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# What Causes the Local Fiscal Crisis in China: the role of intermediaries

LINDA CHELAN LI and ZHENJIE YANG\*

*Local governments in China are seriously under-funded relative to their assigned expenditure responsibilities for public services, resulting in the infamous 'revenue–expenditure gap'. The dominant explanation of local fiscal difficulties given in the literature refers to central government behaviour, namely the excessive centralization of tax revenue, but it does not tally with the large flows of central subsidies to local coffers in more recent years. The alternative account we put forward stresses the working of an intermediary level embedded in the multi-tiered governance structure of a large country, and the interaction between local officials' fiscal behaviour and the revenue–expenditure gap. Employing fine-grained analysis of aggregate statistics and local case data, we argue that broader intergovernmental dynamics and practices of local intermediaries, and not only central government policy, are critical to fiscal health and government performance at the county level.*

## Introduction

Many local governments in China suffer from a constant state of fiscal deficit. As many as 70% of the total number of counties and up to 90% of towns/townships, the lowest two tiers of governments in a five-tier structure, were estimated to be in the red in the mid-2000s.<sup>1</sup> Many have hence lost the ability and moral authority to

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1. If we conduct a snap-shot count in the middle of the first decade in the new millennium, as of 2005 there were 2,862 counties and 41,636 towns/townships nationwide. This means as many as 39–618 local governments at these grassroots levels were in trouble financially (three-quarters of 2,862 and 90% of 41,636). For details, please see: Ligang Liu and Shaoqiang Chen, 'An analysis of local government debt' ['Difang zhengfu juzhai tanxi'], (2006), available at: [http://www.rieti.go.jp/cn/events/bbl/04122201\\_cn.pdf](http://www.rieti.go.jp/cn/events/bbl/04122201_cn.pdf) (accessed 13 January 2013); 'National Development and Reform Commission: fiscal debt per county reached 100 million yuan on average', (2008), available at: [http://news.xinhuanet.com/fortune/2008-04/03/content\\_7913318.htm](http://news.xinhuanet.com/fortune/2008-04/03/content_7913318.htm) (accessed 14 January 2013).

provide necessary public goods to local residents, focusing their energies on meeting the minimal costs of running the government—pay arrears were habitual and pervasive in rural localities from the 1990s.<sup>2</sup> Many local governments turned to borrowing and incurred huge debts to make ends meet, despite official requirements for a balanced budget at all sub-national, or local, government levels.<sup>3</sup> The quality of government performance and public services, under such circumstances, was low. Government–citizen conflicts were commonplace, and a movement of ‘rightful resistance’ emerged.<sup>4</sup>

While governments at the grassroots levels are struggling with keeping the most basic functions in place,<sup>5</sup> China on the whole has enjoyed continuous economic growth at an impressive rate over three successive decades since the late 1970s, drawing questions as to how the local difficulties and the ‘China Miracle’ could have co-existed. What significance do the fiscal difficulties at the county level and below hold against the national picture: are they a minor nuisance in the broader context of overall growth and development, or the tip of an iceberg of broader problems?

Most analyses on the Chinese political economy, from within and outside China, have blamed inadequate intergovernmental fiscal arrangements for causing a large part of the local fiscal difficulties. Both World Bank and Chinese researchers in the State Council National Development Research Institute, for instance, have published influential studies maintaining that governments of county and township levels were loaded with excessive expenditure responsibilities and allocated far too little

2. Roy W. Bahl, *Fiscal Policy in China: Taxation and Intergovernmental Fiscal Relations* (Ann Arbor, MI: University of Michigan Press, 1999); Era Dabla-Norris, ‘Issues in intergovernmental fiscal relations in China’, (February 2005), available at: <http://www.imf.org/external/pubs/ft/wp/2005/wp0530.pdf> (accessed 10 June 2012); Research Team of Pay Arrears in Research Institute for Fiscal Science of Ministry of Finance, ‘A study on pay arrears in county and township level governments’ [‘Xianxiang zhengfu qianfa gongzi wenti yanjiu’], *Public Finance Research* [Caizheng yanjiu] 4, (2002), pp. 36–41; Ting Gong and Alfred M. Wu, ‘Central mandates in flux: local noncompliance in China’, *Publius: The Journal of Federalism* 42(2), (2012), pp. 313–333; Wei Lin, ‘Clearing off teachers’ pay arrears’ [‘Changqing tuoqian jiaoshi gongzi jiuzhang’], *Outlook* [Liaowang] 37, (2008); Xiwen Chen and Jun Han, ‘On fiscal crises of county and township government in China’ [‘Guanzhu woguo xianxiang gonggong caizheng de weiji’], (2002), available at: <http://www.dajunzk.com/xianxiangweiji.htm> (accessed 6 January 2012).

3. Unofficial estimates of county–township debts as of the early 2000s were between 1,000 billion and 3,000 billion yuan. The Budget Law of China, enacted in 1994, explicitly prescribes that ‘various local tiers of government shall follow the principle of balancing revenue and expenditure in budget formulation, and local governments must not issue local government bonds unless prescribed otherwise by other laws or State Council regulations’ (Article 28). Local government debts have been on the rise, however, reaching a level of some 20,000 billion yuan in 2012, as controls were relaxed in 2008 as part of the economic stimulation policy to encourage investment and spending in the aftermath of the Global Financial Crisis, while the National Audit Report published on 30 December 2013 claims that local debt increased from 15,886 billion yuan at the end of 2012 to 17,890 billion in June 2013, an increase of 12.6%. For details, please see: National People’s Congress, ‘Budget Law of China’, (22 March 1993), available at: [http://www.law-lib.com/law/law\\_view.asp?id=10301](http://www.law-lib.com/law/law_view.asp?id=10301) (accessed 10 June 2014); Gang Zhang, ‘How to solve thousands of billion yuan debt of county and township governments’ [‘Wanyiyuan zhaiwu ruhe huajie’], *Development* [Fazhan] 5, (2005), p. 31; Guanxiang Dong, ‘The former finance minister Xiang Huaicheng estimated Chinese local government debts to surpass 20,000 billion yuan’, (2013), available at: <http://finance.chinanews.com/cj/2013/04-06/4705499.shtml> (accessed 10 April 2013); National Audit Office, ‘Chinese government debt audit report’ [‘Quanguo zhengfu xingzhai wushenji jiegou’], (30 December 2013), available at: <http://www.audit.gov.cn/n1992130/n1992150/n1992500/n3432077.files/n3432112.pdf> (accessed 31 December 2013).

4. Kevin J. O’Brien and Lianjiang Li, *Rightful Resistance in Rural China* (New York: Cambridge University Press, 2006).

5. Local government budgets at the county and below levels have thus been characterized as ‘chifan caizheng’ (literally, government finance for meals) in the Chinese literature.

resources.<sup>6</sup> The resultant ‘revenue–expenditure gap’ was filled by controversial fees and charges extracted from local residents, or by borrowing, leading to the infamous problem of ‘peasants burden’ and the subsequent Rural Tax Reform,<sup>7</sup> and proliferation of debts to local service providers from constructors of rural school premises to rural teachers.<sup>8</sup> The dominant view is that excessive centralization of revenues and decentralization of expenditure responsibilities have precipitated a fiscal crisis in many Chinese counties and townships, with dire consequences to local governance.<sup>9</sup>

The ‘gap’ argument emphasizes the relative ratio of central *vis-à-vis* local revenues and the impact of decentralization of expenditure, and slights the impacts of other parallel fiscal developments, in particular the large flows of central subsidies to local coffers since the 1994 Tax Sharing Reform. As pointed out by the few sceptics,<sup>10</sup> the presence of a large and growing central fiscal subsidy, of a comparable size to the centralized tax revenues, means that logically the latter *cannot* in itself constitute a sufficient condition for local fiscal difficulties. What then accounts for the difficulties, as localities are *not* blatantly short of monies? In this article we revisit the basis of the ‘gap’ argument and put forward an alternative explanation which draws upon the analysis of the dynamics of fiscal management in a locality. We find that fiscal difficulties at the grassroots levels are as much a result of the working of the intermediary levels between the central and the county–township governments embedded in the multi-tiered governance structure of a large country, as that of the proportion of taxes assigned to central *vis-à-vis* local budgets.

