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# Non-Tax Levies in China: Sources, Problems and Suggestions for Reform

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Non-tax revenue refers to all kinds of government revenue except taxation; it includes user charges, fees, fines, and revenue from government capital and government funds.<sup>1</sup> A wider definition of non-tax revenue would also include debt, but while it accounts for a large portion of non-tax revenue, debt will not be discussed in this article, because it is quite different in nature from charges and fees. In developed countries, non-tax revenue has little importance in financing government, although its importance as a source of government finance has increased since the 1980s (Anderson, 1991). However, in most developing countries, it is an important financial source for governments, in particular local governments. World Bank research on 21 developing countries covering a period of almost two decades suggests that non-tax revenue accounts on average for one-third of local government revenue.<sup>2</sup> In China, it is the main source of local government<sup>3</sup> revenue and is also an important revenue source for the central government.

In China, the proliferation of non-tax levies has important political and social implications. This article will discuss these implications by considering the mechanism and sources of non-tax revenue. The main argument will be that, because of the strong independence and expertise of local government, viable approaches to reforming charges and fees have to create the correct incentive structure for local government to co-operate. Policies that do not have the co-operation of local governments or that threaten their revenue base, such as the recent tax-for-fees programme, will be thwarted at the local level.

This article is organised as follows. The next section provides an overview of the scale and structure of non-tax revenue in China, followed by a section

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1. In China the latter two refer to revenue from state-owned enterprises (SOEs) and various funds established by the government.

2. This research investigated 37 cities in developing countries which included Bangladesh, Bolivia, Botswana, Brazil, Colombia, India, Indonesia, Iran, Jamaica, Kenya, Republic of Korea, Nicaragua, Nigeria, Pakistan, Peru, Philippines, Thailand, Tunisia, Venezuela, Zaire, Zambia. The period covered was from 1968 to 1986 (see Bahl and Linn, 1992: 33-40).

3. In this article 'local' refers to all government units at the provincial level and below.

which considers the mechanisms underpinning non-tax levies. The socio-economic impact of the proliferation of non-tax levies is then examined, followed by a consideration of certain recommendations for the reform of existing policies. The obstacles to reform are then examined, focusing on the central-local tensions in China. The final section concludes with a discussion of which changes are feasible in the light of China's current economic conditions.

### **An overview of non-tax revenue in China**

There are three main types of government revenue in China — budgetary revenue, extra-budgetary revenue (EBR) and non-budgetary revenue (NBR). Budgetary revenue consists of taxation, revenue from enterprises, the Energy and Transportation Key Construction Fund (ETKCF), the Budgetary Adjustment Fund (BAF), extra charges for education, subsidies to loss-making enterprises and other revenue. If all items other than taxation are included in the category of non-tax revenue, the share of non-tax revenue in budgetary revenue<sup>4</sup> dropped nearly 10% from 18.8% in 1985 to 9.27% in 1998. This indicates that the importance of non-tax revenue in budgetary revenue has been falling.

As EBR and NBR are not included in the formal budget some researchers refer to these as 'off-budget funds' (see, for example, Wong, 1997; Brown, 1998). Extra-budgetary funding dates back to the beginning of the 1950s, while non-budgetary funding is a more recent phenomenon. All of the revenue items in the extra-budgetary category are non-tax revenue comprising various kinds of funds, fees and charges. There are three sub-categories of extra-budgetary funds: local government, administrative agency and enterprise extra-budgetary funds. The first two are fiscal funds, made up of a range of fees and surcharges, while enterprise extra-budgetary funds comprise relatively few sources, with retained earnings, depreciation and major repair funds of enterprises making up over 90% of the total. At the beginning of the 1980s, supervisory departments could exercise extensive control over the use of these funds, and could even block the bank accounts in which they were mandatorily held. However, with increased enterprise independence, the government's control over these funds has diminished, making it increasingly inappropriate to include them in a fiscal fund. As a result, since 1993, enterprise extra-budgetary funds are no longer included in EBR. Therefore, only administrative and local government EBRs are comparable pre- and post-1993.<sup>5</sup> Of the three kinds of revenue, NBR is the most

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4. The term 'budgetary revenue' used here is adjusted to take account of subsidies to loss-making enterprises.

5. From 1997, a new category, 'Revenue from Fund-raising Programmes of Township Governments,' is listed as a component of EBR.

difficult to pin down. This form of revenue has become prominent since the market reforms started and has been given several names.<sup>6</sup> It is difficult to ascertain the exact size of NBR because of the reluctance of local governments to disclose all of their available resources. However, in general, NBR consists of four main funds; extra-legislative funds, government fund-raising and cost-sharing, fees and fines and transferred funds.

