu used by local governments to cope with the central collection of local revenues is very rich and far reaching. Restricting our observation to the published data, we can claim that the most important strategy used by local governments to protect their revenue is to accumulate extrabudgetary funds. Either hiding the profits of local enterprises or tapping into their retained earnings through ad-hoc measures, local governments have sought strategically to put aside as many resources as possible for their own expenses.

An interesting conclusion drawn by Lin (1994, pp.256-257), who reported on reform and the situation in Shanghai, is the following: "it became clear that as far as gaining local control over fiscal resources was concerned, it was no longer sufficient to confine the thrust of local strategy to a better revenue-sharing agreement with the center. It was the ability to gain access to new opportunities and the policy discretion to turn such opportunities to local advantage (not necessarily the specific amount of central transfers) that would make the difference between gaining concessions and gaining control. Shanghai was finally able to do the latter, and therefore gradually became much more in control of its vast fiscal resources than at any previous time." Needless to say, Shanghai gained more control from the center by, among other things, expanding extrabudgetary funds.

Some statistical evidence is due for supporting the claims above. Tables 8 though 10 present fiscal statistics for the two most affluent municipalities, Shanghai and Beijing, and a show-case province in China's open door policy, Guangdong. The formats of the tables are same: the first column reports the ratio of revenue to expenditure, both from the budget; the second is the same ratio, but from the extrabudget; the third is a mixture of the preceding two ratios, i.e., the ratio of extrabudgetary revenue to budgetary revenue; and the last is the ratio of extrabudgetary expenditure to budgetary expenditure.

We start with Shanghai. The first column clearly shows how the city's financial condition has changed during the reform period. In 1983 Shanghai collected eight times as much resources as expenditures, implying that massive transfers were made from the city to the center or to other provinces. The succeeding years saw drastic declines in revenues relative to expenditures. That is, Shanghai's fiscal situation became gradually closed in the sense that it started to manage its budget independently. This, however, does not necessarily mean that Shanghai's fiscal

Table 8 Shanghai's Fiscal Status

(%)

Year	Budgetary revenues to expenditures	Extrabudgetary revenues to expenditures	Extrabudgetary revenues to budgetary revenues	Extrabudgetary expenditures to budgetary expenditures
1983	807.7	—	—	—
1984	581.8	—	—	—
1985	431.6	—	—	—
1986	312.7	124.7	47.3	118.7
1987	329.3	116.3	58.6	166.0
1988	227.1	111.2	74.5	152.3
1989	208.8	101.0	68.9	142.5
1990	208.4	96.6	65.8	141.9
1991	189.0	—	—	—

Sources: General Planning Department of Ministry of Finance, 1989, *China Finance Statistics* (1950-1988); 1992, *China Finance Statistics* (1950-1991).

Table 9 Beijing's Fiscal Status

(%)

Year	Budgetary revenues to expenditures	Extrabudgetary revenues to expenditures	Extrabudgetary revenues to budgetary revenues	Extrabudgetary expenditures to budgetary expenditures
1983	203.2	—	—	—
1984	168.0	—	—	—
1985	159.0	—	—	—
1986	136.3	113.4	87.7	105.4
1987	128.1	104.6	93.8	114.8
1988	128.7	119.3	108.6	117.2
1989	119.0	113.3	109.5	115.1
1990	110.9	110.1	112.8	113.6
1991	111.2	—	—	—

Source: Same as in Table 8.

situation improved, but rather that the revenue transfer system went into near collapse.

The extrabudgetary accounts have been in balance, though it seems that extrabudgetary expenditures have grown somewhat faster than revenue. The third column shows the city's dependence on the extrabudget on the revenue side. The dependence is high and even seems to be

Table 10 Guangdong's Fiscal Status

(%)

Year	Budgetary revenues to expenditures	Extrabudgetary revenues to expenditures	Extrabudgetary revenues to budgetary revenues	Extrabudgetary expenditures to budgetary expenditures
1983	96.5	—	—	—
1984	104.4	—	—	—
1985	103.8	—	—	—
1986	92.0	105.6	63.1	55.0
1987	99.3	111.0	70.1	62.6
1988	93.4	114.4	78.2	63.8
1989	97.0	110.1	66.3	58.4
1990	87.0	104.8	73.6	61.1
1991	105.3	—	—	—

Source: Same as in Table 8.

increasing; a fact we have stressed above. Nearly the same observation can be made from the last column; the city started to depend more on off-budget resources for its expenses.