The article proceeds as follows. The next section reviews how the literature explains the local fiscal crisis, *via* tax revenue centralization and the resultant revenue–expenditure gap, and discusses its limits. We then employ case data obtained through ethnographic field research on the interactions between a district (county-level) government and its city-level superior in Central China to illustrate

6. Xiwen Chen, ed., *A Study of County and Township Finance and Peasants Income Growth in China* [Zhongguo xianxiang caizheng yu nongmin zhenshou wenti yanjiu] (Taiyuan: Shanxi Economy Press, 2003); Jun Han and Yang Xie, ‘The current situation of county–township finance in China: problems and implications’ [‘Zhongguo xianxiang gonggong caizheng xianzhuang: wenti yu yingxiang’], (2005), available at: <http://www.ahnw.gov.cn/2006nwkw/html/200509/%7B5AFA12C9-B630-4DEA-90E5-7A6F0AC39E69%7D.shtml> (accessed 6 January 2013); World Bank, ‘China: national development and sub-national finance—a review of provincial expenditures’, (9 April 2002), available at: <http://ideas.repec.org/p/wbk/wboper/15423.html> (accessed 10 June 2014).

7. C. Göbel, *The Politics of Rural Reform in China: State Policy and Village Predicament in the Early 2000s* (London: Routledge, 2010); Linda Chelan Li, *Rural Tax Reform in China: Policy Process and Institutional Change* (London: Routledge, 2012).

8. Deyong Zhang, ‘County and town debt of China: problems and solutions’ [‘Zhongguo xianxiang zhaiwu: Wenti yu duice’], *Finance & Trade Economics* [Caimao jingji] 7, (2006), pp. 75–80.

9. Chengjun He, ‘Status quo, reasons and way out of county and township fiscal crisis’ [‘Xianxiang caizheng kunnan: xianzhuang chengyin chulu’], *Rural Economy in China* [Zhongguo nongcun jingji] 2, (2003), pp. 17–22; Kang Jia and Jingming Bai, ‘Overcoming county and township governments’ fiscal dilemma and fiscal institutional innovation’ [‘Xianxiang caizheng jiekun yu caizheng tizhi chuangxin’], *Economic Research Journal* [Jingji yanjiu] 2, (2002), pp. 3–9; Jean C. Oi and Shukai Zhao, ‘Fiscal crisis in China’s townships: causes and consequences’, in Elizabeth J. Perry and Merle Goldman, eds, *Grassroots Political Reform in Contemporary China* (Cambridge, MA: Harvard University Press, 2007); World Bank, ‘China: national development and sub-national finance’; Project Group of Town Deficit and Debt, ‘Fiscal deficit and debt issues of township governments’ [‘Xiangzhen caizheng chizi yu zhaiwu yanjiu baogao’], *Review of Economic Research* [Jingji yanjiu cankao] 78, (2002), pp. 2–11 and 20.

10. Keyu Zhou, ‘Review of the administrative system of city-managing-counties’ [‘Fanshi woguo “shiguanxian” tizhi’], *Urban Research* [Xiandai chengshi yanjiu] 5, (2000), pp. 22–24.

how bureaucratic practices in a multi-tier governance setting created immense fiscal difficulties for the district government as a subordinate actor. The conclusion highlights the importance of adopting a dynamic behavioural approach in understanding what the local fiscal crisis *is*, and its implications.

A note on our case research is in order here. The case material used in the article draws upon fieldwork in Galung City and its subordinate Noan District<sup>11</sup> in Hubei Province of central China during 2008–2010. The major objectives of the fieldwork were to identify the actual boundaries of city–district jurisdictions in the major policy areas, canvass the trajectories of changes in these boundaries and the mechanisms and city–district interactions underlying these changes, and assess their impact on the local fiscal situation and local provision of public services. These are sensitive questions inquiring into opaque government operations. Seeking data was difficult; validating obtained data was even more so. Indeed, while a good number of informed sources, including well-connected local academics, told us in confidence that they were certain of the existence of ‘money siphoning’ at the city–district interface, either through their personal experience or observations, they often could not offer any independent evidence other than their own testimony. Nor did they, individually, have a clear and definitive view of the bigger picture. The scope and amount of siphoning in a locality was beyond the reach of any single respondent we talked to. One reason is that such practices took place in multiple government bureaus, and there was no incentive to collect and analyse information on these practices centrally, much less to share it with people outside the government. The picture we present here in this article was reconstructed through triangulation of anecdotal information from interviews with over 80 government officials at national, provincial, prefecture, district and township levels in different government sectors.

### Explaining local fiscal crisis

The expenditure–revenue gap argument consists of two parts: (1) counties were overloaded with expenditure responsibilities; and (2) they were stripped of funds due to excessive centralization of fiscal revenue. The expenditure part of the argument maintains that county and township governments bore the brunt of the fiscal burden of providing the bulk of local public services: school education, medical care, social security, law and order, physical infrastructure, culture as well as economic development.<sup>12</sup> Official statistics show that the sub-national share of total fiscal expenditure has kept rising since economic reform, increasing from 45% in 1981, to 60% in 1985, and to 72% in 1993 on the eve of the Tax Sharing Reform. The share then stabilized and declined slightly, before returning to an upward trend since 2000. By 2012, local budgetary expenditure stood at 85.1% of total expenditure, the highest point ever, against 69.7% in 1994 (Table 1). The extensive range of local functions went beyond the limited capacities, fiscal and administrative, of counties and

11. Both Galung and Noan are pseudonyms.

12. Kang Jia and Jingming Bai, ‘Overcoming county and township governments’ fiscal crisis and fiscal institutional innovation’; World Bank, ‘China: national development and sub-national finance’.

**Table 1.** Revenue–expenditure gap in sub-national governments

Year	Sub-national budgetary revenue (billion yuan)	Budgetary revenue: sub-national shares (%)	Sub-national budgetary expenditure (billion yuan)	Budgetary expenditure: sub-national shares (%)	The ‘gap’ (billion yuan)	The ‘gap’ (percentage points)
1981	86.5	73.5	51.3	45	+ 35.2	+ 28.5
1982	86.6	71.4	57.8	47	+ 28.8	+ 24.4
1983	87.7	64.2	65	46.1	+ 22.7	+ 18.1
1984	97.7	59.5	80.8	47.5	+ 16.9	+ 12.0
1985	123.5	61.6	120.9	60.3	+ 2.6	+ 1.3
1986	134.4	63.3	136.9	62.1	– 2.5	+ 1.2
1987	146.3	66.5	141.7	62.6	+ 4.6	+ 3.9
1988	158.3	67.1	164.6	66.1	– 6.3	+ 1.0
1989	184.2	69.1	193.5	68.5	– 9.3	+ 0.6
1990	194.5	66.2	207.9	67.4	– 13.4	– 1.2
1991	221.1	70.2	229.6	67.8	– 8.5	+ 2.4
1992	250.4	71.9	257.2	68.7	– 6.8	+ 3.2
1993	339.1	78	333.0	71.7	+ 6.1	+ 6.3
1994	231.2	44.3	403.8	69.7	– 172.6	– 25.4
1995	298.6	47.8	482.8	70.8	– 184.2	– 23.0
1996	374.7	50.6	578.6	72.9	– 203.9	– 22.3
1997	442.4	51.1	670.1	72.6	– 227.7	– 21.5
1998	498.4	50.5	767.3	71.1	– 268.9	– 20.6
1999	559.5	48.9	903.5	68.5	– 344	– 19.6
2000	640.6	47.8	1,036.7	65.3	– 396.1	– 17.5
2001	780.3	47.6	1,313.5	69.5	– 533.2	– 21.9
2002	851.5	45	1,528.1	69.3	– 676.6	– 24.3
2003	985	45.4	1,723	69.9	– 738	– 24.5
2004	1,189.3	45.1	2,059.3	72.3	– 870	– 27.2
2005	1,510.1	47.7	2,515.4	74.1	– 1,005.3	– 26.4
2006	1,830.4	47.2	3,043.1	75.3	– 1,212.7	– 28.1
2007	2,357.3	45.9	3,833.9	77	– 1,476.6	– 31.1
2008	2,865	46.7	4,924.9	78.7	– 2,059.9	– 32.0
2009	3,260.3	47.6	6,104.4	80	– 2,844.1	– 32.4
2010	4,061.3	48.9	7,388.4	82.2	– 3,327.1	– 33.3
2011	5,254.7	50.6	9,273.4	84.9	– 4,018.7	– 34.3
2012	6,107.8	52.1	10,718.8	85.1	– 4,611	– 34.4

