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Rural Taxation and Local Governance Reform in China’s Economic Transition: Origins, Policy Responses and Remaining Challenges
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Rural Taxation and Local Governance Reform in China’s Economic Transition: Origins, Policy Responses and Remaining Challenges*

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This paper examines the historical evolution of China’s rural taxation system and provides an initial assessment of the ongoing rural tax reform. It is argued that the issue of rural taxation and local governance in China is one typical challenge arising from the inherent tension between an increasingly liberalized economic system and a still centralized political system. Though the rural tax reform has helped to reduce farmers’ tax burden in the short term, the establishment of an effective local governance regime requires coordinated reforms to downsize local bureaucracy by providing social security for laid-off cadres, to strengthen local accountability by granting higher local formal tax autonomy, and to promote meaningful participation by expanding local democracy.

Keywords: rural taxation, reform, China
JEL Codes: H20, O53

1 Introduction

The market-oriented reforms launched in 1978 have changed the economic landscape of China and have improved the dynamism of both the rural and urban sectors. In the past 27 years, China has transformed itself from a centrally planned economy to an emerging market economy whilst achieving an average GDP growth rate of more than 9 percent (Lin et al. 2003). Market-oriented reform also dramatically reshaped China’s countryside. During the early 1980s, agricultural productivity rose steadily with the introduction of the Household Responsibility System (HRS). Rural industrialization also took off rapidly in the second half of the 1980s and continued to grow fast in the early half of the 1990s as town and village enterprises (TVEs) evolved quickly to meet a pent-up demand for consumer goods and take advantage of a pool of cheap rural labor.

However, the transitional path China has been taking so far is not without problems. One of the most serious challenges is the ever-growing spatial inequality that disadvantages the nation’s vast countryside. Though agricultural growth and rural industries expansion in the 1980s significantly raised farmers’ income, urban-rural income disparity, having dropped from a ratio of 2.6 in 1978 to 1.8 in 1984, bounced back to a historical high of 3.2 by 2005 (see Figure 1).

Figure 1: Urban Rural Income Ratio

![Urban Rural Income Ratio](Image)

Source: National Bureau of Statistics (various years)
Within rural areas, spatial disparity is also rising steadily. Economic growth has been much greater in coastal regions that are able to industrialize faster. However, the more agriculture-dependent inland areas witnessed something close to stagnation in the second half of the 1990s. Accompanying the growth slowdown in these regions was a flood of angry public protests powered by farmers’ frustrations arising partly from excessive tax burdens. In China’s major grain-producing provinces such as Anhui, Hubei, Hunan and Sichuan, the tax rates on the poorest farmers sometimes surpassed 30 percent of their incomes (Chen, 2003). Under some extreme circumstances, farmers opted to move to cities on a large scale leaving their land fallow, because they could not afford the heavy taxes (Berstein and Lu, 2000).

To address the bitter complaints from farmers about excessive tax burdens, the central government initiated a series of governance reforms in recent years. The government under the leadership of President Hu Jingtao and Premier Wen Jiabao started removing all local informal fee charges and formal agricultural taxes on farmers when they took office in 2003. The fee and tax have been completely abolished at the beginning of 2006. Local bureaucracy streamlining was also initiated in the same period to downsize local government and reduce expenditure on personnel. Under the most recent move to construct a “New Socialist Countryside,” the central government is planning to channel more transfers to the countryside to improve the development of rural infrastructure and the provision of public services.

This paper examines the evolution of China’s rural tax regime and provides an early assessment of the government’s rural policy initiatives through the first half of 2006. The objective is to provide an analytical framework for investigating local governance issues during economic transition and gain a better understanding of China’s overall transition process. Compared with most other transition economies, many economists consider China to have adopted an unconventional reform approach in embracing “gradualism.” The experimental approach of “Crossing the River by Groping for Stones” has led to rapid economic growth, but it also complicates economic transition. Incomplete institutional changes frequently failed to resolve problems inherited from the plan period, even as they frequently generated new
challenges. In this paper, we argue that the issues of rural taxation and local governance in China are typical of the challenges that arise from the inherent tension between an increasingly decentralized and liberalized economic system and a still centralized political system. Therefore, a full and smooth transition warrants more thorough, better coordinated governance reforms.

The rest of the paper is structured as follows. Part 2 describes the evolution of China’s rural tax system since the plan period. Based on a newly available data set that covers periods both before and after the rural tax reform, Part 3 evaluates the impacts of the reform on farmers’ tax burdens. Relating the ongoing rural tax and local governance reforms to China’s overall transition process, Part 4 provides an analytical framework for China’s local governance regime and pinpoints the remaining challenges. Part 5 concludes.

2. The evolution of China’s rural tax system

2.1 Plan Period: agricultural taxation through price scissors

A formal state agricultural tax was present in the People’s Republic of China as early as the 1950s. The national average rate of this tax was set then at 15.5 percent of a state-defined tax base that was fixed for several decades. In the 1950s and 1960s the tax base was on average a third lower than the national grain output. Therefore, the actual agricultural tax rate was around 10 percent of grain output in China’s first and second “Five-year Plan” periods (1953-57 and 1958-62). As grain output grew in the 1960s and the 1970s, the effective rate declined to 6 and 5 percent respectively in the third and fourth “Five-year Plan periods” (1966-1970 and 1970-1974). Judged by these numbers, the formal agricultural tax was not very high during the command period and even declined from the 1950s to the 1970s.

However, farmers were taxed much more heavily than the state agricultural tax statistics suggest. By controlling the distribution of food and being the main or only supplier of such vital agricultural inputs as fertilizer, pesticides, water and electricity, during the plan period the Chinese state was able to tax agriculture implicitly through the price scissors, increasing the
prices of agricultural inputs and depressing the prices of agricultural outputs. As Lin et al. (2003) have argued, the choice of a heavy-industry-oriented development strategy in China’s plan period compelled the state to extract resources from agriculture through price distortions in order to subsidize the priority sectors. To facilitate such taxation, production brigades and people’s communes were set up in rural areas and a highly controlled allocation system of major agricultural inputs and outputs was established. Compulsory procurement quotas were imposed on farmers and farmers were entitled only to residual grain after state procurement. As a tax in kind, the state agricultural tax was also collected via the mandatory procurement system. Between 1953 and 1978, the implicit taxation through price distortions was as high as CNY 280 billion, 17 percent of total agricultural output in the same period. This greatly exceeds the formal state agricultural tax (CNY 89.8 billion) in the period (Cui, 1988, Yan, 1988).

