

Public Expenditure Assignment in China : Problems and Reform Proposals

This paper, like a medical certificate, is intended to discover the major problems in public expenditure assignment in China and analyze the symptoms by reference to the principles commonly accepted by scholars and bring forth reform proposals.

After brief introductory statement in Part I of current challenges for China's public expenditure, Part II will summarize the thorns in the bush of China's public expenditure in terms of inter-governmental fiscal relations. Later, Part III will try to illustrate the vicious consequences as a result of the aforementioned problems in public expenditure assignment and, finally, Part IV will put forward reformation proposals for fundamental roadmap to a sound and reasonable public expenditure assignment in China. In Part V, conclusive remarks will be given.

Part I. Brief Introductory Statement

In year 2006, total public spending in China is around RMB4,042,273 million, which accounts for 19% of the Gross Domestic Product ("GDP")¹ but this may be an underestimate, as extra-budgetary outlays, which are mainly used by sub-national governments to pay for social security and various other purposes are not accurately and officially recorded and sanctioned. According to academic estimate, the off-budget accounts of public expenditures may be as high as 3%-4% of the GDP. Notwithstanding, China's total public expending level is comparatively below that of many developed countries.

According to a survey done by OECD in 2004 ("OECD Report"), there are some institutional defects in China's public spending system:

Above all is the need for greater transparency and control. Besides the extra-budgetary outlays as previously mentioned, accrual of contingent liabilities and tax expenditures are other two major items of outlays that are not included in the governmental accounts. Contrary to the negative attitude of the central government, to promote local economic development, China's sub-national governments are prone to effectively act as guarantor of lending by banks to local enterprises, which results in significant amount of government interests payment, as sub-national governments assume the final liabilities for bad loans. Also, to attract investment, although legally speaking China's central government reserves the power to decide on tax

¹ If not otherwise indicated, statistical figures in this paper are cited by China Statistical Yearbook 2007 published by the National Bureau of Statistics of China.

exemption or tax holiday, sub-national governments, through loosening nuts on the enforcement of tax law, actually granted a variety of tax preferential treatments, which results in significant amount of tax expenditures.

Secondly is the need for re-orientation towards human development. According to the OECD Report, a large part of public spending funds investment, with total outlays amounting to 9% of GDP in 2002. This ratio is higher than that of nearly all OECD countries and most other large developing countries. In addition, a relatively large portion of spending, almost one-fifth of on-budget outlays, goes to public administration, most of which is spent by sub-national governments. In contrast, the OECD Report points out, only a relatively low portion of outlays are made on basic human welfare and development needs, such as education, health, science, and social security. Notwithstanding, the statistical figures in Table-1 below indicate a remarked reverse development trend after the OECD Report (grey-lighted part), which means this defect has been to certain extent redressed.

Table-1 Government Expenditure by Function

(100 million
yuan)

Year	Total	Economic	Social, Cultural	National	Administrative	Other
	Government	Construction	and Educational	Defence	Expenses	Expenditure
	Expenditure		Development			
1978	1122.09	718.98	146.96	167.84	52.90	35.41
1980	1228.83	715.46	199.01	193.84	75.53	44.99
1985	2004.25	1127.55	408.43	191.53	171.06	105.68
1990	3083.59	1368.01	737.61	290.31	414.56	273.10
1991	3386.62	1428.47	849.65	330.31	414.01	364.18
1992	3742.20	1612.81	970.12	377.86	463.41	318.00
1993	4642.30	1834.79	1178.27	425.80	634.26	569.18
1994	5792.62	2393.69	1501.53	550.71	847.68	499.01
1995	6823.72	2855.78	1756.72	636.72	996.54	577.96
1996	7937.55	3233.78	2080.56	720.06	1185.28	717.87
1997	9233.56	3647.33	2469.38	812.57	1358.85	945.43
1998	10798.18	4179.51	2930.78	934.70	1600.27	1152.92
1999	13187.67	5061.46	3638.74	1076.40	2020.60	1390.47
2000	15886.50	5748.36	4384.51	1207.54	2768.22	1777.87
2001	18902.58	6472.56	5213.23	1442.04	3512.49	2262.26
2002	22053.15	6673.70	5924.58	1707.78	4101.32	3645.77
2003	24649.95	6912.05	6469.37	1907.87	4691.26	4669.40
2004	28486.89	7933.25	7490.51	2200.01	5521.98	5341.14
2005	33930.28	9316.96	8953.36	2474.96	6512.34	6672.66
2006	40422.73	10734.63	10846.20	2979.38	7571.05	8291.47