Sources: Finance Press of China, ed., *Finance Yearbook of China: 2011* (Beijing: Finance Press of China, 2011), pp. 459–462; ‘2011 Final Budgetary Statement and 2012 Final Budgetary Statement’, available at: <http://yss.mof.gov.cn/2011qgczjs/index.html> and <http://yss.mof.gov.cn/2012qhcjs/index.html> (accessed 17 January 2014).

townships, resulting in the proliferation of ‘unfunded mandates’ and under-provision of necessary services.<sup>13</sup>

The revenue strand of the argument stresses the limited means local governments had at their disposal. The gist of the complaint is: centralization of tax revenues in

13. Vivienne Shue and Christine Wong, eds, *Paying for Progress in China: Public Finance, Human Welfare and Changing Patterns of Inequality* (London and New York: Routledge, 2007).



the 1994 Tax Sharing Reform ‘robbed’ the local governments of the resources and authority necessary to perform their duties, as the more lucrative taxes became either central taxes or shared taxes, and local governments were left with taxes which were low-revenue-bearing and costly to collect.<sup>14</sup> Local governments’ share of total fiscal revenue dropped sharply from 78% in 1993 to 44% in 1994. In 2012, the sub-national share of fiscal revenue stood at 52.1% (Table 1). The difference between the local shares in total budgetary expenditure *vis-à-vis* those in revenue constitutes the ‘gap’, a minus sign indicating a deficit situation with more expenditures than revenues. As Table 1 indicates, the gap in the 1980s until 1993 was mostly in the positive, suggesting a surplus of revenue over expenditure, though the surplus was fairly small for most years after 1984. In 1993, on the eve of the Tax Sharing Reform, local budgetary revenue was comfortably in excess of local budgetary expenditure in terms of either absolute value or share percentage. In 1994, due to the Tax Sharing Reform, the small surplus turned into a large deficit of 172 billion yuan and 25 percentage points, and the deficit has kept growing ever since. In 2012, the deficit-gap stood at 34 percentage points and 4,611 billion yuan. Figure 1 depicts this trend. The R (blue) line denoting local share in total budgetary revenue is well below the E (red) line denoting local share in total budgetary expenditure, and the gap is widening as the local spending share is rising and local revenue share stagnates.

The ‘revenue–expenditure gap’ argument summarized above misses out on two concurrent developments, namely the continuous growth in the inflow of central fiscal subsidies since 1994 to local government coffers, and the role of non-tax fiscal income, which constitutes a major portion of total disposable revenue at the county–township levels. Given the importance of these two sectors to local finance, as we shall see below, it is misleading to focus only on tax revenue in explaining fiscal difficulties faced by counties and townships.

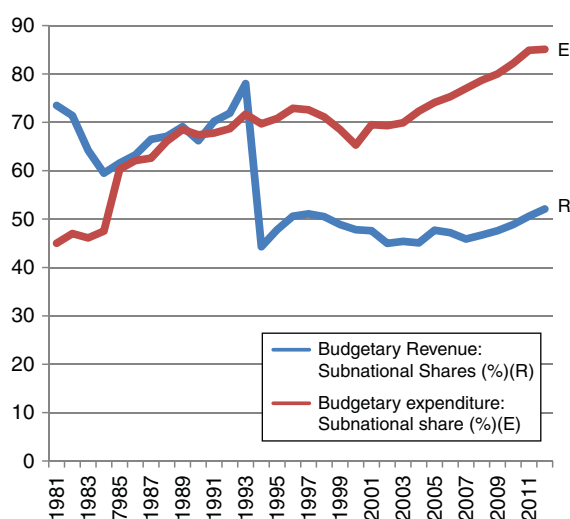
### *Central subsidies*

Apart from apportionment of tax revenue, there is a parallel flow of fiscal monies across government levels through local remittances and central subsidies. Local remittances refer to the remittances from sub-national government tiers to the central coffer in accordance with the fiscal contracts under the pre-1994 intergovernmental fiscal system, when the local governments collected almost all taxes and transferred part of the revenue as remittances to the central government.<sup>15</sup> At the time of the 1994 Fiscal Reform, the original remittances from local governments and central fiscal subsidies in accordance with the pre-reform system were ‘preserved’, by and large, at their pre-existing value, and continued to appear as separate categories in statistical tables on central and local government fiscal flows. Meanwhile, as shown in Table 2, the value of central fiscal subsidies has had

14. Christine Wong and Richard Bird, ‘China’s fiscal system: a work in progress’, *International Tax Program Papers* 0515, (2005); Dabla-Norris, ‘Issues in intergovernmental fiscal relations in China’; World Bank, ‘China: national development and sub-national finance’.

15. The exception was tariffs, which were collected by the National Customs.





**Figure 1.** Sub-national shares in budgetary revenue and expenditure.

Source: Based on Table 1.

a phenomenal and continuous growth since 1994. The figures of ‘Net central fiscal subsidies’ show the net inflows of central subsidies after deduction of local remittances. In 1994, the year when fiscal tax revenues were centralized, net central subsidies increased by 3,407%, and thereafter have continued to grow by, on average, nearly 20% annually between 1995 and 2012 (Table 2). By 2012, net subsidies to sub-national governments reached 4,536 billion yuan, almost 25 times that of the value in absolute terms in 1994, and equivalent to 42% of total local fiscal expenditure of the year (Figure 2).

Table 3 and Figure 3 compare the net central fiscal subsidies to the ‘gap’ between local revenue and expenditure: the two more or less cancel one another out. In other words, whilst local fiscal deficit (the local revenue–expenditure ‘gap’) was expanding as more tax revenues were centralized and local governments assigned more expenditure responsibilities, the local coffers were also compensated with a largely equivalent value of fiscal subsidies. The symmetrical shape of the lines A and B in Figure 3 vividly depicts this message. Indeed, to the extent that the two lines are different, a larger sum of subsidies has been injected to local budgets during more years than the value of the local revenue–expenditure gap.<sup>16</sup> In 2012, the subsidy reached an all-time high of 4,536 billion yuan. The availability of central subsidies of a scale similar to the loss in local tax revenues throws questions on the earlier premise of local fiscal difficulty, or at least the nature of it. Clearly the centralization of tax revenues and the resultant ‘revenue–expenditure gap’, in itself, cannot be blamed for causing the subsequent difficulties in local fiscal governance as widely documented. An explanation needs to be found elsewhere.

16. Central subsidies played a key role in local fiscal balance. See Andrew Wedeman, ‘Agency and fiscal dependence in central–provincial relations in China’, *Journal of Contemporary China* 8(20), (1999), pp. 103–122.