Besides the formal agricultural tax and the implicit tax collected via the price scissors, farmers faced further levies imposed by local communes and production brigades. Before farmers received their incomes from rural collectives, the brigades and communes deducted their collective accumulation fund, welfare fund and cadre compensation. Only thereafter did team members receive part of their work-points part in grain and part in cash (Lin, 1992). Therefore, in the plan period the formal agricultural tax was automatically collected through a mandatory procurement system in which farmers were required to sell most of their agricultural output to the state. Because rural collectives were able to control income distribution among farmers through the work-point system, local levies by communes and production brigades were also collected before farmers were paid for state-procured grain (Lardy, 1983, Rozelle, 1996).

2.2 The 1980s and early 1990s: gradual changes in agricultural tax instruments

The agricultural reforms since the late 1970s not only raised agricultural productivity

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1 Such taxation through pricing has long been a central topic in discussions of development (Dixit, 1973, Lipton, 1977, Sah and Stiglitz, 1987).
dramatically, but also gradually reshaped the way agriculture was taxed. In the late 1970s, reform in the agricultural sector was mainly characterized by de-collectivization. The Household Responsibility System (HRS) adopted since then furnished individual rural households with incentives by making them the residual claimants to farming returns once they fulfill the state grain quota and agricultural taxes and fees (Lin, 1992, Debra et al., 2004). In the early 1980s, the mandatory grain quota system was abolished and replaced by grain procurement contracts in which every rural household was required to sell a certain amount of its grain output at state-set procurement prices. With rare exceptions, the market prices exceed the state procurement prices and farmers thereafter could market their surplus produce (Lin 1992). This price margin enabled the state grain sector, as the agent of the state, to continue tax agriculture implicitly.

However, the introduction of the HRS deprived local governments and village community organizations of their power to distribute income within villages. To collect revenue for townships and village collectives, the government introduced two major categories of fees, i.e., the so-called “five township-pooling funds” to township governments to provide basic public goods such as education, public security, law and order, and civil service, and carry out the state mandates of family planning and grain procurement, and the “three village levies” to village community organizations to provide for collective capital accumulation, collective welfare funds and cadres’ salaries.

Besides the two major fee categories permitted by the state, townships and villages also collected revenue implicitly by adding a margin for household grain procurement above the state quota. Adding a margin over the state procurement quota would contribute to local revenue as local officials could exploit the price margin between the market price for grain and the state procurement price. In practice, farmers usually had no way to know if there was such

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2 Though the state set the grain quota for each locality, it was up to township governments to allocate the quota to villages and the latter to individual households. Local officials, in the name of fulfilling grain procurement contracts, usually over-procured grain by adding a margin over the state quota. Then farmers sold their grain at below market prices to the state grain sector, the latter often worked with local cadres in tax and fee collection.

3 Furthermore, the higher the quota margin over the state grain quota, the higher the payment should, in
a margin and/or how large it was. In many places, implicit taxes on such economic crops as cotton, rapeseed, jute, hemp, and tobacco; sideline products such as cocoons and pigs; and agricultural inputs such as fertilizers and pesticides were also collected by local governments through their control of the transaction channels and prices. Under the state grain procurement system, local governments had every reason to assert the necessity of regulating the whole agricultural production structure in order to fulfill their state grain quotas. In practice, many local officials dictated farmers’ specific farming operations. They not only required a specified share of the total arable land be allocated to grain production, but also frequently mandated that farmers plant certain cash crops and sell to them at depressed prices.

Therefore, as in the plan period, the continued (though declining) existence of state grain procurement greatly facilitated the imposition of the agricultural tax and various local informal fees. Before farmers obtained the state payment for procured grain sold to the state grain sector, township governments and village community organizations, with cooperation from the state grain sector, deducted all the taxes and fees. Farmers were then paid the residual. Because state grain quotas were still relatively large, only in rare case was there nothing left when farmers were required to pay more, either in cash or in kind (Bernstein and Lu, 2003). Given that every rural household was allocated some land under the HRS, in practice both the agricultural tax and most local fees were mainly levied on land allocation, while some other fees were levied on household members or laborers. Since the land is allocated largely according to family size and labor force, agricultural taxes and fees in rural China can be largely viewed as land-based tax burdens. With the introduction of HRS, China’s countryside witnessed a gradual transition in which rural taxation began to change from the dominant tax instrument of the price scissors to a principle, be made to farmers (even at the state procurement price), and the more room local officials had to deduct agricultural taxes and fees before paying the farmers.

Unlike the late industrializing countries of Africa or Latin America that are often plagued by bureaucracies lacking organizational capacity, the Chinese bureaucracy is an elaborate network that extends to all levels of society, down to the neighborhood. As the Maoist legacy, the Chinese bureaucracy exhibits a high degree of discipline by international perspective (Oi, 1995). Therefore, there is no lack of administrative capacity to conduct cadastral surveys and administer the land-based tax. After the communist revolution, there have been no interest groups strong enough to resist the taxation on land (Bardhan, 2002).
combination of the pricing instrument and land-based agricultural taxation with the latter becoming increasingly important.

However, rural taxation was still not a prominent issue in the 1980s and the early 1990s as some share of agricultural taxes and fees was collected through the implicit instrument of the price scissors, and almost all agricultural taxes and local levies could be deducted beforehand under the remaining grain procurement arrangements. Neither was the issue of local illegal levies a very serious one in this period. Even when such levies existed, they were at least not very explicit since they were either deducted prior to the payment for grain procurement deliveries, or through the over-procurement from farmers and the control of major agricultural input distribution by local governments.

2.3 The 1990s: the emergence of excessive informal taxation in agricultural regions

After the introduction of the HRS in the early 1980s, China’s agricultural sector in the witnessed a faster market liberalization that began in the late 1980s continued through the 1990s (Weersink and Rozelle, 1997). The issue of excessive rural taxation emerged in the 1990s when many rural areas (especially those in agriculture-based regions) experienced a surge of diverse, local illegal fundraising. These fees were imposed on farmers, without explicit government regulations or legislation, for anywhere between a few dozen and more than one hundred items, ranging from charges for road and school construction and other local improvement projects, to purchase of insurance, to charges for marriage certificates or housing construction, to prohibitive prices for electricity and tap water, and so on. For example, in some regions marriage certificates cost CNY 600, a quarter of the farmers’ average annual net income. In many localities, villages were forced to purchase various newspapers or periodicals (State Planning Commission, 2000). In the 1990s in rural China, a large share of the village and township government expenditure came from such informal charges. These fees did not enter into formal budgets but constituted an important share of local extra-budgetary revenue for township governments and village collectives.