The figures for Beijing convey basically the same messages, with some differences in magnitude. Beijing collected twice as much revenue as expenditure in 1983, a rate which was significantly lower than Shanghai, but in 1991 the revenues of the nation's capital were just about equal to its expenditures. As for extrabudgetary accounts, Beijing mobilized more revenues from off-budget than from the on-budget sources.

The picture of Guangdong is slightly different from the other two cities. The lump-sum transfer system enabled the province to keep at its disposal whatever was left after the contracted transfers. This explains the province's balanced budget. However, in spite of the fact that the contract should not have hampered its incentives for collecting on-budget taxes, Guangdong has depended much on extrabudgetary accounts on both the revenue and expenditure sides, implying that the lump-sum transfer system still continued to have adverse effects on revenue-raising incentives in the province (Cheung, 1994).

4.2 The Coalition between Local Governments and Local Enterprises

A very important outcome of the strategic reactions of local governments to the central extraction of resources has been the emergence of dual roles for local governments. In short, local governments have taken on two faces: one when they face the central government, and another

toward local enterprises. State enterprises have been virtually the sole source of revenues for both the central and local governments. Hence, when they confront the central government, local governments act to protect their local enterprises and make demands for greater retentions and other managerial autonomy from the center. However, local governments continue to intervene in the management of local enterprises for the benefit of their respective regions and of the people affiliated with the enterprises, and in order to protect the vested interests of local bureaucrats. As a result, the separation of politics and business management has failed in China's economic reform. One can say that one of the most important requisites for the development of markets has been stifled.

It is not surprising, therefore, that one encounters quite a few remarks concerning this development in Chinese economic reform. Gong Ting and Chen Feng (1994, p.84) called the problem "dual performance pattern on the part of local government," Zhang Amei and Zou Gang (1994, p.171) "the mutual dependence of localities and enterprises," and Wong, P. (1991, p.694) "the dependence of local budgets on the financial health of local industry."

Wang Shaoguang (1994, p.100) projects the issue onto a political screen: "In sum, while decentralization has demolished some aspects of the command economy, it has also reproduced and even strengthened other aspects of the command economy on a smaller scale. There is a real danger that China's national economy could be further fragmented, which would pose a threat not only to China's market-oriented economic reforms but also to China's national unity."

The corollaries of the dual roles of local governments abound as well. With the lack of central integrity, provinces have begun to maximize their immediate benefits. Conflicts of interests among provinces have ended up in "wars" such as the "tobacco wars," "tea wars," and "silkworm wars." The mechanism of these wars is as follows:

During the pre-reform era, regional economic balances were maintained through transfers from industrial provinces to their agricultural and inland counterparts. As we saw in the preceding section, Shanghai and Beijing transferred huge resources to the center in the early 1980s. Part of the revenues extracted from the industrial provinces was, then, transferred to the provinces that supplied the raw materials. Since prices were set artificially low in that era, it can be said that the provinces supplying raw materials were paying implicit taxes, which were transferred to industrial provinces in the form of inexpensive materials.

Economic reforms have now cut this linkage among the provinces. The governments of industrial provinces have aimed to keep all their collections in their pockets. The underlying problem is that price reforms have not been complete, and have been very sluggish, in Chinese reform.

Accordingly one part of the old system was unaltered, and suppliers of raw materials bore the costs unilaterally. The "wars" are in effect declarations of the losers that they will block the flow of raw materials out of their territories.

One corollary of the wars is what many scholars of Chinese economy call "duplicated investments and productions." Let us take the case of tobacco. This is a perfect candidate to provide quick revenues to local governments. Since compensatory transfers are no longer paid by the center, inland provinces have every reason to produce tobacco for themselves. The same applies in one manner or another to other materials. The very reason for moving toward a market economy should have been to achieve a more efficient allocation of resources; however, economies stalled far before markets were able to start doing their jobs.

Seen from a macro economic side, the Chinese economy tends to be an easy prey for inflation. So long as enterprises continue to assume the role of revenue machines for governments, neither central or local production and investment decisions will not be governed by markets. The underdevelopment of financial markets may make the economy vulnerable to inflation, too, but the point we want to make here is that an important source of the vulnerability is the governments themselves.