Thirdly is the issue of getting the spending to where it is most needed. As illustrated by the OECD Report, China's sub-national governments carry out the bulk of public expenditures and bear the main responsibility for education, health, social welfare, and infrastructure. However, revenues are not as highly decentralized as expenditure responsibilities. Moreover, while responsible for carrying out most spending, sub-national governments have almost no control over local tax rates nor over what can be taxed. They are also subject to extensive central government direction of their spending and have increasingly been burdened by unfunded mandates, such as paying for restructuring of local state-owned enterprises and supporting their laid-off workers. This gap between expenditure responsibilities and revenues has brought forth severe financial difficulties to China's sub-national governments and encouraged the accumulation of substantial illegal government debt at sub-national levels and the resort to off-budget spending.

People should bear in mind all these institutional defects in discussion of public expenditure assignment in China. The third institutional defect, actually, has called for reforming relations among governmental levels. Also, the other two institutional defects are interrelated because, as a general principle, a sound and reasonable public spending mechanism should be the cornerstone where the public expenditure assignment stands.

Part II. Primary Characteristics of China's Public Expenditure

Assignment and Existing Problems

1. No clear assignment of functions among governmental levels

Although the *Constitutional Law* and *Local People's Congresses and Local Governments Organization Law* of China provide for, respectively, functions of the central government and sub-national governments, a closer observation may discover that relevant legal provisions are very ambiguous and there lacks clear-cut, meticulous and exercisable division of power. Excluding a few exceptional public goods, such as national defense, diplomacy, etc., responsibilities bestowed upon China's sub-national governments seem to be restatement of those of the central government.

The tax sharing reform carried out in 1994 failed to provide solution to this troublesome problem but preserved the obscure division of functions. In writing assignment of functions are broad-brush while, in practice, responsibilities of the central government and sub-national governments to a great extent intersect and overlap. In line with that China's sub-national governments are merely branches of the central government in localities, almost all governmental functions assigned to sub-national governments are extension and thinning of those of the central

government.

2. No stable rules for assignment of public expenditure

There are two major reasons accounting for the instability of China's public expenditure assignment scenarios. On one side, as China is a unitary state on the basis of centralization of power, China's sub-national governments are subject to extensive supervision and control of the central government. Also, it is stipulated by law that all China's sub-national governments are under the leadership of and obedient to the State Council and the people's government at lower level must be responsible to the people's government at next higher level. The central government, rather than sub-national governments and, local government at higher level, rather than local government at lower level, have the power to determine substantive public expenditure assignment. In light of the bureaucratic advantage of the central government or local government at higher level, functions and responsibilities are assigned among governmental levels rather discretionarily.

On the other side, China's historical and rampant lack of rule of law means public expenditure assignment in writing may become merely a dead letter. It is red-taped documents issued by the central government or governments at higher levels, which are understandably changeable from time to time, instead of official enactments, are the operating codes in reality to decide on public expenditure assignment.

3. Contradictory criteria in determining public expenditure assignment

As a transition country which is hesitant to embrace market-orientation economy and western style public financing, in determining assignment of public expenditure, China adopts multiple standards in determining public spending assignment. The hybrid of modern criteria and those as heritage of the central-planning tradition, however, are inherently self-contradictory.

Modern criteria, e.g. subsidiarity, service or benefit area, redistribution, scale, etc., require that public expenditure shall be assigned in accordance with type of governmental functions, in order to reach the equilibrium level of both efficiency and fairness. In contrast, traditional criteria inherited murky matrix fragmentation, dreadful management as well as significant rigidities and waste¹ in public spending sector left by the former Soviet model. Consequently, public spending management is weak at all levels of governments and expenditure functions and responsibilities are unreasonably assigned among governmental levels.

4. Overloaded sub-national governments and lower level governments

¹ For example, along with the transformation of state functions, many governmental institutions oriented to central- planning economy should have been revoked and spending for personnel thereof should have been cut off. Nevertheless, these institutions are still there with their jobless personnel still have to be paid.