The emergence of excessive rural taxation and the surge of informal fee charges did not occur uniformly throughout China. It is a regional, though still relatively broad-based, phenomenon that
mainly involved inland agriculture-based areas in the second half of the 1990s. Using a 6000 household panel data set from 1986 to 1999 collected by the Ministry of Agriculture, we calculate rural tax burdens as a share of farmers’ income for 10 provinces (both developed and under-developed) across China in 1986, 1993 and 1999. As shown in Table 1, on average, there was no significant increase in rural direct taxes as a share of rural net income in the period covered. In most provinces, total tax burdens on rural households (both formal taxes and informal fee charges) grew only by 1-4 percentage points as a share of rural net incomes from 1986 to 1999. In some more developed coastal provinces such as Guangdong and Zhejiang, there was even some decline of tax rates in the period.
However, further investigation shows that rural taxation became an acute problem because of a fast increase in rural income disparity after the 1990s and the uneven tax and fee

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Note: 1. Burdentotal is defined as all formal taxes paid by individual households plus all township and village informal levies as a percentage of household net income.

2. Feetotal is defined as township and village levies (including village and township levies permitted by the central government, plus various local charges not legitimated by national government policy as a percentage of household net income.

3. Fee1 is defined as the township and village levies permitted by the central government.

4. Fee2 is defined as those various charges not legitimated by national government policy but imposed by local (county or township) government and village community organizations as a percentage of household net income.
distribution among different income groups. Still using the same data from the Ministry of Agriculture, we find that rural income inequality in the 10 provinces increased significantly from 1986 to 1999; over the same period the incidence of rural taxation among different income groups did not change correspondingly. Figure 1 and Figure 2 show the rural tax burdens by income groups for 1986 and 1999, respectively. If we include all formal tax and informal fees paid by rural households, the tax burden for the lowest-income group in 1986 (annual per capita income less than CNY 200) was 10.5 percent of net income, while that for the highest-income group (annual per capita income larger than CNY 4000) was 9.5 percent. However, in 1999, the tax burdens for the lowest-income group (with an annual per capita income less than CNY 400) climbed to as high as 25.6 percent of net income, while that of the highest-income group (with annual income larger than CNY 8000) was only 4.4 percent. Therefore, the increasingly regressive nature of rural taxes and the heavier burdens on poor farmers, rather than the increase of average rural tax rate, is at the heart of the rural taxation issue in China.

The reason that the poor farmers pay much higher shares of their incomes for taxes and relates to the nature of the rural tax system in China’s economic transition. Taxes on the Chinese rural households are predominantly agricultural taxes levied on arable land. However, since the early 1990s, an increasing share of rural income has derived from non-agricultural sources, such as township and village enterprises and migrants remittances, which have not been subject to state tax administration. This is especially true for farmers in more developed regions. Since the poor usually comprise the group of people with the lowest proportion of income from non-agricultural sources, they are more vulnerable to rural direct taxes (Tao and Liu, 2005). Therefore, rural taxation became an increasingly serious issue essentially because with rising rural income inequality the rural tax system failed to respond accordingly and taxes fell disproportionately on the shoulders of the relatively poor farmers dependent on agriculture. As a result, though the state formal tax, i.e. the agricultural tax, was, in effect, only around 2-3 percent of farmers’ average incomes across the nation and 4-5 percent in less developed
agricultural regions, informal fees in many less developed regions are much higher, usually reaching 20-30 percent of average incomes for the poor farmers.

As a result, though in effective tax rates the state formal tax, i.e. the agricultural tax was on average only around 2-3% of farmers’ income across the nation and 4-5 percent in less developed agricultural regions, informal fees in many less developed regions are much higher, usually reaching 20-30 percent for the poor farmers.

2.4 Institutional mechanism of rural informal taxation in China

Our discussion of China’s rural taxation so far begs answers for the following three questions. First, what was the fundamental source of rural taxation and why did rural informal fees emerge in China? Second, why did the issue become serious only in the late 1990s rather than in earlier period? Finally, why was the phenomenon confined to the more agriculture-based regions?

Our answer to the first question relates to the policy mandates imposed on local government at county/township level and village community organizations in China. In China,
local governments were not elected and their policy directives are issued and monitored from above. Therefore, local governments have to fulfill many tasks mandated by higher-level governments. For example, at township level, these include government grain procurement, birth control and compulsory education. These policy burdens could create a justification for local governments to levy informal taxation from within community. Though the upper level government could theoretically provide fiscal transfers to cover the policy implementation costs, the financial and personnel costs of local policy implementation are not fully known to, thus could not be covered by, the upper level government. The latter, understanding that transfer alone would be insufficient to induce policy coordination, has to grant local governments certain autonomy in informal taxation (by e.g. turning a blind eye to illicit fee collections). However, once such autonomy is granted, unelected local governments could take advantage of, and draw on the legitimacy of the higher-level government to overcharge farmers and even engage in rent-seeking. Therefore, in many rural areas, the bulk of local cadres’ work was to charge fees, and then to use the revenues to implement the policies required by upper-level governments. Given that many policies were quite unpopular among farmers, administrative costs usually turned out to be very high. High personnel and administrative expenditures rendered rural governments in many less developed regions incapable providing basic public services within budgets.

Therefore, a plausible explanation of the rural informal taxation in China must be placed in the context of upper level policy mandates. If the policy mandates are heterogeneous across locality, heterogeneous rural tax burdens and local expenditure in fulfilling the mandates ensued. This is not only because heavier federal mandates would entail heavier policy implementation costs in terms of financial and personnel resources, but also, under information asymmetry with regard to the exact policy enforcement costs, local governments could pad costs and intentionally increase the costs of implementing mandates by such means of cost manipulation.

The most telling example of such policy heterogeneity is the state grain procurement.
Though the central government implemented the policy in almost all provinces across China, the quantities of government grain procurement (both in gross or per capita terms) vary significantly by locality. For example, using the Ministry of Agriculture data, we present the per capita grain procurement for the 10 provinces for 1987, 1995 and 1999. As shown in Figure 4, in 1987 the inland province of Jilin had a highest per capita state grain quota of about 350kg while the province of Henan had a lowest per capita state grain quota of about 70kg. Speaking generally, there was a clear declining trend in state grain quota per capita from 1987 to 1999 in almost all the provinces, though significant heterogeneity across provinces still existed even in 1999. Significant differentiation in policy mandates across localities help to account for heterogeneous tax burdens and local (township government and village organization) expenditure.