Extra-legislative funds comprise administrative funds, education funds, housing funds and, perhaps most important, different forms of social welfare funds. Revenue from cost-sharing is used to provide local public goods such as road and bridge construction, hospitals and schools. Local governments, in particular in cities and towns, rely largely on this source to finance local infrastructure. This type of revenue is also an important source for township and village governments in providing staff salaries and meeting running expenses. In rural areas the most popular revenue-raising devices are unified and retained levies. In most cases these are levied as fixed quotas on each household.

Local governments and administrative agencies have considerable power to impose fees and fines arbitrarily. There is a range of avenues to accomplish this, including making enterprises attend fairs and charging them high registration fees; making enterprises purchase designated products; and issuing decrees which impose fees. These forms of revenue are important sources for the 'small treasury' (*xiao jinku*), which is popular in units of all levels and is used for autonomous expenses. It is estimated that billions of illegal funds contribute to the 'small treasury' each year (Jia and Bai, 1998).

Theoretically, no fund can be established in China without the permission of the central government. However, one investigation revealed that, of the 519 funds established between 1990 and 1996, only 37 funds, or less than 10%, gained the prior approval of the central government (Ma, 1997). Ministry of Finance statistics suggest that in 1997 there were 530 different types of fees levied on vehicles in the transportation sector alone, 245 of which were unauthorised (Shen, 1998).

Transferred funds refer to funds illegally transferred from the extra-budgetary fund, or even the budgetary fund. Extra-budgetary funds must be deposited into a special account, but it is still estimated that 30% of EBR is not deposited into the designated account (Lu, H., 1998). Recent data collected from the 'Inspection of Finance, Taxation and Price' shows that EBR should have been 384.3 billion RMB in the mid-1990s, which is 143.7 billion RMB more than what was reported (Wan, 1998).

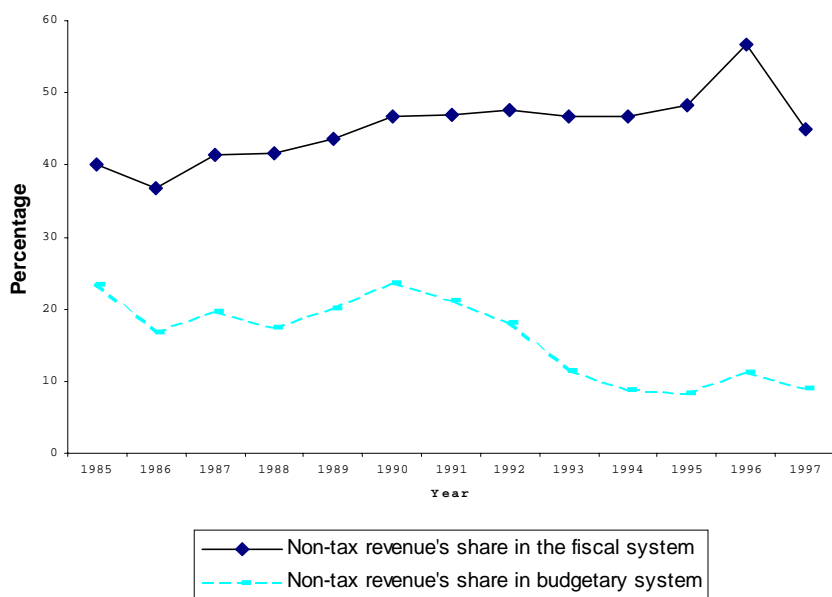
Overall, it is difficult to put an exact figure on the size of non-tax revenue in China. As Lee (1999:3) states, 'There is no systematic statistics of the non-tax

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6. Some of the names used are extra-legislative revenue, the third budgetary revenue (since EBR is called the second budget) and abnormal revenue.

revenues simply because many types of the revenues are informal or even illegal'. However, as a rough approximation, the amount of non-budgetary revenue might be taken as approximately equal to the size of the extra-budgetary fund. This extrapolates from several studies suggesting that the bulk of non-budgetary revenue is about 50% of budgetary revenue (see Jia and Bai, 1998; Lu, H., 1998; Wong, 1997; Yang, C., 1998). Based on this estimate, the share of non-tax revenue has grown from 36.86% in 1986 to 56.75% in 1996 (see Figure 1). Figure 1 suggests that as a whole non-tax revenue is a more important source of revenue than taxation.