**Table 2.** Central fiscal subsidy (billion yuan)

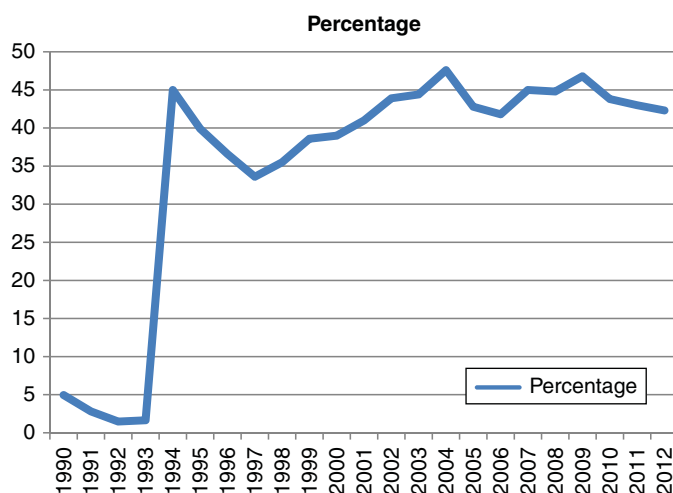
Year	Central fiscal subsidy	Local fiscal remittance*	Net central fiscal subsidy	Net central fiscal subsidy, annual growth rate (%)	Net central fiscal subsidy as a proportion of local expenditure (%)
1990	58.5	48.2	10.3	–	4.95
1991	55.5	49	6.5	– 36.9	2.8
1992	59.7	55.9	3.8	– 41.5	1.48
1993	54.5	60	– 5.5	– 114.5	1.65
1994	238.9	57	181.9	3,407	45
1995	253.4	61	192.4	5.8	39.9
1996	272.3	60.4	211.9	10	36.6
1997	285.7	60.4	225.3	6	33.6
1998	332.2	59.7	272.5	21	35.5
1999	408.7	59.8	348.9	28	38.6
2000	466.5	59.9	406.6	16.5	39
2001	600.2	59.1	541.1	33	41
2002	735.2	63.8	671.4	24	43.9
2003	826.1	61.9	764.2	13.8	44.4
2004	1,040.8	60.7	980.1	28	47.6
2005	1,148.4	71.2	1,077.2	10	42.8
2006	1,350.2	78.7	1,271.5	18	41.8
2007	1,813.8	86.3	1,727.5	35.9	45
2008	2,299.1	94.6	2,204.5	27.6	44.8
2009	2,954.6	98.2	2,856.4	29.6	46.8
2010	3,339.1	105	3,234.1	13	43.8
2011	4,110.6	118.5	3,992.1	23	43
2012	4,657.2	121	4,536.2	13.6	42.3
Average annual growth rate (1995–2012)				19.8	–

Sources: Finance Press of China, ed., *Finance Yearbook of China: 2011* (Beijing: Finance Press of China, 2011), pp. 459–462; ‘2012 central and local budget report’, available at: <http://yss.mof.gov.cn/2012qhczjs/index.html> (accessed 17 January 2014).

### Non-tax revenues

The ‘gap’ argument dwells on the relationship between local expenditure responsibilities and local fiscal revenue. Too much revenue has been centralized relative to spending responsibilities. The analysis is also confined to budgetary tax revenue only—calculation of central–local revenue shares in the literature has relied primarily on national fiscal statistics, that is data on budgetary revenue and expenditure, notwithstanding the large presence of non/extra-budgetary resources in local finances in China.<sup>17</sup> Overall, extra- and off-budgetary revenues are estimated to account for 19–

17. In China, local governments were allowed to collect fees based on regulations promulgated by central and provincial governments, most of which were managed outside of the budget, and most went to local coffers historically. From the late 1990s the central government sought to rationalize the management of these funds by way of incorporating them, gradually, into the budget. Officially this process was completed in 2012, since when all formerly extra-budgetary funds were part of the budget, to give improved oversight of these monies. For details, please see: R. S. Eckaus, ‘Some consequences of fiscal reliance on extrabudgetary revenues in China’, *China Economic Review* 14, (2003), pp. 72–88; Gary H. Jefferson, ‘China’s economic future: a discussion paper’, *Journal of Asian Economics* 8, (1997), pp. 581–596; Jun Ma and John Norregaard, ‘China’s fiscal decentralization’, (1998), available at: <http://www.imf.org/external/pubs/ft/seminar/2000/idn/china.pdf> (accessed 10 June 2013); Ministry of



**Figure 2.** Net central subsidies as a proportion of local budgetary expenditure.

Source: Based on Table 2.

27% of GDP around the turn of the century, against a 12% share of budgetary revenue.<sup>18</sup> These suggest that the revenue argument suffers from considerable distortion by confining to *tax* revenue only in its discussion of central–local revenues. County and township governments might not have been as cash-strapped as depicted in the mainstream fiscal management literature if the availability of non-tax revenues, and central fiscal subsidies as noted above, was taken into account. Rather, as our case of Noan District suggests, the difficulties for local governance, and in particular local fiscal difficulties, may be attributable to the acute tension and uncertainties arising from a reliance on these resources (non-tax resources and central fiscal subsidies), as well as practical difficulties in a system lacking in transparency and subject to multiple control points from the upper levels.

### The balance sheet, Noan District

There are six county-level administrative units under the jurisdiction of Galung City, including Noan, the only urban district, and five rural counties.<sup>19</sup> As the sole urban district, Noan houses the administrative seat of Galung City Government, but it is still

Footnote 17 continued

Finance, ‘Notice on bringing extrabudgetary fund into budgetary management’ [‘Guanyu jiang an yusuanwai zijin guanli de shouru nanru yusuan guanli de tongzhi’], (1 June 2010), available at: [http://www.mof.gov.cn/zhengwuxinxi/caizhengwengao/2010nianwengao/wgd5q/201007/t20100723\\_329410.html](http://www.mof.gov.cn/zhengwuxinxi/caizhengwengao/2010nianwengao/wgd5q/201007/t20100723_329410.html) (accessed 10 June 2014).

18. The estimates can vary considerably. For example, the Ministry of Finance once estimated the size of extra-budgetary funds at about 8–10% of GDP while officials of the State Administration of Taxation opted for at least 15%. For more information please see: Christine Wong and Guijuan Wang, ‘Tax for fee: Reform of extra-budgetary revenue and intergovernmental fiscal relations’ [‘Fei tai shui zhongguo yusuanwai zijin he zhengfujian caizheng guanxi de gaige’], *Comparative Economic & Social Systems* [Jingji shehui tizhi bijiao] 6, (2000), pp. 14–21.

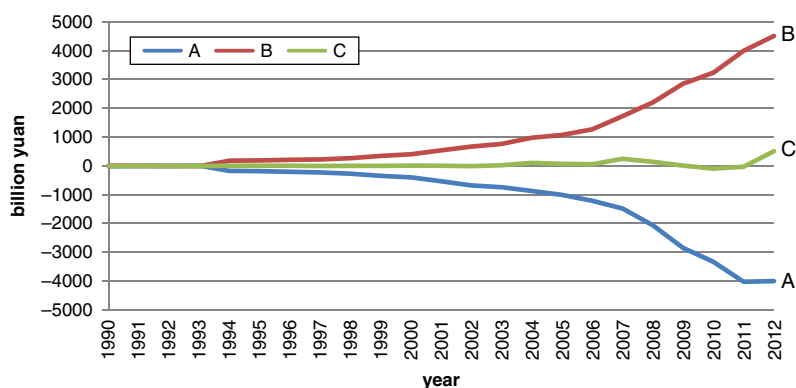
19. District governments have an administrative rank equivalent to county governments. Noan County became Noan District in 1999 when Galung City was established from the former prefecture.

**Table 3.** The net gap (billion yuan)

Year	(A) The 'gap' between local revenue and expenditure	(B) Net central fiscal subsidy	(C) = (A) + (B) Net gap
1990	- 13.4	10.3	- 3.1
1991	- 8.5	6.5	- 2
1992	- 6.8	3.8	- 3
1993	+ 6.1	- 5.5	0.6
1994	- 172.6	181.9	9.3
1995	- 184.2	192.4	8.2
1996	- 203.9	211.9	8
1997	- 227.7	225.3	- 2.4
1998	- 268.9	272.5	3.6
1999	- 344	348.9	4.9
2000	- 396.1	406.6	10.5
2001	- 533.2	541.1	7.9
2002	- 676.6	671.4	- 5.2
2003	- 738	764.2	26.2
2004	- 870	980.1	110.1
2005	- 1,005.3	1,077.2	71.9
2006	- 1,212.7	1,271.5	58.8
2007	- 1,476.6	1,727.5	250.9
2008	- 2,059.9	2,204.5	144.6
2009	- 2,844.1	2,856.4	12.3
2010	- 3,327.1	3,234.1	- 93
2011	- 4,018.7	3,992.1	- 26.6
2012	- 4,611	4,536.2	- 74.8

Source: Compiled from [Tables 1](#) and [2](#).

largely agricultural, with half of its 1,500 square kilometre hilly terrain covered by forest vegetation. Outside a small central urban area, which also houses a small manufacturing sector, most of its 500,000 inhabitants depend on agriculture for a living. Its economic development level is of the 'middle-level' amongst all counties

**Figure 3.** The net gap

Source: Based on [Table 3](#).

in the province and its fiscal situation shares many characteristics of cash-strapped counties in China.<sup>20</sup>

In 2001, in a move to centralize further tax revenues, the central government raised its sharing ratios in value added tax, corporate income tax and individual income tax.<sup>21</sup> The impact was immediate: Noan's local tax revenue dropped from 73 million yuan in 2001 to 46 million yuan in 2002, and the percentage of tax revenue in local budgetary revenue fell to 65% in 2002 from 80% in 2001 (Table 4).