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5. The quantity of grain procurement for every locality is determined by the center according to a set of rules that take account of factors such as natural conditions, local history, and even political concerns, such as local food self-sufficiency.

6. Another example of heterogeneity in policy enforcement cost is the state’s birth control policy. In less developed areas where income is lower, non-agricultural employment more limited and women and girls are less well educated, farmers usually strongly prefer to have more children than do farmers living in richer regions. Therefore, poorer regions face greater difficulties in fulfilling the birth control quota set by the center, which implies higher administrative costs and more financial and personnel resources.

7. Using the Ministry of Agriculture data, we empirically test the hypothesis and find that higher policy mandates (state grain quota per capita) indeed lead to higher formal and informal taxes (per capita), other things controlled. Please see Tao and Liu (2006).
Note:  the provincial grain quota per capita is calculated by first summing the state grain quotas of all surveyed households within a province then dividing by the total population of all surveyed households.

The answer to the second question, i.e., why did rural taxation become a serious issue only in the 1990s rather than earlier, relates to further marketization of major agricultural outputs and inputs. Starting from the early 1990s, changes to the procurement system, further lifting of restrictions on trading of commodities, moves to commercialize the state grain trading system, and calls for the expansion of market construction in rural and urban areas all led to a surge in market-oriented activity (Sicular, 1995, Rozelle 1996, Rozelle et al, 2000, Debray et al 2004). These liberalizations in agriculture in the 1990s reduced both the quantity of the state grain quota as well as the grain market-procurement pricing margin. This period also witnessed a fast liberalization of all major cash crops, sideline products and agricultural inputs. As explained in section 2.2, in the 1980s, local governments collected implicit taxes on crops such as grain (through over-procurement), cotton, rapeseed, sideline products such as cocoons and pigs, and

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For example, in the case of fertilizer, Ye and Rozelle (1994) show that after an early attempt at market liberalization in 1986 and 1987, perceived instability in the rural economy in 1988 led to sharp retrenchments. Only in the early 1990s did agricultural officials once again remove the controls on fertilizer marketing and begin to encourage private trade. Local governments had been able to earn some revenue from its control on distribution over major agricultural inputs.
agricultural inputs such as fertilizers and pesticides, since they could control the transaction channels and prices. The gradual erosion of state grain procurement quotas, along with the gradual erosion of regulations on cash crops and declining controls on transaction channels for major agricultural outputs and inputs, reduced the implicit taxes local governments could exploit, resulting in rising explicit taxes levied on individual farm households.  

Still using the Ministry of Agriculture data, we can see the gradual decline of the margin between grain market prices and the state procurement price. Figure 5 shows the price margin for all 10 provinces plus the provinces of Hunan and Zhejiang from 1987 to 1999. The Figure shows that, although the late 1980s and the middle 1990s witnessed two temporary rises in such price margins due to inflation, the clear overall trend was one of declining price margins from the 1980s to the 1990s,. Therefore, when China started to liberalize agricultural prices, the implicit taxation through pricing instrument gradually eroded.

Besides the liberalization in agricultural sectors, marketized reforms in other sectors also contributed to the emergence of the issue of excessive rural taxation. In the course of the accelerated marketization that took place during the 1990s, the power of the central government to directly control the economy and local governments was greatly reduced. The center had previously been in firmer control of the macro-economy through its command of economic resources and regulations on investment and foreign trade. But from the mid-1990s, with the effects of broader liberalization and administrative decentralization, the center found itself incapable of establishing effective incentives and disincentives for local governments. The center’s response was to re-centralize fiscal revenues so that transfers could be used to help ensure policy implementation. Such revenue centralization imposed large pressures on county and township governments’ fiscal balance sheets and pushed them to find more resources on their own. Local governments then were forced to look for other ways to mobilize revenue. Taxing farmers through various fees was seen as a way out for many local governments in less developed regions.

A further channel through which the general economic transition affected the rural taxation has been the economic restructuring of local SOEs and TVEs. That contributed to the expansion of local bureaucracy and perpetuated the rural tax problem With a significant restructuring of local SOEs and TVEs from the middle 1990s, ex-leaders and the well-connected employees of the bankrupt SOEs and TVEs shifted to local government agencies and public service units both at county and township level. This was more serious in less-developed regions when local SOEs and TVEs experienced fierce competition from enterprises from more developed regions.
Note: the provincial price margin is approximated by first calculating the average price of the grain sold in the free market to the average price of the state-procured grain for all the households surveyed in a village, and then calculating an arithmetic average of all villages within a province. Adopting such an approach avoids the possible heterogeneity in grain varieties across villages within a province.

There is a further channel through which the liberalization of the agricultural sector affected rural taxation, namely through the gradual decline of state grain quotas. The gradual erosion of state grain procurement quotas made it increasingly infeasible for the township and village officials to deduct taxes and fees before paying farmers for their state grain quota delivery. As a result, local officials now had to draw taxes and fees directly from the farmers’ pockets. This raised significantly the costs of tax collection, and in turn raised local cadres’ administrative work and personnel costs. In response, even higher local fees had to be collected to compensate for revenue shortfalls.

Still based on the MOA data, there was decreasing availability of direct tax deduction via the grain procurement system. Figure 6 shows the share of taxes and fees that could not be deducted beforehand via the state grain procurement system for all the 10 provinces in RCRE data set and also for two provinces of Hunan and Zhejiang from 1987 to 1999. From the figure, there was a clear tendency for this share to rise, thereby illustrating the decreasing capacity to deduct taxes and fees beforehand via the grain quota system.
Now we turn to the third question, i.e., why was the issue of much greater concern in agriculture-based regions? This is because the higher level of industrialization, and thus the larger non-agricultural tax base, in coastal regions contributed to their lower taxation on agriculture. It is more cost-effective, on average, to collect a unit of tax from an industrial firm than it is from individual households, especially when implicit taxation via pricing instruments becomes less readily available with the deepening of marketization.\footnote{As Zhang (2005) has argued, regions with faster industrialization prefer to levy taxes on industrial firms. Moreover, the industrial base creates a high opportunity cost for labor. When there are abundant high-paying jobs available, the job of collecting taxes from individual households may be unappealing.}