**Figure 1**  
**Non-tax revenue's share in fiscal and budgetary systems**



Note: The figure of non-tax revenue is an estimation which is double the Extra-budgetary Revenue plus the non-tax revenue in budgetary revenue.

Source: ZTN, *China Statistical Yearbook* (1998, 1999).

## Mechanisms underpinning proliferation of non-tax levies

### *Fiscal decentralisation*

Fiscal decentralisation created a linkage of interests between local government and enterprises. Even before market reforms were launched in 1978, the locus

of decision-making in China was much more diffuse than in Eastern Europe or the Soviet Union. China's administrative structure is multi-tiered and multi-regional. From the province down to the township and village, each level of government is an organisational and hierarchical mirror image of higher levels, meaning that the same functional departments are duplicated at each level of government (Granick, 1990; Qian and Xu, 1993).

Before the reform, the linkage between the government and state-owned enterprises was an administrative one. With decentralisation, the linkage between the government and enterprises is still strong, but the administrative aspect has faded, while the interest aspect has become stronger. With the devolution of administrative power from the central government and the planning department, functional departments and, in particular, lower-level governments have acquired more independent control over resources and hence have greater autonomy in developing the regions or managing the industries under their respective jurisdictions. Local government decisions have a strong influence on the profitability of enterprises, given that their power and resources are fairly flexible. Thus, enterprises are often prepared to pay non-tax levies either to avoid undue local government interference in their business activities or in anticipation of preferential treatment from local government, even if the fees are perceived as being unfair.

In China's fiscal system, taxes are collected by agents at lower levels and shared upwards with higher levels of government according to revenue-sharing arrangements which are decided by the higher authorities (Oi, 1992; Wong, 1992). While local autonomy is very limited, local governments still have de facto control over the revenue base, and this is exercised by means of control over the tax contract with enterprises.<sup>7</sup> Another method of expanding the local revenue base is by offering tax relief. Provincial governments have the authority to grant temporary exemptions of up to RMB 30,000 per application for enterprises in financial difficulties, and this authority is often delegated to sub-provincial level. This form of tax relief is used to expand the local revenue base, since it is employed either to help enterprises finance capital investments or is offered as a favour in exchange for future co-operation in collecting non-tax levies.

However, fiscal decentralisation has not simply opened up new opportunities to impose non-tax levies, but, from the perspective of local government, has also made the introduction of non-tax levies a financial necessity to meet revenue shortfalls. An unintended result of fiscal decentralisation is that it has starved local governments at all revenue levels (Wong, 1991). At the same time,

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7. Since the mid-1980s enterprises sign contracts with the government to decide the remittance of profits and other responsibilities of the enterprise and are expected to remit the quota on the contract to government.

it has forced lower levels of government to take on more expenditure responsibilities. Some of these have been transferred from the centre and some, such as the increased demand for local public goods, reflect economic development. Local governments in China, however, are not just responsible for local public goods in the usual sense, such as public utilities, but are also responsible for 'special' public goods which are manifestations of economic transition. These include so-called 'vegetable basket projects' which have been set up in almost all Chinese cities to meet the local demand for staple items such as eggs, fish, meat and vegetables.

There are few restrictions on the central government's power to transfer more responsibilities to lower levels. The problem facing local governments is that, once the revenue-sharing arrangements were put in place in the mid-1980s, it has been difficult (if not impossible) to get additional funding from higher levels of government to finance their budgets. There are strict restrictions placed on local government borrowing and the extent to which local governments can impose new taxes.<sup>8</sup> Hence, when expenditure exceeds revenue, often the only choice left is to impose non-tax levies, which are flexible. Compared with taxes, non-tax levies are also more acceptable in the sense that they are supposed to be temporary measures, and the amount of each levy is relatively small. Thus, in most localities the authorities are able to impose charges and fees without the approval of higher authorities.

### *Instability of the revenue-sharing system*

China's revenue-sharing system is not stable and the border of revenue and expenditure between central and local government has never been clear. Many different revenue-sharing arrangements have been tried since 1940, although these arrangements can be roughly grouped into two categories: centralised and decentralised. Since 1980, the fiscal system has been characterised by decentralisation, as represented by the fiscal contract system. This means that the division of rights and responsibilities between the central and local governments is decided periodically by contract. Although there have been various contracts to accommodate differences in local conditions and financial status, the basic principle is the same. The central government sets the general rules, according to which a portion of the revenue collected is set aside as central government revenue and the rest is shared between central and provincial governments according to pre-set rates. Local governments enjoy