5. AN OUTLINE AND ASSESSMENT OF THE 1994 REFORMS

In the face of ever-increasing regional protectionism and the experience of the failure of the "tax on profit" (*ligaishui*) reform, the Chinese central government started a new round of reform in 1994. The underlying theme of this reform package was to strengthen its fiscal extractive capacity and to improve its fiscal integrity. Of the several important reforms that are now seemingly underway, the "tax assignment system" (*fenshui zhi*) is the most critical new step.

In truth, however, the reforms are still in their infant stage, and there are not yet sufficient statistics to allow us to make a quantitative evaluation. This restricts the scope of this section; it tries to provide a provisional assessment of the new reforms with an emphasis on the "tax assignment system." The publications on the latest government proposals that we will be referring to are the following: He Zhenyi (1994), and Tsang Shu-ki and Cheng Yuk-shing (1994) for background information of the reforms; Meitan Gongye Chubanshe (1994) and IMF (1994) for more detailed schemes of both the "tax assignment system" and the new taxes. We will begin with an outline of the reforms, and will follow with a tentative discussion on the extent to which they could open a new horizon on the Chinese fiscal landscape.

5.1 An Outline of the Reforms

The formal political decision concerning the reforms was made by the Third Plenary Session of the Fourteenth Party Central Committee in 1993, which proposed gearing fiscal management from contract-governed systems to a tax assignment system (Tsang Shu-ki and Cheng Yuk-shing, 1994, p.770). However, as was often done in China, the "tax assignment system" had previously been experimentally undertaken in nine regions in 1992 prior to its full implementation. The experimental regions consisted of three provinces, Liaoning, Zhejiang, and Xinjian, and six cities, Shenyang, Talian, Wuhan, Qingdao, Tianjin, and Chongqing.

Based upon this preliminary test of the new system, the central government launched the 1994 reforms. The package had two broad parts: the first for the reform of central and local relations; the second for tax reform. Improving the relations between the center and local governments meant essentially strengthening the tax bases of the central government and constructing better interregional transfer systems from rich to poor provinces. Two of the most pressing agendas for tax reform were how to implement the enterprise income tax and value-added tax (hereinafter, VAT).

The "tax assignment system" is a new proposal of the government intended to reform central-local relations. It classifies tax bases into central, local and shared ones. The idea of classifying revenues into three parts is nothing new in China's fiscal management, as we saw it in the third section. What makes the latest reform different from the previous ones, however, is that it would be first under which the reform would be synchronized with tax reform and, second, that the tax collection, too, would be independently executed by the center and localities (*fenbie shoushui*). In a word, as will be discussed shortly, tax reforms are aimed in the whole at broadening tax bases and tapping more revenues to the center.

As far as the institutional aspect of tax collection is concerned, a novel feature of the reforms is the establishment of a National Tax Service. The central and shared taxes are now being collected by the National Tax Service, while the collection of local taxes has been left to local agencies. This may help the central government strengthen its capacity to collect taxes and to monitor excessive concessions granted by local governments to enterprises in their jurisdictions. However, how stringent the administration of the National Tax Service is would be another story, and so far no concrete evidence has been provided on the contribution of the new institution to the coffer of the central government.

On the front of tax reforms, the enterprise income tax and the VAT are the most important ones, especially in conjunction with central-local relations. The last section has pointed out several important loopholes in collecting revenue from state enterprises. One of the primary concerns of the new tax policy is to replace management contracts at state enterprises with an income tax. In short, broadening the enterprise income base and applying non-discriminative tax rates to all types of management encompassing state, collective and private ventures are the spirit of the reform.

Thus, repayments of principle on loans (*shuiqian huandai*), probably one of the most important loopholes in the old system, may no longer be permissible, and only interest payments will be deductible (*shuihou huandai*) from taxable income. The tax rates are progressive and applied uniformly to all enterprises. The three tax rates of 33%, 27% and 18% correspond respectively to annual incomes above 100,000, between 30,000 and 100,000, and below 30,000 yuan.