Compared with other transition countries, China offered a reverse example of growing inequality in terms of public expenditure assignment among governmental levels. Empirical studies reveal that the central government, with relatively wealthy fiscal resources because of the tax sharing reform in 1994, is assigned lesser expenditure responsibilities while sub-national governments, with relatively limited fiscal resources, are saddled with higher preponderance of public goods deliveries and expenditure responsibilities.

Table-2 Government Revenue of the Central Government and Local Governments and Ratios

Year	Total			Ratio (%)	
	Revenue (100 million yuan)	Central Government	Local Governments	Central Government	Local Governments
1978	1132.26	175.77	956.49	15.5	84.5
1980	1159.93	284.45	875.48	24.5	75.5
1985	2004.82	769.63	1235.19	38.4	61.6
1990	2937.10	992.42	1944.68	33.8	66.2
1991	3149.48	938.25	2211.23	29.8	70.2
1992	3483.37	979.51	2503.86	28.1	71.9
1993	4348.95	957.51	3391.44	22.0	78.0
1994	5218.10	2906.50	2311.60	55.7	44.3
1995	6242.20	3256.62	2985.58	52.2	47.8
1996	7407.99	3661.07	3746.92	49.4	50.6
1997	8651.14	4226.92	4424.22	48.9	51.1
1998	9875.95	4892.00	4983.95	49.5	50.5
1999	11444.08	5849.21	5594.87	51.1	48.9
2000	13395.23	6989.17	6406.06	52.2	47.8
2001	16386.04	8582.74	7803.30	52.4	47.6
2002	18903.64	10388.64	8515.00	55.0	45.0
2003	21715.25	11865.27	9849.98	54.6	45.4
2004	26396.47	14503.10	11893.37	54.9	45.1
2005	31649.29	16548.53	15100.76	52.3	47.7
2006	38760.20	20456.62	18303.58	52.8	47.2

a) The revenue of the Central Government and local governments each refer to own revenue.

b) Revenue in this table does not include revenue from domestic and foreign borrowings.

Table-3 Government Expenditure of the Central Government and Local Governments and Ratios

Year	Total			Ratio (%)	
	Expenditure (100 million yuan)	Central Government	Local Governments	Central Government	Local Governments

1978	1122.09	532.12	589.97	47.4	52.6
1980	1228.83	666.81	562.02	54.3	45.7
1985	2004.25	795.25	1209.00	39.7	60.3
1990	3083.59	1004.47	2079.12	32.6	67.4
1991	3386.62	1090.81	2295.81	32.2	67.8
1992	3742.20	1170.44	2571.76	31.3	68.7
1993	4642.30	1312.06	3330.24	28.3	71.7
1994	5792.62	1754.43	4038.19	30.3	69.7
1995	6823.72	1995.39	4828.33	29.2	70.8
1996	7937.55	2151.27	5786.28	27.1	72.9
1997	9233.56	2532.50	6701.06	27.4	72.6
1998	10798.18	3125.60	7672.58	28.9	71.1
1999	13187.67	4152.33	9035.34	31.5	68.5
2000	15886.50	5519.85	10366.65	34.7	65.3
2001	18902.58	5768.02	13134.56	30.5	69.5
2002	22053.15	6771.70	15281.45	30.7	69.3
2003	24649.95	7420.10	17229.85	30.1	69.9
2004	28486.89	7894.08	20592.81	27.7	72.3
2005	33930.28	8775.97	25154.31	25.9	74.1
2006	40422.73	9991.40	30431.33	24.7	75.3

- a) The expenditure of the Central Government and local governments each refer to own direct expenditure.
- b) Expenditures before 2000 in this table do not include the payment of the principal and interest of domestic and foreign debts and the expenditure for capital construction using foreign loans. Expenditures of Central Government and local governments since 2000 include all payment for the principal and interest of domestic and foreign debts.

It should be noted that the above tables only reflect the fiscal inequality between the central government and provincial governments as, legally speaking, direct fiscal relations only exist between the central government and provincial governments. As for sub-provincial inter-governmental fiscal relations, it is another obscure side of the ledger and a variety of management methods, e.g. “Province Governs County”, “Province Governs Prefecural City” etc. co-exist. Notwithstanding, common phenomena throughout the country are governmental functions are mainly delivered and financed by lower level governments, such as those at township-levels or county-levels.