Using supplementary county level data that matches the Ministry of Agriculture data, Figure 7 presents the industrialization level by province for the 1995, 1997 and 1999.\footnote{Our county data comes from the China Statistical Material for Prefectures, Cities, and Counties Nationwide, published by the Ministry of Finance 1994-2003.} One can observe that the industrialization level varies considerably across provinces. Over the years, the industrialization level has increased. In 1999, the share of industrial output was as high as 90 percent in Zhejiang and Guangdong, but only 50-60 percent in Jilin and Gansu. In sum, when marketized reform rendered implicit taxation through pricing less likely, the erosion of the grain procurement system made it less handy to deduct taxes and fees prior to grain quota payment.
payment, the cost of collecting taxes directly from individual rural households rose. If that cost exceeds the revenues generated, it is more cost-effective for the local government to forego such taxes and make up the lost revenue from industrial firms. However, in regions with slower or little industrialization, local governments have no other option but to directly levy fees on individual farmers.\footnote{13}

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{industrialization.png}
\caption{Industrialization Level by Province: 1995, 1997, 1999}
\end{figure}

**Note:** the provincial industrialization is approximated by first summing the industrial output of all counties within a province in which the Ministry of Agriculture has fixed-point village for its survey, and then divided by the sum of industrial and agricultural output of these counties.

\footnote{13 Though local governments in more industrialized regions have access to more revenue from growing manufacturing and service sectors, farmers in these regions have not been exempted from local government predation. Compared to their counterparts in less developed regions who were taxed more explicitly, farmers in more developed regions were mostly exploited through appropriation of their land. With faster industrialization and urbanization contributing to rising land values, rural land requisitioning has increased significantly in suburban areas and in places that lie in the way of main transportation projects such as roads, highways and railroads. Under a problematic land requisition system, local governments in developed regions have established a large number of industrial parks and urban new development zones by expropriating arable land from farmers without reasonable \textquoteleft define\textquoteright compensation. Revenue-hungry city governments have every incentive to tax farmers implicitly through aggressive land requisition since such land revenues fall into the locally controlled extra-budgets. As extra-budget revenues, such incomes in principle are to be used to finance urban infrastructure development. However, lack of transparency often makes it difficult to monitor and rent-seeking involving collusion between land developers and local governments has been pervasive and has significantly undermined farmers' interests (Zhou, 2004).}
3. Rural tax and governance reforms: policy responses and an initial assessment

3.1 Rural tax reform: evolving policies

To accommodate the bitter complaints from farmers in less developed regions about heavy tax burdens, a series of policy changes have been installed by the central government in recent years. These reforms were first introduced on a local level pilot basis in 2000, and then promulgated as a national initiative. In March 2000, the central committee of the CCP and the State Council issued the “Circular on Implementing Pilot Project of Rural Taxation Reform”. It announced that rural tax reform would be carried out in the Anhui province on a pilot basis at the beginning in 2000, and that other provinces could select a few counties or cities as their own pilot projects. By the end of 2001, in addition to Anhui province, Jiangsu provincial government also decided to carry out pilot rural tax reforms in the entire province according to its own reform agenda. In 2002, 20 provinces in China already began their rural tax reform on a pilot basis. In the years before 2004, rural tax reform consisted of the following elements: (1) Abolish the existing township pooling funds, but raise the agriculture tax rate to 7%; (2) Abolish the three village levies. Remuneration of village cadres, social relief and administration expenses, which used to be financed by village levies are now financed by a so-called “agricultural tax supplement”, which could be no more than 20% of the baseline agricultural tax.14

In general, the reform measures in the earlier period can be characterized as a “fee-tax swap”, which was intended to remove all fees and replace them with agricultural taxes (and the agricultural tax supplement as township and village revenue). By disallowing local governments to levy any informal fees, the higher-level governments hoped to halt the trend of increasing rural fees charged to peasants. However, these measures did not address the issue of regressive taxation since the agricultural tax rate was raised. These policies made local revenue

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14 In addition, the slaughter tax was also abolished and farmers’ compulsory labor would be gradually abolished. There was also adjustment of the agricultural special product tax with tax rates for cash crops slightly higher than the baseline agricultural tax rate.
at the county and township level more dependent on the agricultural tax. They could only aggravate the regressive nature of rural taxation, since lower-income groups are more dependent on agricultural income.

Since 2004, the central government has begun to readjust its agricultural tax policy by accelerating the pace of rural tax reduction. In 2004, pilot programs to fully exempt farmers from agricultural tax were run in the Northeast provinces of Heilongjiang and Jilin. Another 11 agriculture-based provinces were asked to cut their agricultural tax rates by 3 percent that year, and all other provinces by at least one percent per year. The center also stated that the relatively developed provinces could move faster in rural tax reform. Premier Wen Jiabao promised in 2004 that all agricultural tax would be phased out within five years. By the end of 2005, 28 of 31 provincial areas in China’s mainland have exempted farmers from agriculture tax. A further step was taken in 2005 when the center announced the phase out all agricultural tax at the beginning of 2006.

As a coordinated policy, the central government increased transfers to compensate for local revenue shortfalls. In 2002 and 2003, the center transferred CNY 17.9 billion and 30.5 billion respectively to compensate local governments (mainly in inland agriculture-based regions) for revenue shortfalls. In 2004 and 2005, such transfers were further increased to RMB 51.0 billion and 66.4 billion respectively.

Along with the rural tax reform, the Chinese government also began to streamline its local bureaucracy by downsizing local governments and cutting personnel expenditures. From the very beginning, the restructuring of rural governments and staff reductions have been the core components of the rural tax reform. The central authority realizes that downsizing has become an essential source of the savings needed to offset revenues lost through bans on local government fees and levies. In many localities there have also been measures to consolidate villages, townships, and school districts to create more efficient scale for service provision. For example, smaller townships have been merged to larger ones and the number of townships in China was reduced from 43735 in 2000 to 38028 by 2003 (Zhao, 2005).
3.2 Policy impacts: a mid-term empirical evaluation

3.2.1 Farmers’ tax burden

Rural tax reform has significantly reduced farmers’ tax burdens. Based on a large survey of 60 villages randomly selected across 6 provinces in China collected by the Center for Chinese Agricultural Policy at the Chinese Academy of Sciences in 2005 (CCAP data set hereafter), we are able to examine the farmers’ tax burdens across localities. Table 2 presents farmers’ tax burdens in 2000 and 2004. These include the so-called “legally permitted taxes” such as the agricultural tax, township pooling funds and village levies (before the reform), agricultural tax supplement (after the reform), and compulsory labor. Though the rural tax reform has prohibited most miscellaneous informal levies, in practice local governments still levy farmers through some fund-raising and various administrative fees. The latter includes vehicle plate fees, marriage certificates, and user charges for residential land. Therefore, we also put them together under an item of miscellaneous informal levies in Table 2.