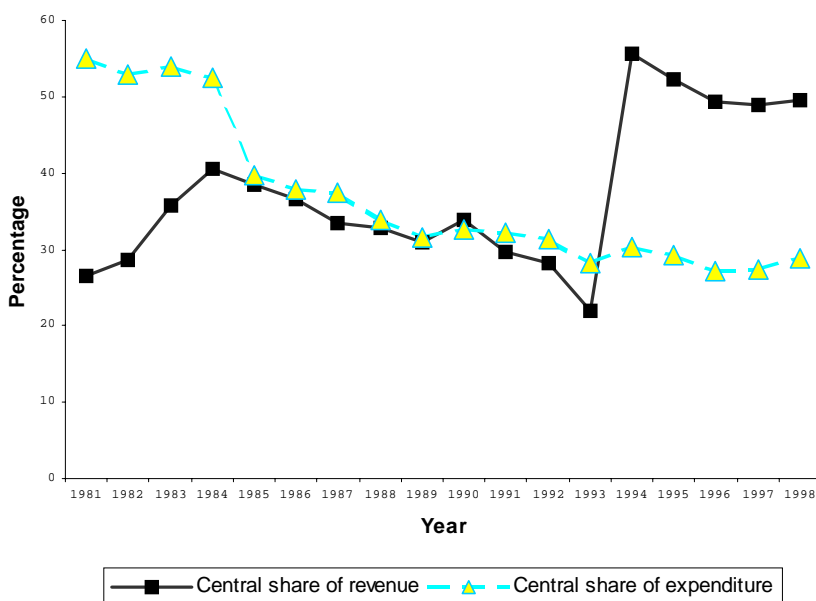
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8. There are strict limits on local government borrowing, either through issuing bonds or obtaining loans from financial institutions. However, in practice, they are able to exercise significant influence on the lending of local branches of state-owned banks - in fact, their influence is so strong that the People's Bank of China (the Central Bank) has decided to reform its organisational structure so as to limit this influence.

autonomy in local administration, including collecting taxes and providing local public goods. In other words, as long as the lower-level authorities reach the tax quotas set in the contract, they have full autonomy over the remaining resources.

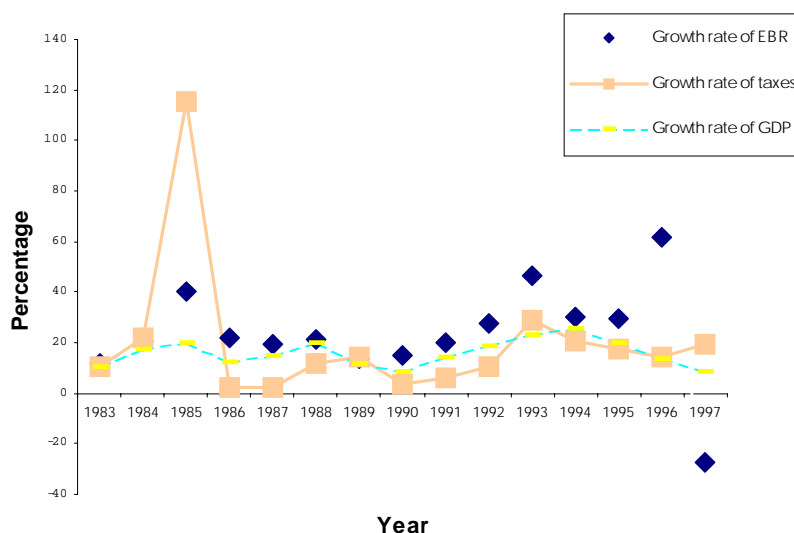
However, as the higher authorities could change the rules and did so, governments at lower levels found that greater revenue collection invited a higher remittance quota in the next round. Even if the revenue-sharing arrangement was not violated, a range of other components remained negotiable on a mainly year-to-year basis. In fact, throughout the 1980s, the central government repeatedly expanded the scope of the central share by means of 'centralising the ownership' of SOEs, introducing new taxes and 'borrowing' from local governments (Wong et al., 1995: 87-8). Figure 2 shows that the central government's share of revenue (before revenue-sharing) had grown from 15.5% in 1978 to nearly 50% in 1998 despite decentralisation. Hence, the confidence of local governments in the central government's commitment to revenue-sharing agreements is understandably low. One outcome of the instability of the fiscal system is that the central government's attempts to raise further its share of total revenue are being undermined at local government level.