Part III. Aftermaths of the Flaws in China’s Public Expenditure

Assignment

1. Misorientation of governmental functions

As mentioned above, assignment of public expenditure among China’s governmental levels is vague and ill-defined. In addition, the primary incentive of the reform since 1980’s was to resuscitate revenue collections. Virtually less attention was paid to building up a sound system of expenditure assignment.

Unlike those of other transition countries, China’s governments are yet keen on providing intermediate and advanced governmental functions to boost economic development and market maturation, nevertheless, leave out delivery of basic public goods, in specific, those towards basic human welfare and development needs, such as education, health, science, social security, environmental protection etc.. As motivated by maximization of revenues, China’s governments at various levels have been focusing on competition for revenue resources and expansion of tax bases at the locality at the sacrifice of squeezing out public spending on provision of basic public goods.

This short-sighted premium on economic development and contempt on basic public goods has led to misorientation and distortion of governmental functions. Lower level governments, especially those at county-levels and township-levels assume most expenditure functions and responsibilities for delivery of basic public goods.

However, their weak administration capacities and dearth of fiscal resources lead to insufficient supply of these public goods, which will be dwelled on in the following paragraphs.

2. Revenue-stranded local governments

As discussed above, significant public expenditure to be assigned by China's sub-national governments is hardly matched to sufficient fiscal resources either by revenue assignments or an effective system of transfer. This lack of supporting system has left many sub-national governments unable to perform their assignments.

The tax sharing reform in 1994 worsened the case as barycenter of revenue collection and assignment moved upward while public expenditure remained primarily to be responsibilities of local governments. As China's economic development has since early 1990's become more concentrated in eastern coastline regions, revenue disparities accelerated, and the result was a sharp rise in interregional disparities in public spending, accompanied by a gradual deterioration of public services in hinterland regions. As admitted by the then China's Finance Minister to the National People's Congress in 2004, many local governments at county-levels and township-levels were even unable to meet payroll in full for civil servants¹. According to commentators, the fiscal problems are very serious in China's poor regions.² In these hinterland regions, free medical care and epidemic prevention program are eliminated and local clinics and health stations are closed, which has stirred nationwide panic in the SARS crisis in 2003.

3. Inconsistency in delivery of public goods and expenditure assignment

As previously stated, public expenditure assignment among China's governmental levels is not very reasonable and proportionate to availability of fiscal resources. Meanwhile, assignment of revenues is not as highly decentralized as that of public expenditure.

Considering that higher level governments with better fiscal capacities assume lesser responsibilities while lower level governments undertake significant expenditure responsibilities with merely access to very limited fiscal resources and, in addition, some governmental leaders are eager for prompt success and instant benefit, the scope, priority and level of public goods to be provided by China's governments are to a great extent distorted. Tales of "mislocation", "offside" and "default" of governments are widely heard throughout the country.

¹ The Minister of Finance's Report to the Second Session of the Tenth People's Congress, see news.xinhuanet.com/newscenter/2004-03/17/content_1371358_1.htm.

² Bird, Richard M. and Wong, Christine P.W., "China's Fiscal System: A Work in Progress" (October 2005). Rotman School of Management Working Paper No. 07-11 Available at SSRN: <http://ssrn.com/abstract=875416>.

The lack of transparent and normative management of public expenditure has resulted in extravagant and wasteful public spending on magnificent vanity projects and, equally serious, fiscal stringency in provision of fundamental governmental functions. On one side, fiscal budgets are not effectively prepared, executed, monitored or implemented, which leads to numerous redundant and aimless constructions and investments. On the other side, due to structural distortion in public expenditure assignment, such public sectors seeming irrelevant to economic boost in the short-run as agricultural development support, environmental protection, social security etc., are in the plight of competing for finite fiscal resources.

Part IV. Reformation Roadmap

To build up a sound inter-governmental fiscal structure and to improve the efficiency and quality of delivery of public services, most Chinese scholars have agreed that reformations should be taken in such approaches as clear division of governmental functions, upward move of expenditure responsibilities and thorough implementation of sectoral reforms.

1. Adjustment of governmental levels to an appropriate extent

As known to all, Chinese governments are divided into five tiers, namely the central government, provincial governments, prefectural governments, county-level and township-level governments, which is unprecedented in the world. With development of technology and amelioration of transportation network, this five-tier governmental structure has led to undesirable consequences and incurred widespread criticism. The focal points of reformations in this respect shall be on the restructuring and reorientation of county-level and township-level governments, which in reality assume significant public services delivery.