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15 The survey covers 120 villages, 60 townships and 30 counties located in 6 provinces in China. One province was first randomly selected from each of China’s major regions. These are Shaanxi (NW), Sichuan (SW), Hebei (Central), Jilin (North/NE), Jiangsu (East) and Fujian (East/South). Then 5 counties were identified in each province by ranking all counties within the province according to measure of income and selecting one county per quintile. Next, two townships within each county were randomly selected and two villages in each township were randomly selected. In each village 18 rural households were selected for surveys.

16 The value of compulsory labor is calculated in monetary terms. For 2000 it is CNY 6 per labor-day and for 2004 CNY 10 per labor day.
As shown in Table 2, the total farmers’ tax burdens fell significantly with the introduction of rural tax reform. For all the farmers surveyed across six provinces, the per capita taxes and fees dropped by more than half from CNY 145 in 2000 to CNY 72 in 2004. However, the reduction was purely due to changes in the “legally permitted taxes.” They dropped by 71 percent from CNY 103 per capita in 2000 to CNY 30 per capita in 2004. For the “miscellaneous informal levies,” the per capita levies did not change with a per capita level of CNY 42 for both 2000 and 2004. Within the “legally permitted taxes,” township pooling and village levies dropped by 85 percent while agriculture tax and supplement also dropped by 70 percent. Within the “miscellaneous informal levies,” the 3 percent drop of administrative fees was offset by a 4 percent increase of local fundraising. Apparently, the rural tax reform has significantly changed the structure of tax burdens. Before the tax reform, “legally permitted taxes” comprised around 71 percent of total tax burdens, but by 2004 to the figure was only around 40 percent. In overall terms, farmers’ tax burdens as a share of their net incomes dropped from 6.5 percent to 2.4 percent during this period.
Table 3 shows the tax burdens by province in 2000 and 2004. As shown in the table, there is huge regional heterogeneity both before and after the rural tax reform. In 2000, Jilin province had a per capita tax burden of CNY 214, while in both Fujian and Shaanxi the burden was less than CNY 80. By 2004, Jiangsu had the highest per capita tax burden of CNY 147 while Shaanxi had the lowest burden of CNY 24. Though all provinces witnessed a reduction of taxes, the changes were spatially very uneven. There was a drop of around 80 percent for Jilin, but only a 20 percent drop for Jiangsu.

There was also significant regional heterogeneity in the changes of “legally permitted taxes.” This is basically consistent with the progress of different provinces in tax reform. In 2000, per capita “legally permitted taxes” were around CNY 150 in both Jiangsu and Jilin, while Fujian was lowest at CNY 32. In 2004, this figure dropped to less than CNY 10 for Fujian, Jilin and Shaanxi, while in Jiangsu it remained at a relatively high level of CNY 88. The fast change in Jilin was due to its reform policy, which fully exempted farmers from agricultural tax in 2004, while the relatively developed province of Fujian had a low tax even back in 2000 and took further steps to exempt all “legally permitted taxes” in 2004. The change of “miscellaneous informal levies” also varied from one locality to another. While Sichuan, Jilin and Shaanxi witnessed a drop of 20 percent from 2000 to 2004, the per capita “miscellaneous informal levies” in Jiangsu and Hebei grew by 20 percent.

In summary, the rural tax reform has led to a significant decline of overall rural tax burdens. Thanks to the tax reform and other policies to benefit rural agriculture, farmers’ annual income growth has picked up quickly to 4-6 percent at least in the past 3-4 years. Complaints about excessive informal fees have gradually declined in rural China. With lower taxes, increasing numbers of farmers now find agriculture more attractive. Many now opt to stay in the countryside, since higher income growth from agriculture has raised the opportunity cost to rural laborers who seek off-farm employment in cities. This helps to account for the labor shortage experienced by some of China’s urban manufacturing centers in the past several years.
3.2.2 Impacts on tax among villages with different income level

The rural tax reform has also helped to address the issue of regressive tax in the countryside, and partially alleviates the ever-enlarging rural income disparity. This is because, prior to the reform, poorer farmers were paying the lion’s share of rural taxes and fees, while the richer farmers earned most of their income from off-farm sources, and thus were less subject to agricultural taxation. Let us first look at tax burdens across provinces. Table 3 gives the per capita net income of farmers for 6 provinces. From the Table, we can see that, except in the relatively developed province of Fujian, which already had a very low tax rate in 2000, all other provinces had a tax rate ranging from 6.4 percent to 12.1 percent in 2000 and provinces with lower incomes tended to have higher tax rates. However, by 2004, the tax rates for all six provinces had declined and the range became much smaller, indicating a much less regressive tax regime across provinces.

We further look at this issue at a more disaggregate village level. Based on the same data collected by CCAP, Table 4 presents the average tax burdens for villages of different average incomes. Both for 2000 and 2004, all villages surveyed are divided into four income groups, each of which has approximately the same number of villages. In 2000, villages within the lowest-income group (per capita average net income of CNY 764) had an average tax rate of 17.3 percent, while those in the three higher-income groups had average rates of 10.6, 6.0 and 3.3 percent, respectively. The corresponding numbers for 2004 are 3.5, 3.2, 2.5 and 1.7 percent, respectively. Apparently, the tax also became less regressive across villages with the introduction of rural tax reform.
4 Rural tax and local governance in China: institutional logic and remaining challenges

4.1 The Institutional logic of rural tax and local governance in China

The issue of rural taxation that emerged in the latter half of 1990s in China reflected a tension between the country’s increasingly decentralizing and liberalized economic system and the still centralized political system. Even though China has made significant progress in economic liberalization in the 1980s and 1990s, the country has maintained a centralized political system with the Communist Party as the single ruling party and local officials appointed from above.