A major reform of indirect taxes (*liuzhuan shui*) has reorganized them into the VAT (*zengzhi shui*), the consumption tax (*xiaofei shui*) and the business tax (*yingye shui*). In the era of the command economy the major sources of government revenues were the remittances from state enterprises and the turnover taxes. This was the case in China, too. The turnover tax was called the consolidated industrial and commerce tax (*gongshang tongyi shui*) in China. The reform of 1984 split this tax into the VAT, the product tax (*chanpin shui*) and the business tax. Of these, the product tax was a remnant of the turnover tax. The business tax was a type of turnover tax, but it was levied mainly on services such as communications, transportation, construction, banking, and insurance.

The latest reform streamlined indirect taxes by abolishing the old turnover tax (the product tax) and merging it with the VAT. The consumption tax replaced the various specific excise taxes and was applied to goods like cigarettes, alcoholic beverages, cosmetics and luxury goods.

These are the two key parts of the 1994 reforms. This combination of the "tax assignment system" and the tax reforms has yielded the tax system as shown in Figure 1. A glance will suggest that the broadened-base uniform enterprise income tax and the three quarters of the VAT that are earmarked for the central government should contribute substantially to the central revenues, as long as the new tax system functions as was envisaged by the architects of the central government.

5.2 A Provisional Assessment of the Reforms

The goal of the latest reforms has been to set the Chinese tax system free from the web of contracts exchanged between various agents: fiscal contracts between the center and localities; and the management responsi-

Figure 1 China's New Tax System

Taxes of the central government (Zhongyang guding shouru)	Custom duties VAT on imports Consumption tax Enterprise income taxes from central state enterprises Enterprise income tax from non-banking financial companies Taxes from railways, banks and insurance companies
Taxes of local governments (Difang guding shouru)	Business taxes excluding railways, banks and insurance companies Enterprise income taxes from local enterprises excluding non-banking financial companies Personal and agricultural income taxes City and town land use taxes Capital gains tax on fixed investments Stamp taxes Slaughter taxes Inheritance and gift taxes VAT on real estate Other specific taxes
Shared taxes (Gongheng shouru)	VAT, of which 75% goes to the center, the rest to the local government. Resource taxes Stock transaction taxes

Sources: Meitan Gongye Chubanshe (1994), IMF (1994) and Tsang Shu-ki and Cheng Yuk-shing (1994).

bility system between governments and enterprises. The "tax assignment" (*fen shui*) and the "separation of taxes and management" (*shui li fenliu*) are the most important concepts behind the reform, and the central government is struggling to achieve the goal by transforming the key concepts into a workable policy package.

Can the latest reform package, and especially the "tax assignment system," be seen as a successful step toward this goal? Our assessment of the reforms, though only provisional at this stage, leads us to a rather negative answer to this question. In short, our assessment is this: first, a crucial problem that has been blocking the fiscal integrity of the central government has not been tackled by the reforms; and second, on-budget

revenue raising incentives of local governments will be suppressed by the reforms, and activities aimed at putting more resources into their extra-budgets may even be strengthened.

We feel that one of the most essential fiscal problems in China has been the formation of coalitions between local governments and enterprises in their jurisdictions. Various local command economies have sprouted, each one of them protecting its own "market." In this regard, the "separation of taxes and management" is the key to the success of the reform of Chinese fiscal problems.

A relevant question at this point would be whether the latest uniform enterprise income tax can do the job. The answer would probably be negative, for unless the crucial pre-capitalistic linkage between local governments and enterprises are separated, taxes and management will never be separated. Put more simply, the new tax system assigns the taxes from local enterprises to local revenues. That is, the very linkage that has been the deep cause behind China's fiscal problems has been left untouched.

The continuation of coalitions between local governments and enterprises will, then, have impacts on both the incentives of local governments to comply with the new tax system and ultimately on the revenue raising capacity of the central government. The reforms seem to have had adverse effects on local governments' commitment to the new tax system in the following two respects.

The first aspect of the reforms that may weaken local governments' tax compliance would come from "Revenue rebates" (*shuishou fanhuan*) in the "tax assignment system." After new rules for taxation have been set up, the government claims that it will let no locality be left short of revenues that it might otherwise have collected. This is typical of Chinese policy changes. One might be tempted to call it "gradualism," but one can more properly call it an outcome of negotiations and compromises between the center and local governments.