- “County governs towns”

With the overall cancellation of agricultural taxes in 2006, township-level governments, which are mainly situated in rural areas, are saddled with severe burden with constrained revenues. Except for a few county towns where county-level governments are seated, most township-level budgets exist in name only.

Considering weakening of functions of township-level governments, it is widely proposed by Chinese commentators that township-governments should be converted into dispatched and enforcement agencies of county-level governments. In addition, public spending for all towns throughout a certain county should be uniformly administrated, monitored and assumed by the county-level government.

Reformation of “county governs towns” has been provisionally implemented in some

Chinese provinces. The result is, to some extent, revenue-stranded township-level governments have been relieved of their fiscal burdens and fiscal disparity within one certain county has been redressed¹.

- “Province governs counties”

“Province governs counties” requires that prefectural governments should be progressively disassociated with county-level governments in terms of fiscal relations, so that provincial governments will directly administer county-level governments. By this decrease of bureaucratic levels, governmental administration expenses could be significantly reduced and fiscal management, especially budgetary preparation and supervision, could be more transparent and efficient.

By the same approach, because of the direct interactions between provincial governments and county-level governments, it will be feasible that a large proportion of basic governmental spending, which are mainly undertaken by county-level and township-level at present, could be transformed to be solely assumed or jointly shared by provincial governments. Meanwhile, more stable and efficient fiscal transfers system could thereby be established in sub-provincial intergovernmental fiscal relations, so as to subsidize .

2. Upward move of expenditure responsibilities and downward move of fiscal powers

To address the uneven gap between public expenditure assignment and fiscal capacities, as abovementioned, barycenters of public expenditure responsibilities should be shifted from overloaded county-level and township-level governments to the central government and provincial governments, which are entitled to relatively richer fiscal resources.

According to their inherent natures, delivery of public services and financing responsibilities therefor should be assigned among all levels of governments reasonably and proportionately, in order to establish a balanced fiscal mechanism between capacities and responsibilities.

Public goods of nationwide interest or in relating to Macro-economic stability should be solely delivered and financed by the central government, so that sub-national governments will be emancipated from requisition apportionments of expenses for national defense, diplomacy and adjustment of Marco-economic development and able to focus on basic public services and social management. Such public services as

¹ According to my personal experiences in Tongling, a city where I once lived in Anhui Province, public expenditure for primary and middle schools have been universally undertaken by the county-level government. This has provided a solution to the drainage of qualified teachers in remote townships and villages, as their payroll is as equal as that of the teachers in the county town.

education, medical care, social security etc., of which spillover effect is distinctive, should be jointly provided and financed by the central government and provincial governments, the sharing portion of which is prescribed by clear-cut and consistent legislations.

At the same time, the central government should hand over more fiscal power and discretions to lower-level sub-national governments, which actually have better informative advantage to devise public management mostly suitable to localities. By this means, sub-national governments will be capable of expanding their own revenue bases through flexible tax policies instead of resorting to illegal off-budgetary resources. For example, sub-national governments in China's western provinces, with less access to enterprise income and business taxes as a result of relatively less-blossom investment activities but more endowment of mineral resources, may impose lower enterprise income and business tax rates to attract investors and higher mineral resources tax rates to make up for fiscal revenues. Obviously, under current uniformly enforced tax legislations allowing no flexibilities, they are unable to adopt such policies.