Under continued political centralization with no election mechanism to reveal voters’ preferences and to monitor local governments from below, the policy targets of local governments have to be set from above and the performance of local governments is evaluated on the basis of how well or poorly those policy targets are achieved.\(^{17}\) To ensure that policy

\(^{17}\) At each level of government, there are performance indicators set by upper level government that are used to evaluate lower level government officials. These indicators usually include a number of economic targets such as the annual growth of local GDP, the revenue collected and the contributions to
targets are met, the center not only controls political appointments, but has strong incentives also to control formal fiscal revenues and spend them in the form of transfers. However, because the upper-level policy mandates need to be implemented locally and there is significant information asymmetry about policy implementation costs, transfers from above alone would be insufficient since local governments may always claim higher costs than the upper level transfers. Under such circumstances, local governments also have to be granted certain autonomy in local informal taxation. However, once such autonomy was granted, excessive rural taxation and abusive land requisition soon became socially, or even politically, destabilizing. Facing increasing complaints and social unrest from disgruntled farmers, the center, unwilling to yield political control, had to respond with further fiscal and administrative centralization to contain local transgressions. Indeed, China in recent years has seen a trend toward further centralization of fiscal powers. Besides the rural tax reform that deprives local governments of their power to tax informally, the center has begun to claim a higher share of the personal and enterprise income taxes that used to belong exclusively to localities. 19

4.2 Remaining challenges

In light of some of the serious problems that prevailed in rural taxation and the social unrest thus ensued, one can easily understand why the center has chosen to implement rural tax reform and other coordinated reforms in local governance and inter-governmental relationships.

higher levels of the state apparatus, the amount of foreign investment attracted, as well as various ‘social’ targets such as those for birth control, maintaining public security, raising school enrollments and so on (Edin, 2003). Successfully reaching or exceeding the targets set by higher-level governments is decisive for local officials seeking political promotion (Li and Zhou, 2005). Throughout the 1980s and 1990s, reaching the state grain procurement quota and implementing the birth control policy were invariably two essential policy targets to be fulfilled at the township and village levels in most agricultural-based regions (Liu and Tao, 2004).

19 Centralizing administrative measures have also been introduced in the rural land requisition system. Responding to protests by farmers about the inadequacy of land compensation, the center sent out many policy documents to local governments requiring them to constrain their abusive land requisition and raise compensation to farmers. The center also plans to centralize land requisition power to the provincial and central level by establishing a vertically controlled land management system with tighter land supply quotas and stronger supervision. Starting in 2005, numerous development zones have had to be removed and national inspection teams have been sent out. A newly-promulgated Party document has declared that China intends to establish and implement the most rigorous arable land protection system in the world to ensure farmers’ rights and national food security (State Council, 2004).
Nevertheless, serious challenges remain.

4.2.1 Difficulties in local government downsizing

The first challenge is how to downsize local governments after rural tax reform. Though many townships have been merged both before the rural tax reform and thereafter, downsizing local bureaucracy has been so far unsuccessful. A recent study by Zhao (2005) based on a survey across 10 provinces finds that out of 20 townships surveyed, 12 have the experiences of merging. However, personnel downsizing in township restructuring has been extremely difficult in practice because it involves breaking numerous “iron rice bowls.” Apparently, township heads have an interest in maintaining a system that allows them to offer employment and associated benefits to people who have supported the party or the government in certain ways. On account of this, even when townships have been merged, most of the cadres from the previous townships have remained and little genuine downsizing has actually occurred.

Government downsizing has been more difficult in less developed regions where there are fewer job opportunities outside of the government sector. Our own survey in Gansu, a less developed province where the private sector is weak and the highest wages are to be found in the government sector, found it is very difficult to institute any genuine staff lay-offs from government departments. In fact, after upper level authorities mandated that teachers’ and officials’ salaries be paid in full and on time, there has been a significant increase in the numbers of both teaching and administrative staff at township level public schools.20

The difficulties in downsizing local governments are also related to the large number of local government personnel and the general lack of a social security system at county and township level. In 1994, the number of fiscal dependents at the township and county level was

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20 In contrast, in one of the author’s field studies in Jiangsu, a province where the private sector is booming, some local cadres had left their government jobs for private sector jobs after recent reforms. Local governments in Jiangsu had also taken some measures to encourage laid-off cadres to seek jobs elsewhere. For instance, they sent some cadres to schools for further training whilst at the same time providing the payment of salaries for three years. They paid other cadres severance money in exchange for leaving their government institutions on a voluntary base. And they paid pensions to older cadres to encourage them to retire at an earlier age.
22.5 million, but by 2000 it increased to 29.6 million with a salary expenditure increase of at least CNY 100 billion. At present, the township and county level account for around 70 percent of all fiscal dependents nationwide, while they only control 40 percent of the fiscal revenue of the nation. This implies that most of the county and township expenditures go to salaries (World Bank, 2002). There are 12.85 million fiscal dependents at the township level alone (Zhao, 2005). However, China’s social security system has so far barely touched rural townships, and this is more so in less-developed regions where employment opportunities outside the public sector are much limited. Even under the “hunger therapy” of rural tax reform, local governments in these regions still dare not cut personnel and risk social instability; usually they opt to keep all employees and cut their salaries.

Under present circumstances, no matter how difficult it is to downsize in practice, continuing to keep existing cadres or admit new cadres on to the payroll is just not financially feasible. The ongoing rural tax reform means that local governments cannot levy money from the farmers and at the same time they receive only limited funds from upper level transfers. So in the longer term, a full restructuring of local government at township and even county level has to be carried out, and the downsizing of millions of existing fiscal dependents will be inevitable. Although some of the more able, younger or more educated staff cut from the township government agencies and local schools may find jobs through their own efforts, a significant number of the redundant staff will find it difficult given their age, education and limited working experience. Under such circumstances, fiscal transfers from upper level governments, or more generally, a social security system that includes unemployment insurance, medical insurance and pensions needs to be set up to avoid large scale unemployment in rural townships and ensuing social instability.

4.2.2 Inadequacy and ineffective use of upper level transfers

Serious concerns also exist with regard to the adequacy and effective use of upper level transfers. The rural tax reform has largely eliminated the ability of township governments to generate self-raised funds from agriculture. However, there have been insufficient upper-level
transfers to many less-developed regions. According to Zhang (2005), rural tax reform has led to a reduction of around CNY 150-160 billion of agricultural taxes and fees in 2005. However, the central transfer was only CNY 66.4 billion. By banning extra-budgetary levies and by replacing them with only limited transfers, the government has caused local budgetary situations to deteriorate significantly. For example, based on the CCAP data set, we found that Jilin province had an average township surplus of CNY 67,000 in 2000, but this turned to a deficit of CNY 81,000 by 2004. In Hebei province, the average township deficit increased from CNY 1.13 million in 2000 to CNY 1.52 million in 2004. As far as township debt is concerned, township net debt rose in all surveyed provinces except Sichuan. In Jiangsu province, the average township net debt increased from CNY 4.56 million in 2000 to CNY 14.36 million in 2004. Under some extreme cases, insufficient transfers and huge deficits and debt have resulted in townships collapsing into county administrative shells. With much lower revenue and inadequate transfers, many townships inevitably have become less effective in providing basic services.