The rule on rebates is as follows: First, the revenue of each local government (say, a province) in 1993 is set as the base revenue, and this is granted to local governments. Let us denote this R_{93} , and let the revenue that could have been collected under the new tax system be R_{93}^N . Notionally, an identity

$$R_{93} = R_{93}^N + (R_{93} - R_{93}^N)$$

prevails, and it implies that the local government's revenue is decomposed into its proper revenue R_{93}^N under the new system and the rebate, $R_{93} - R_{93}^N$. Thus, there is no change in revenue to the local government for the year, but the rebate for the year has been determined and it is called "the Base of Rebate" (*fanhuan qishu*).

The second rule of the rebate is how to determine it for years after 1993. Here, the "1: 0.3" rule has been advocated. To explain this, let R_{94} and R_{94}^N be, respectively, revenue granted to the local government and revenue collected under the new system. Then, the R_{94} , the revenue at the disposal of the local government, is determined by:

$$R_{94} = R_{94}^N + (R_{93} - R_{93}^N)(1 + \alpha),$$

where α is the rate of increase of the rebate, and is set equal to 30% of the rate of increase of the sum of the VAT and the consumption taxes. Thus, the rebate in 1994 is the second term of the equation above, and setting α equal to 0.3 is called the "1:0.3" rule. For the years after 1994, say the year 1995, the rebate in 1994, $(R_{93} - R_{93}^N)(1 + \alpha)$ is the Base Rebate, and the "1: 0.3" rule is applied to it.

The effects of this revenue rebate on the incentives for local government compliance with the new tax system seems to be obvious. The rule simply caps their revenues at the sum of the revenue under the new system and the rebate. If a province is growing quickly and the former fiscal contract with the center yields it more revenue, it will have relatively smaller incentives to stay with the new system. We have seen in the third section of this chapter how rich the menus of local governments are in reacting to the policies taken by the center.

The old stories will be repeated. Local government will start to complain that the "1: 0.3" rule is too small. If their voices are not heard, they will eye off-budget revenue sources. Enterprises, whether state, collectives or others, are still under their control. There should be numerous ways available for local governments to transfer on-budget revenues into their pockets.

The second adverse effect of the new tax system on local governments' tax collection efforts is the rate at which the VAT is split between the center and localities. With three quarters of the tax revenue going to the center, it would be no surprise to see localities losing interest in this huge source of revenue. Here again they have a whole range of capacities for maneuver on the collection of the VAT; the value added of enterprises is highly dependent on book keeping, and independent auditing of local enterprises would be a nearly impossible task for the newly established National Tax Services. In this circumstance, local governments and enterprises benefit from forming coalitions and underreporting value added to the center.

Thus, in a word, our assessment of the 1994 reforms would be that they are by far too little to fundamentally alter China's pressing fiscal problems. The pre-capitalistic linkage between local governments and their subordinate enterprises has been left untouched. The revenue rebate system and a sizable allocation of the revenues from the VAT to the cen-

tral government will discourage the efforts of local governments to raise on-budget revenues. In China, the progress of fiscal reform has been very slow, as is probably the case for any other country, but the nation will not be able to postpone dealing with its deep-rooted fiscal problems for ever.

6. CONCLUSION

The central theme of this chapter has been the emergence of coalitions between local governments and enterprises. The sharp decline of revenues to the central government has left it with no choice but to give greater fiscal autonomy to local governments. However, gaining more fiscal independence does not imply that local governments have become richer. On the contrary, they, too, have suffered from declining revenues.

Chinese "gradualism" has postponed the reform of state enterprises. And under this circumstance the best strategy for local governments is to share revenues with enterprises in their regions. In order for China to achieve a better allocation of resources enterprises will have to stand alone, and the bondages between governments and enterprises will have to be cut.

This whole chapter has been devoted to providing supportive evidence and strengthening the reasoning for this contention. Statistical evidence, especially for Shanghai, Beijing and Guangdong, supports it, and shows these nation's most prosperous regions have been struggling to gain control from the center.

The latest tax reform package has also been examined as a possible solution to the problems stemming from local coalitions. Our evaluation is that so long as the tax system assigns revenues from enterprises to local governments, the progress of economic reform will be very slow. It is anybody's guess whether the present trend toward fiscal decentralization will fuel political centrifugal movements, but it cannot be denied that the Chinese central government will have to continue playing a substantial role in economic development, e.g. in terms of providing public goods and the social safety net and for sustaining regional balances. China needs, more than anything, explicit rules about how to delineate the roles played by the central and local governments.

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