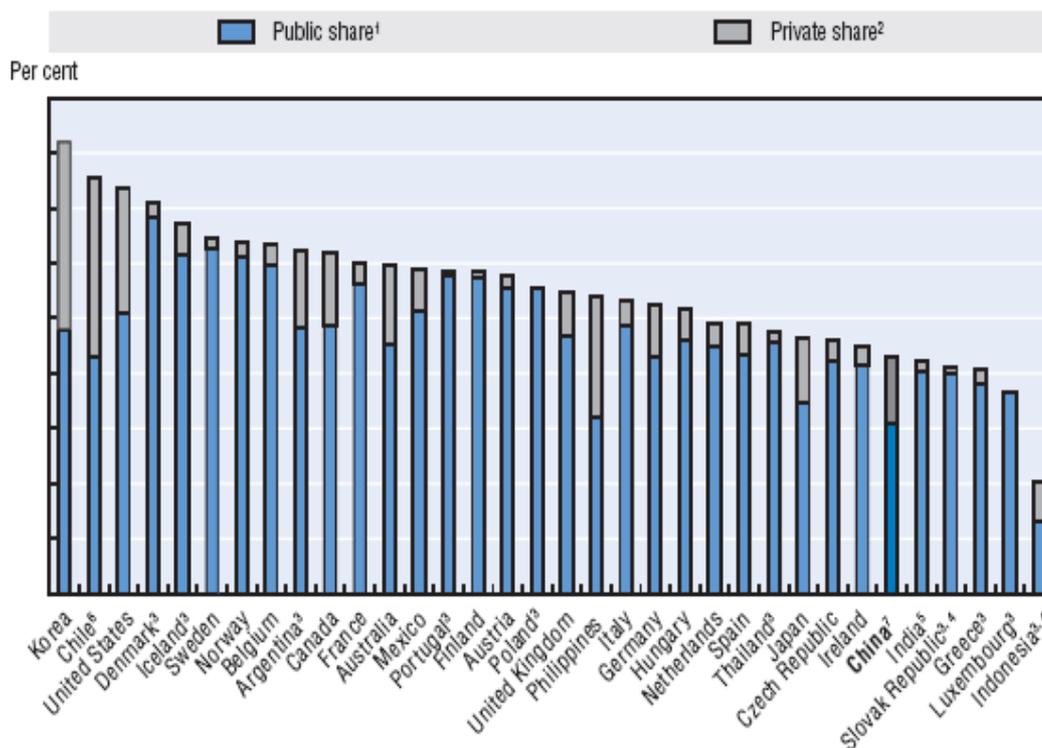
3. Sectoral reforms in key aspects

The final directions of China's sectoral reforms in key aspects, e.g. housing amenities, medical care, high education and social security, do not appear to be very crystal or certain while, on the contrary, full of controversies.

In the latest session of the National People's Congress held in early March 2008, previous fiscal policies carried out in such sectoral reforms have been extensively criticized and labeled as "unscrupulous privatization" of fundamental public sectors. Statistical figures show, the share of total public spending going to education, health, and science has fallen over the last decade while more and more people have to rest on private funds to exchange such services that are fundamental for human dignity and values.

Taking education as an example, as illustrated below, in relation to GDP, public spending on education and health is well below that of nearly all OECD as well as most comparable developing countries, while private spending in these areas is among the highest in the world.

Figure-1 Public and private education spending as percentage of GDP in selected countries, 2001



1. Including public subsidies to households attributable for educational institutions. Including direct expenditure on educational institutions from international sources.
2. Net of public subsidies attributable for educational institutions.
3. Public subsidies to households not included in public expenditure, but in private expenditure.
4. Year of reference 1999.
5. Direct expenditure on educational institutions from international sources exceeds 1.5 per cent of all public expenditure.
6. Year of reference 2002.
7. Includes on-budget and extra-budgetary education-related spending.

(Source: OECD Report, 2004)

The reason behind is the education reform initiated since late 1990's was merely a transitional fix to a transitional problem to cater for drastically growing demands of education while omitted coordinated supporting reforms. Localization of education without due intervention and supervision of the central government has contributed to a number of undesirable consequences for the Chinese society, including regional disparity, social inequality, employment mismatch, and even impoverishment of rural families.

Part V. Conclusive Remarks

China should more systematically tackle the serious problems that have emerged in public expenditure assignment among governmental levels and financing of public goods delivery. Without due redress, the current unsatisfactory system will over time increasingly distort resource allocation, increase distributional tensions and, in the end of the day, significantly show down the impressive recent growth Chinese

economy. The strong “development-path-dependent” must be taken into account in designing Chinese fiscal reform schemes and, therefore, historical evolvement of inter-governmental fiscal relations should be consistently and rationally reflected.

Moreover, a more consistent and purposive framework seems needed, given the complexity of the underlying problems in China’s public expenditure assignment. Experiences in China has shown, undue weight put on recent issues has led to gradualist and incremental reforms, merely responding to immediate problems with short-term fixes, which, in turn, create more problems more permanently.

To ensure a concerted long-term institutional change in the sector of fiscal expenditure administration, further research must be done as it is of critical importance to be aware of the flaws. Notwithstanding the above-mentioned, once seized of all problems, the Chinese people endowed with great wisdom will undoubtedly be able to deal with them and find a way out.