Fiscal subsidies from the central and provincial levels had a large presence in Noan's budget. Total fiscal revenue increased three-fold in Noan during 2002–2008; 85% of the new revenue was due to growth in upper-level subsidies, the rest to tax and non-tax revenues (Table 5). There have been varied growth trends amongst the different revenue categories. Budgetary revenue had an average annual growth rate of 29%, which is high but was significantly slower than the average growth rate (39%) of transferred grants from upper-level governments (Table 4). On the other hand, extra-budgetary revenues, as recorded in local accounts, registered an absolute decline during 2002–2008 by 7 million yuan, contributing to –1% of the growth in total fiscal revenue during the period (Table 5). As of 2008, subsidies through transferred grants accounted for 76% of Noan's total fiscal revenue, against 33% in 2001 (Table 4).

A central component of the revenue–expenditure argument is that local fiscal difficulties are caused by expropriation of locally-derived revenues by central coffers. Information from Noan suggests that this is only partially true. Table 6 shows that central government has centralized between 39% and 45% of tax revenues from Noan, against 12–14% by the provincial government and 7–9% by the prefectural. Whilst this appears to confirm the revenue–expenditure gap thesis, which blames tax revenue centralization by the central government for county fiscal difficulties, Table 7 suggests that the prefectural government also played a large role. By extending the picture beyond taxes to non-tax revenues as well, Table 7 shows that the prefectural government was the superordinate tier receiving the most revenues generated from Noan District, and its share was only slightly less than Noan's own retained share. Galung City Government had a 31% share of all revenues from Noan during 2002–2008, against the central's 26%, the provincial's 8% and Noan's 35%. In other words, while the central government has apportioned the largest slice of tax revenue from Noan (Table 6), the effect of the centralized tax revenues have been superseded by the non-tax revenues centralized by the prefectural level (Table 7). The question is:

20. The evaluation system on county economic development (including district and county-level city), which the provincial government of Hubei Province devised to assess county officials, includes these indices, amongst others: GDP, budgetary revenue, per capita GDP, per capita income, tax revenue growth rate, investment and urbanization. Eighty county level units fell into three categories by these indices: good (20 counties), middle level (40 counties) and poor (20 counties). Noan District was in the 'middle level' group. For details, please see: General Office of Hubei Provincial Party Committee and General Office of Hubei Province Government, 'Economic performance evaluation mechanism of county-level government in Hubei Province' ['Hubei sheng xianyu jingji fazhan zonghe pingjia kaohe banfa'], (31 August 2009), available at: [http://guoqing.china.com.cn/gbbg/2012-04/26/content\\_25244624.htm](http://guoqing.china.com.cn/gbbg/2012-04/26/content_25244624.htm) (accessed 11 June 2013).

21. The State Council, 'Notice on reforming the income tax sharing ratio' ['Guanyu yinfa suodeshui shouru fenxiang gaige fangan de tongzhi'], (2001), available at: [http://yss.mof.gov.cn/zhuantilanmu/zhongguocaizhengtizhi/cztzjw/200806/t20080630\\_55299.html](http://yss.mof.gov.cn/zhuantilanmu/zhongguocaizhengtizhi/cztzjw/200806/t20080630_55299.html) (accessed 10 June 2014).

**Table 4.** Revenue components of Noan District Government (million yuan)

Year	Total fiscal revenue A = (B + G)	Total budgetary revenue B = (C + F)	Own-level budgetary revenue C = (D + E)	Tax (D) D/C (%)	Non- tax (E)	Subsidies (F) F/A (%)	Extra- budgetary (G)
2001	230.43	167.82	91.13	73.14 (80%)	17.99	76.69 (33%)	62.61
2002	247.34	198.61	70.77	45.98 (65%)	24.79	120.11 (49%)	48.73
2003	253.94	210.95	75.49	54.35 (72%)	21.14	134.90 (53%)	42.99
2004	325.78	280.30	90.66	63.20 (70%)	27.46	181.35 (56%)	45.48
2005	375.71	336.80	102.59	57.99 (57%)	44.60	224.74 (60%)	38.91
2006	483.85	445.25	116.19	65.80 (57%)	50.39	316.64 (65%)	38.6
2007	652.91	610.53	145.86	86.99 (60%)	58.87	454.11 (70%)	42.38
2008	975.48	933.85	187.91	118.82 (63%)	69.09	742.81 (76%)	41.63
Average annual growth rate	25%	29%	12%	11%	23%	39%	— 5%

Sources: Annual budgetary reports (2002–2009) and annual extra-budgetary fund reports (2002–2009) of Noan District.

how did things work out this way? How did Galung City manage to out-do the central government in centralizing fiscal monies from below?

### The intermediary's role

Studies of intergovernmental relations have highlighted the role of the intermediary governments in grassroots-level governance.<sup>22</sup> Given the developing state of the rule of law in Chinese public administration, bureaucratic supervision by superordinate tiers has historically played a pivotal role in the implementation of state directives. The prefecture-city government, being the next level up from the county government, thus has a large presence in the conduct of business at county and township levels. In particular, with respect to the management of local finances which is the subject of interest here, the prefectural tier has had three avenues to exert its impact.

First, the prefectural government set the sharing ratios of tax revenues between itself and the county government. Under the Tax Sharing System established in 1994, the central government decides how tax revenue raised from various taxes is apportioned between central and sub-national coffers on the whole, but leaves open

22. John P. Burns, 'China's nomenklatura system', *Problems of Communism* XXVI, (1987), pp. 36–51; Hon S. Chan, 'Cadre personnel management in China: the nomenklatura system, 1990–1998', *The China Quarterly* 179, (2004), pp. 703–734; Jae Ho Chung and Tao-chiu Lam, 'China's "city system" in flux: explaining post-Mao administrative changes', *The China Quarterly* 180, (2004), pp. 945–964.

**Table 5.** Noan revenue increase by category, 2002–2008 (million yuan)

Total revenue increase				
Budgetary revenue increase			Extra-budgetary revenue increase	
Own-level budgetary revenue increase		Fiscal subsidies increase		
Tax revenue increase	Non-tax revenue increase			
72.84 10%	44.3 6%	622.7 85%	– 7.1 – 1%	
			728.14 100%	

Source: Calculated from Table 4.

**Table 6.** Tax revenue share in Noan District

Year	The Central		The Provincial		Galung City		Noan District	
	Million yuan	%	Million yuan	%	Million yuan	%	Million yuan	%
2002	46.90	39	17.20	14	9.87	8	45.98	38
2003	54.40	40	16.75	12	10.08	7	54.35	40
2004	64.84	40	20.19	13	12.34	8	63.2	39
2005	78.59	45	24.08	14	14.99	9	57.99	33
2006	94.83	45	29.73	14	18.49	9	65.8	32
2007	109.83	44	34.38	14	20.86	8	86.99	35
2008	142.22	43	45.12	14	27.26	8	118.8	36

Source: Statistical Yearbook of Noan District (2003–2009).