Even if local bureaucracy downsizing succeeds and higher transfers from above are realized, there is still a question of effective use of upper level transfers. Though these measures may help to alleviate the serious financial shortfall in China’s countryside, they have not helped to raise local government incentives to effectively provide public goods and services that cater to real local needs. Given that most of China’s fiscal grants are in the form of earmarked transfers that have designated uses, spending financing through such transfers necessarily limit local spending autonomy and would reduce local incentives to use these resources effectively. Since these funds are allocated from above and the performance has to be evaluated

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21 After the 1994 fiscal reform, the center has gained a great deal of allocative control. However, a large share of central revenues is returned to the localities through the relatively discretionary earmarked transfers rather than the formula-driven equalizing general-purpose transfers (World Bank 2002). The fact that the center had significantly increased earmarked transfers to local governments is perhaps because the center knew local governments might divert general-purpose transfers to bureaucratic expansion and staff wages, rather than to public goods and services that reach the villagers. However, usually decisions on these earmarked transfers are made in very arbitrary way that has led to tactics of extensive negotiation, unhealthy competition, political performance that caters to higher level, and further rent seeking by local authorities.
by certain “core” indicator that are relatively easy to monitor, local governments competing for upper level transfers have strong incentives to showcase in fiscal spending and investment that usually does not bring even short-term benefits to the poor rural population. In the end, these transfers may usually degenerate into poorly targeted patronage-type programs that provide grants too small and dispersed to meet basic needs in poorer regions and help the poor rural people effectively.

In another word, even if central transfers can be established, under a centralized political system with little local government accountability, there still exists no institutional mechanism to ensure that such transfers will be used effectively to provide for real local needs. The upper level government would have difficulty to adequately track where, how, or how much public money is spent, what services the public sector delivers, or how many people the state employs. Under a circumstance in which government downsizing is very difficult to implement, enhancing transfers may only result in more political competition for the transfers that are used to fill the shortfall in personnel expenditure. Our field investigations in the less-developed province of Gansu in 2004 found that, after the rural tax reform, although the central government had significantly increased transfers for rural education, the local finance bureau diverted almost all of the transfers for school operating expenditures to other uses. Another study by Xu et al (2004) on the subsidy delivery of China’s Sloped Land Conversion Program (Grain for Green) in three western provinces from 1999 to 2002 also found that almost all cash subsidies and a significant share of the grain subsidies to participating farmers had been appropriated by local governments to compensate for local fiscal shortfalls.

An alternative approach is to link local finance and fiscal authority more closely to local government’s service provision responsibilities and functions, so that local officials will have higher incentive to effectively provide the needed public goods and services. This would mean 22 In these regions, transfers for teachers’ salaries were actually delivered because a delay in salary would likely result in immediate complaint, and also higher levels have stipulated that teacher’s salaries shall be directly deposited in bank accounts established for individual teachers. However, according to Wang (2004), lack of operating expenditures for primary and middle schools has particularly undermined the quality of education services in less developed regions.
that the center, while depriving local government of powers in arbitrarily collecting informal fees, need to grant local governments some formal taxation autonomy. This could be done, for example, by introducing property tax as a purely local tax.

4.2.3 Lack of local government accountability

Therefore, a more fundamental challenge is how to reconstruct the accountability of local governments in the post-tax–reform period. Unfortunately, the current reforms, by further centralizing political, administrative and fiscal powers to the county level, run the danger of reducing governments’ accountability to local populations and weakening their incentives to serve local needs. This is evident from local governance reform experiments in recent years. One approach that has recently gained increasing currency is to abolish the township as a level of local government altogether and set up county-designated administrative branches at township level to provide key public services. In the inland province of Hubei, local governance reform pilots along this line have been carried out in quite a few prefectures with strong support from the provincial government. However, given that many townships have a population of over 100,000 after township merging, it is difficult to imagine how such a large population could be effectively served through a number of county administrative branches and how coordination between different county level agencies could be achieved at township level. More important, because these officials are appointed by county line bureaus and their salaries are dispatched from above, they may have even less incentives to serve the local populations.24

An alternative, perhaps more effective approach to promote local government accountability is expanding local democracy. In another inland province of Sichuan, this approach emerged largely as a result of a discursive opening on expanding grassroots

24 A similar accountability issue is also present in rural land requisition in urban expansion. The central government’s reaction is to further centralize power in land administration by tightening local land requisition quotas and raising compensation. Even if this could limit abusive land requisition in the short term, it is unclear whether such policies could last long because of the high monitoring costs. Unless there is a functioning land-use change market in the process of urbanization and local governments can be granted some formal taxation autonomy on land-use changes (such as through a land value added tax), they will still have an incentive to predare by grabbing farmers’ land (Tao and Xu, forthcoming).
democracy to higher level as local leaders endeavored to promote their careers by taking the lead in initiating electoral reforms. Rather than abolishing township governments, this approach aims to empower them by expanding grass-roots democracy from the village level further to the township level. Experiments to directly elect township party secretary and township heads have been held in this province for the past several years. Unfortunately however, such experiments have been recently stopped due to intervention from higher level governments.

5 Conclusion

Given the enlarging urban-rural divide and serious lack of public services in rural China, the Chinese government’s new policies of rural tax reform and more funding for the “New Socialist Countryside” are certainly laudable. However, the center’s attempt to improve rural livelihood by exempting farmers from taxes and transferring more financial resources from above may prove unsuccessful if coordinated reforms in local governance are not in place.

In the case of rural taxation, to sustain tax reduction after rural tax reform, local governments need to be significantly downsized. Even though the central government fully understands this need, effective downsizing can only be achieved when there is a well-functioning social security system at local level for the laid-off cadres from townships. Under the current regime, higher transfers from the center might simply lead to fund diversion to maintain the local bureaucracy and reduce the local cadres’ accountability for local needs. This issue of low local fiscal accountability may be partly addressed by granting local governments some formal tax autonomy such as installing local property tax. In the long run, a better functioning local governance regime to achieve “harmonious development” as advocated by the center may necessitate more meaningful participation by expanding local democracy.

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