**Table 7.** Noan local revenues\* shared by different levels of government (million yuan)

Year	Central		Provincial		Galung City		Noan District	
	Revenue	%	Revenue	%	Revenue	%	Revenue	%
2002	46.9	29	17.2	11	28.87	18	70.77	43
2003	54.4	29	16.75	9	38.77	21	75.49	41
2004	64.84	25	20.19	8	67.64	28	90.66	37
2005	78.59	23	24.08	9	70.93	26	102.59	37
2006	94.83	30	29.73	10	68.79	22	116.19	38
2007	109.83	20	34.38	6	252.36	47	145.86	27
2008	142.22	25	45.12	8	191.76	34	187.91	33
2002–2008 average	84.52	26	26.78	8	102.73	31	112.78	35

Note: \*Noan local revenues refer to total (tax and non-tax) fiscal revenues generated in Noan District.

Source: Table 6; information from fieldwork.



the distribution of the sub-national portion amongst the various sub-national tiers to the provincial government. In practice the province prescribed the sharing ratios between itself and the next level down only, namely the prefecture-cities. The cities, in turn, determined the sharing ratios between cities and counties. In other words, the result of centralization of tax revenue from county coffers, seen from the county's end, has been the cumulative effect of decisions made at the prefecture-city, provincial and central levels.

Prefecture-city governments may also access non-tax revenues of the counties, and upper-level transfers and subsidies that are earmarked for the counties. Non-tax county revenues are usually administrative fees and penalty charges, such as education surcharges, parking offence penalties, highway tolls and urban construction fees. Prefectural governments may centralize such county incomes by centralizing the functions.<sup>23</sup> In more extreme cases, only the revenues are centralized, whilst the corresponding responsibilities to deliver services (and thus spending) remain with counties. The prefecture-city government may also 'siphon' part of the monies from central or provincial fiscal subsidies as the subsidies are routed through its coffers before reaching counties and townships. In 2003, for example, prefecture-level governments in Hubei Province reportedly retained 0.33 billion yuan of upper-level subsidies which should have gone to county governments,<sup>24</sup> which is equivalent to 2.7% of total fiscal revenue (including tax and non-tax revenue and transferred grants) of all counties in Hubei in the year.<sup>25</sup> Manipulations of these sorts generated immense city-county tension,<sup>26</sup> and precipitated the introduction of the 'province managing counties' finances' reform in some provinces since the early 1990s.<sup>27</sup>

### *How did Noan District lose out to Galung City?*

Our data show that Galung City Government has amply utilized its positional authority as the superordinate authority of Noan and convenience afforded by its status

23. In China's fiscal management there is a general principle that the government function is directly associated with the personnel number (*bianzhi shu*) and corresponding budgetary revenue created from this function and expenditure to fulfil this function (including personnel salary and working expenditure) (*quanshui shizou, renshui shizou, feishui shizhuan*). When the function is transferred from one government to another one, the personnel number and budgetary expenditure and revenue will go with the function. For example, the state-owned enterprises all belong to one tier of government. Management responsibilities for an enterprise of one tier of government bureau align with responsibilities/privilege with the enterprise finances—profit/loss. With the change of the 'host' government, the management responsibilities and related enterprise finances will also be transferred to the new government.

24. Huaxin Wang, 'Implementing the policy of "province directly managing counties" and fostering social and economic development' ['Shixing shengguanxian (shi) guanli tizhi cujin xianyu jingji shehui xietiao fazhan'], *Review of Economic Research [Jingji yanjiu cankao]* 38, (2005), pp. 38–42.

25. Jinbao Gong and Tao Chen, 'Analysis of fiscal management mechanism in Hubei Province' ['Hubei sheng xianxiang caizheng guanli tizhi shizheng fenxiyu yanjiu'], (2009), available at: [http://www.ecz.gov.cn/structure/zthd/nljns/cjlt/zw\\_1055\\_1.htm](http://www.ecz.gov.cn/structure/zthd/nljns/cjlt/zw_1055_1.htm) (accessed 10 February 2013).

26. Shih-Shen Chien, 'Prefectures and prefecture-level cities: the political economy of administrative restructuring', in Jae Ho Chung and Tao-chiu Lam, eds, *China's Local Administration: Traditions and Changes in the Sub-national Hierarchy* (London and New York: Routledge, 2010); Keyu Zhou, 'Review of the administrative system of city-managing-counties'.

27. Zhejiang Province started the reform after 1992. Since the start of the twenty-first century, many provinces have begun to launch this reform. Nationally, the central government expected all provinces to launch the reform before the end of 2012. However, the Ministry of Finance changed the tone and allowed each province to consider their own situation to promote the province managing counties' finance.

as an intermediary in the administrative hierarchy in accessing Noan's resources. This section describes three major means whereby Galung City Government appropriated revenues from Noan District: undercutting the district revenue base; manipulating tax collection arrangements; and siphoning resources 'in transit'.

*Undercutting Noan's revenue base.* Despite substantial reforms to the tax and fiscal systems since the 1980s, in China a number of taxes, such as Enterprise Tax and business taxes, are still allocated in accordance with the 'subordination relations' (*lishu guanxi*) between the tax-paying unit and the administrative unit, a feature dating back to the central planning period.<sup>28</sup> The 'subordination relations' principle allows revenues to be legally transferred from one tax-collecting unit to another through adjusting the 'subordination relations'. During the early 1980s, it enabled the central government to implement its decentralization strategy quickly: a good number of centrally-subordinated enterprises were made provincial enterprises in one stroke of administrative order, in a move to 'enliven' the local governments as drivers to economic growth and reform.<sup>29</sup> However, as the upper-level governments were empowered to adjust the subordination relations of tax-paying units in its subordinate levels, this gives leeway to an upper-level government to engage in self-benefiting behaviour should it choose to. The direct application of the subordination-relations principle at the local levels for such a dubious objective has been in decline in more recent years as market reform deepens and the state sector of the economy, by the early 2000s, has been largely confined to big conglomerates at the central level. The principle remains influential in administrative practices, however, and its application has been extended to the allocation of non-tax revenues, which have a large presence in county budgets. In the case of Galung–Noan, the city government centralized all revenues from administrative fees and state assets of several state-sector units and bureaus in Noan when these units were made city-subordinated units during an administrative reorganization in 2001. The units include, amongst others, the County Planning Bureau, the County Transport Police Unit, the County Land Bureau, the County Administration of Radio, Film and Television, Office of Public Transportation Management, Office of Civil Defence and Water Supply Plant. Counting monies received from administrative fees alone, revenue lost to Galung in 2001 through administrative reorganization amounted to some 11 million yuan.<sup>30</sup> As Table 8 indicates, the centralization of land management authority and land revenues cost Noan dearly financially, as land-based revenues became increasingly important to local government finance.<sup>31</sup>

28. For example, if the enterprise is 'of the prefecture-city', this enterprise's tax will be collected by the prefecture-city tax bureau. The county government cannot share the tax revenue of this enterprise even though geographically the enterprise situates at the county.

29. Barry Naughton, 'The decline of central control over investment in post-Mao China', in David M. Lampton, ed., *Policy Implementation in Post-Mao China* (Berkeley and Los Angeles, CA: University of California Press, 1987); Linda Chelan Li, *Centre and Provinces: China, 1978–93. Power as Non-zero-sum* (Oxford: Clarendon Press, 1998).

30. Noan District Government, 'Issues and suggestions in relation to the operation of city–district relations' ['Shiqu tizhi yunxing zhong de youguan wenti he jianyi'], internal document, (2005); interview in Noan District, 2008.

31. Noan officials assessed the loss during 2002–2005 to be 15–25 million yuan a year, but it then skyrocketed to 200 million by 2007, as the local economy picked up (interview, 2008).

**Table 8.** Net land revenue, Galung City Government (million yuan)

Year	Net land grant fee*
2002	< 4
2003	< 12
2004	< 40
2005	> 40
2006	28.8
2007	200
2008	133

*Note:* \*Net land grant fees of Galung City urban proper and its related ratios from 2002 to 2006 are estimated based on the calculation that net land revenue accounted for 40% of gross land revenue.

*Source:* Information from fieldwork.

Reassignment of subordination relations and administrative reorganization will not cause any problem if resources and responsibilities match. Where resources are centralized but not corresponding responsibilities, however, the lower-level government is often left to shoulder the blame for shortfall in public services, and a fiscal- and governance-deficit is created—as *new* resources need to be found and supplied, not always effectively or with legitimate means, to bridge the performance gap. The case of the former county-level Administration of Radio, Film and Television is a good example in this regard: how administrative reorganization creates *new* local fiscal deficits.

Prior to its centralization to the city level in 2005, Noan Administration of Radio, Film and Television had a fairly steady annual fee revenue of 2 million yuan, which was collected mostly from urban residents for the cable television service. As noted previously, Noan had a largely rural social landscape, and cable television fee revenue from the townships was relatively small. The Noan Government had traditionally deployed part of the revenues collected from urban residents to cover the cost of services in the townships. This delicate equalization arrangement was put to a halt when the bureau was centralized, as Galung City focused its cable television spending in the urban areas only. Township residents were forced to resort to illegal devices to access television programmes,<sup>32</sup> causing additional fiscal pressure for Noan to make up the service shortfall.<sup>33</sup> Similar developments—a cultivated mismatch of responsibilities and resources—were also found in other policy areas. In another example, Galung City had centralized from the district the authority to issue shipping and vehicle licences and to collect the corresponding fees, but it did not centralize as well the inspection of ships and vehicles, which was constitutive of the licence approval processes. Noan District Government was expected to find other resources to pay for the inspection work.<sup>34</sup> Figure 4 gives further examples.

32. Weiping Qu, 'Difficulties in regulating private satellite television sets' ['Daguogai weixing dianshi zhili nan'], *Journal of Broadcasting Equipment and Technology* [Guangdian shebei yu jishu] 1, (2009); Wusan Sun, 'Top-down policies versus grassroots resistance: the management of illegal satellite dishes in Chinese villages', in Wangning Sun and Jenny Chio, eds, *Mapping Media in China: Region, Province, Locality* (New York: Routledge, 2012).

33. Noan District Government, 'Issues and suggestions in relation to the operation of city–district relations'.

34. *Ibid.*

Items
<b>Shortage of police</b> Traffic Police, which constituted half of total police establishment in Noan District, were centralized to Galung City. This inhibited Noan's capacity to flexibly deploy resources to perform various police duties, and to deal with emergencies such as flood and drought relief.
<b>Detention facilities</b> Galung City Government did not have its own detention facilities. Detainees under investigation by the city police bureau, procuratorate and court were habitually sent to facilities in Noan, and the numbers accounted for nearly half of the total handled in Noan. This cost was a drain to Noan's resources as the city government did not provide any funds.
<b>Public transportation management</b> Galung City Government centralized from Noan the Office of Public Transportation Management and related fees, including 400,000 yuan annual fee contributed by the district bus company annually. Performance was poor however. The planning of bus stops was bad and many illegal motorcycles and taxis emerged due to chaotic public transportation planning.

**Figure 4.** Where responsibilities and resources did not match—examples  
*Source:* Fieldwork in Galung and Noan.

*Manipulating tax collection arrangements.* While undercutting the district revenue base is, strictly speaking, within the narrowly construed legal confines and authority of the City Government, manipulations of the tax collection regime edge towards bending, if not breaking, the rules of the Tax Sharing System. A parallel national tax collection system was established along a local system at the time of the 1994 Tax Sharing Reform, with the intended objectives of enhancing tax collection efficiency to the central coffers and reducing the reliance on the local system.<sup>35</sup> Under the new tax collection system, the National Taxation Bureau, with its local field branches, is charged with the collection of central taxes and most shared taxes, while the Local Taxation Bureau at provincial, city and county levels collects the local taxes. The collected revenues will then be allocated to respective central and local coffers in accordance with the stipulated sharing ratios. The national and local taxation bureaus are supposed to work in coordination to enhance efficiency and reduce overlap to taxpayers. In practice, however, confusion and competition quickly surfaced during the early days of the new system and have persisted ever since.<sup>36</sup>

In theory the national and local tax bureaus should follow strictly the State Council regulations on work distribution. The principle of locality then defines the jurisdiction of each tier of national and local taxation bureaus. That is, the tax bureaus

35. Jae Ho Chung, 'Beijing confronting the provinces: the 1994 tax-sharing reform and its implications for central-provincial relations in China', *China Information* 9(2/3), (Winter 1995), pp. 1–23; Shuanglin Lin, 'The decline of China's budgetary revenue: reasons and consequences', *Contemporary Economic Policy* 18(4), (2000), pp. 477–490; The State Council, 'Decision on implementing tax sharing reform' ['Guanyu shixing fenshuizhi caizheng guanli tizhi de jue ding'], (15 December 1993), available at: [http://www.csj.sh.gov.cn/pub/xxgk/zcfg/swzsgl/200210/t20021010\\_284358.html](http://www.csj.sh.gov.cn/pub/xxgk/zcfg/swzsgl/200210/t20021010_284358.html) (accessed 10 June 2014); Le-yin Zhang, 'Chinese central-provincial fiscal relationships, budgetary decline, and the impact of the 1994 fiscal reforms: an evaluation', *The China Quarterly* 157, (1999), pp. 115–141.

36. The early conflicts led to the issuance of new guidelines by the State Council in 1996, two years after the new system was put in place, in order to adjust some of the early arrangements. Shanghai City also quickly abandoned its attempt to set up the dual national and local tax bureaus and has collected taxes with one unified bureau in practice since 1994. For details, please see: The State Council, 'Opinion on adjusting tax collecting scope between national tax bureau and local tax bureau' ['Guojia shuiwu zongju guanyu tiaozheng guojia shuiwu judi fangshui wuju shuishou zhengguan fanwei de yijian'], (24 January 1996), available at: [http://www.csj.sh.gov.cn/pub/xxgk/zcfg/swzsgl/200402/t20040220\\_284192.html](http://www.csj.sh.gov.cn/pub/xxgk/zcfg/swzsgl/200402/t20040220_284192.html) (accessed 10 June 2014).

**Table 9.** Centralized revenues by Galung City Government from Noan by categories (million yuan)

Year	Total figure	Tax revenues	Non-tax revenues*	Monies in transit**
2002	40.87	9.87	19	12
2003	51.77	10.08	27.69	14
2004	83.64	12.34	55.3	16
2005	132.93	14.99	55.94	62
2006	83.79	18.49	50.3	15
2007	257.36	20.86	231.5	5#
2008	196.26	27.26	164	5

Notes: \*Non-tax revenues refer to land revenue, environmental protection fee, etc.

#Funds 'centralized' (siphoned) from 'monies in transit' were much lower after 2007, when Galung City Government took full charge of infrastructure construction of the entire urban area, so that the amount of project funding earmarked to Noan became considerably less.

\*\*Monies in transit may include tax and non-tax revenues refunded to City/Noan and upper-level transfer payments to City/Noan. For examples, see Figure 5.

Sources: Table 6; information from fieldwork.

of the lowest-level locality will collect taxes from taxpayers based therein, and then share the collected revenues with upper tiers as and when required by the Tax Sharing System. The actual practice has turned out to be conspicuously different, however. City tax bureaus have often competed with county bureaus to secure tax revenues, at the point of tax collection, from the same pool of taxpayers. Tax bureaus proliferated over a small geographical area, confusing taxpayers. Instead of sharing revenues in accordance with the Tax Sharing System requirements, bureaus at different tiers jealously guarded their collected revenues as their 'own resources'.<sup>37</sup>

In the current case, Noan District officials complained that Galung City Government had violated national and provincial regulations on tax collection by placing lucrative tax-paying units located in Noan District under Galung City purview and refusing to share with Noan the collected revenues.<sup>38</sup> When a new enterprise was established, the city and district tax bureaus both exerted a claim over the tax revenue receivable from the enterprise. The scramble for tax sources was found not only in the cases of large, relatively lucrative taxpayers, but also in those of individual businesses and corner grocery stores. Not surprisingly the district was the more vulnerable party in the game. One estimate by Noan officials put the value of tax monies lost to the Galung City in this way during 2001–2006 at 10 million yuan.<sup>39</sup>

*Siphoning monies 'in transit'.* Besides tax and non-tax revenues, transferred grants contributed substantially to the funds that the intermediary pocketed at the expense of its subordinate level. Table 9 depicts the overall picture showing the three broad

37. These problems have led to doubts about the viability of the dual hierarchies and discussions over merging local tax bureaus into the national system. For details, please see: Xiaoliang Song, 'Experts' comments on the long process ahead in merging the national and local tax bureaus' ['Zhuanjia cheng guoshui dishui hebing yao zou henchang de lu hebing liyu tixiao'], *China Economic Daily*, (25 February 2013), available at: <http://finance.sina.com.cn/china/20130225/093114634914.shtml> (accessed 15 May 2013).

38. Interview, 2008.

39. Interview, 2008.

Item	Circumstance	Value
<b><i>Tax and fee revenues</i></b>		
1. Tax revenue collected from the Beijing–Zhuhai Expressway	According to the tax-sharing rule, the Noan District can share the tax revenue arising from the use of the part of Beijing–Zhuhai Expressway that falls within Noan’s territory (urban maintenance and construction tax, business tax). The taxes were first centralized at the provincial coffers and then routed through Galung to Noan. However, Galung City Government had habitually retained these revenues in transit.	A total of 5.93 million yuan during 2003–2005 alone (respectively, 1.69 million yuan in 2003, 2.3 million in 2004 yuan, 1.94 million yuan in 2005)
2. Tax increment	‘Tax increment’ refers to the additional amount of tax revenue beyond the original baseline set in a prior fiscal arrangement. When an enterprise or administrative unit is transferred to another level of government, established practice would require the new ‘host’ to share the tax increment collected from the unit with the previous host. The Galung City Government should hence share tax increments with the district arising from the activities of those administrative units and enterprises it centralized from Noan. However, Galung did not do it.	Total 6.31 million yuan during 2004–2006 alone (respectively, 1.44 million yuan in 2004, 2.74 million yuan in 2005, 2.13 million yuan in 2006)
3. Road maintenance fee sharing	Provincial regulation stipulated a sharing ratio between provincial/city/county levels, with 20% going to the county/district. The City Bureau established its own agency and then retained the 20% share of revenue which should go to the District.	N/A
<b><i>Earmarked grants</i></b>		
1. Various earmarked grants from central–provincial governments	These grants should be transferred to Noan District, however, they were retained by the City Government. They include different categories of transferred grants from different ministries or bureaus for different purposes.	The Noan District Government claimed that 44 million yuan in 2005 was retained by the city government, while Galun City Government admitted, internally only, 40 million yuan in total.
2. Various city-tier policy grants, such as rural tax reform grant, family planning grant, militia training grant, etc.	City governments were generally required to provide funds to supplement transferred grants from provincial and central levels to the counties. However, in practice, Galung City Government did not provide those matching funds for Noan.	1 million annually for rural tax reform earmarked grant alone.
<b><i>Construction projects</i></b>		
Inaction and discrimination	Galung city did not support Noan’s projects during national and provincial bidding exercise. (1) The city government did not submit Noan’s proposal when Galung also had come up with a similar one. (2) The city government blatantly withheld the project funds when Noan’s proposal won the bidding.	(Estimate) 10 million of project funds annually

**Figure 5.** Siphoning monies ‘in transit’: examples

Source: Fieldwork in Galung and Noan.

categories of revenues centralized by Galung City Government. As central and provincial remittances and subsidies earmarked for most counties need to route



through the city level, the Galung City Government stood in a privileged position to ‘benefit’ from the inflow of construction project funds, shared tax and fee revenues, and earmarked grants. Our interviews suggest that siphoning monies in transit had been a routine occurrence, whilst the scale of the practice was opaque given its illegitimate status. Figure 5 lists some circumstances wherein siphoning has taken place in the Galung–Noan case.

In an internal report by Galung City Government, for example, a cumulative value of some 40 million yuan of transferred grants which were earmarked for Noan’s infrastructure spending was said to have been kept in the city coffers as ‘loans’ to the City Government, who would return the loan when ‘sufficient funds’ were available.<sup>40</sup> During an interview, however, city finance sources strongly denied such a loan, claiming that Galung City would not ‘bother’ to secure such a small sum of monies from Noan District.<sup>41</sup> Meanwhile, an informed Noan official claimed that in 2005 alone, Galung City Government retained 44 million yuan of transferred grants that were originally aimed for Noan during year-end financial settlement, which amounted to a quarter of the value of the total transferred grants which Noan District received that year.<sup>42</sup> Such massive siphoning of resources, Noan officials complained, had hampered the normal functioning of the district government, including the steady payment of staff salaries and provision of public services in good time.

Sometimes the siphoning of resources occurred directly, and was thus more opaque, through the city’s intermediary role in the planning and approval of district projects. The central and provincial governments would call for the submission of project proposals from time to time. All proposals from Noan needed to be routed through the city level, whose recommendation had a substantial impact on the success of Noan’s proposals. Two different situations have come to our attention during discussions in the field. In one situation, Galung City Government would simply withhold Noan’s proposal if Galung was also submitting a similar proposal, in order to enhance the chances of the city proposal getting upper-level support. The other situation involves Galung City Government not transferring the funding in full to Noan when a Noan proposal won fiscal support from the upper levels, but keeping the monies in the city coffers instead.

## Conclusion

What actually underlined the fiscal difficulties in county-level governments, in view of the limitation of the traditional emphasis on the ‘revenue–expenditure gap’? Taking the substantial central subsidies and non-tax revenues available to counties into account, county governments were *not* cash-starved, but yet many still complained of dire fiscal difficulties. Why? What exactly was the complaint?

The case materials we have discussed in this article reveal the missing story: the difficulties that the immediate superordinate level created for the county level.

40. Reform Drafter Team of Galung City Government, ‘Report on reform plans of demarcating function between the city and district governments’ [‘Shiqu zhineng tiaozhen de fangan de baogao’], internal document, (2006).

41. Interview, 2008.

42. Interview, 2008.



The predatory inclination of the intermediary level has recently been highlighted in Wu and Wang's analysis of provincial-level data, which finds a negative relationship between transfer dependence and spending decentralization—the provincial level has likely centralized more resources from its subordinates than contributed additional provincial resources to them as more central transfers flowed in.<sup>43</sup> The detailed analysis of this article focusing on the city–county nexus mirrors the broad observations arising from the provincial-level data, while it also explains how such predation *actually* unfolds at the city level. Whilst the objective of the city is invariably to secure more resources from its subordinates, the damage thus caused to the county goes beyond the value of revenues lost but includes also the added uncertainties of what *other* losses might lay ahead, as well as frustrations arising from the proliferation of vicious gaming manipulations in the day-to-day conduct of government business and city–county interactions. One strategy which Galung City used to secure district resources was through asymmetrical adjustment of the jurisdiction boundary. Authorities were centralized to facilitate control over resources, but part of or even all the constituent 'tasks' of the authorities were left with the district which was expected to 'mend the fence'. The division of jurisdiction was usually highly ambiguous and unclear, however. On the one hand, an explicitly laid out boundary which was blatantly unjust would attract resistance from the district and expose the city politically to upper-level oversight. On the other hand, the city had little incentive to implement a fair distribution of responsibilities and resources. The preferred strategy was, thus, to leave things vague and ambivalent. In response, counties would employ all the options available to the 'weak'<sup>44</sup>—shirking, complaining, bargaining and cheating. These tactics might help to bring concessions at times when grievances were deep and emotions ran high, but the one-off gains not only failed to constrain the power of the superordinate but also created new difficulties: the upper levels were encouraged to return the same tactics to them. In the resultant cycles of vicious gaming lies the root to the perennial problems of ambiguous jurisdictions and agency control in Chinese public administration. In other words, local fiscal difficulties in China today are *not* about the shortage of monies *per se*. While there is a demand for *more* resources, a large part of the complaint over local fiscal difficulties originates not in the size of the budget, but in the government practices in relation to the handling and management of the budget, and in the operational mechanisms at the interface of different government tiers.

43. Alfred M. Wu and Wen Wang, 'Determinants of expenditure decentralization: evidence from China', *World Development* 46, (2013), pp. 176–184.

44. James Scott, *Weapons of the Weak: Everyday Forms of Peasant Resistance* (New Haven, CT: Yale University Press, 1987).