**Figure 2**  
**Central government's share of expenditure and revenue**



Because of the pervasive mistrust between the different levels of government and even between different functional departments, the will of lower levels of government to keep revenue under their control is becoming increasingly strong. One way of achieving this is to transfer revenue from the 'taxable' sector (which the higher authorities control) to the 'non-taxable' sector (which local authorities control). As Whiting (1996: 71) puts it: 'Township officials ... employ discretion in the implementation of central tax policy in order to shift revenues from shared tax receipts to profit channels that the township alone controls'. Local government attempts to transfer revenue from the taxable to the non-taxable sector are reflected in Figure 3 which compares growth in taxation revenue with EBR.

**Figure 3**  
**Comparison of growth rate of taxes and EBR**



Note: EBR includes fiscal EBR only.

Source: ZTN, *China Statistical Yearbook* (1998, 1999)

### *Poor administration of tax system*

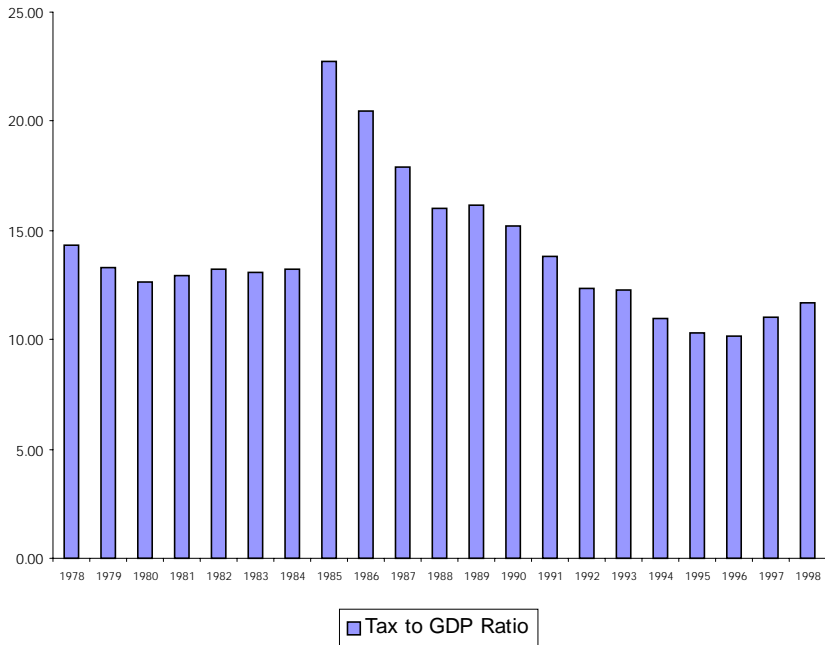
China's tax administrative system is not an effective way of collecting revenue. Figure 4 shows the ratio of taxation to GDP. The fact that this fell from 25 % in 1985 to 11% in 1998 reflects the difficulties facing the authorities. One study



estimates that the amount of taxation that should be, but has not been, collected is RMB500 billion (He, 1999). Taxation revenue runs off mainly through widespread tax avoidance/evasion and tax relief offered by the government. One study in the mid-1990s found that 72% of collective enterprises and 86% of private firms were involved in tax fraud (Wu et al., 1994). More recently, Wang (1999: 47) states that 'more than 90% of enterprises are involved in some degree of tax fraud or tax evasion'. As regards individuals, one estimate suggests that as few as 1% of taxable individuals actually pay income tax (Zhao, 1998). Irregular earnings are pervasive; these include a range of income-in-kind that is not taxed, including payment of travel and children's education expenses. These increased from one-third of regular earnings at the beginning of the 1980s to more than 70% in the 1990s. In the mid-1990s irregular earnings were larger than salaries (Zhang, 1996: 24). In a number of SOEs, irregular earnings are more than double regular income (Zuo, 1995: 47).

There are at least three factors responsible for this situation. The first is the widespread occurrence of cash transactions. Almost all individuals are paid in cash. Cash transactions are also popular in the enterprise sector as well. Most sole proprietors carry out all their transactions in cash, as do many other small businesses, such as private enterprises and township and village enterprises (TVEs); cash is even used in some of the transactions of SOEs, which violates government regulations. Large numbers of cash transactions make it difficult for the tax authorities to determine actual incomes and expenditures. In fact, in the case of small businesses that do not keep financial records, the tax authorities simply assess an estimated tax liability without regard to the actual income of the business. A second factor is loopholes in the tax legislation. While tax incentives are viewed as a means of increasing investment, standards for offering them and for tax relief are flexible. Thus, some enterprises find it easy to get legal tax relief by making full use of different types of tax preferences. Poor administration is a third factor contributing to tax evasion and avoidance. As mentioned above, the present tax system was drawn up in the mid-1980s; with the rapid expansion of new organisational forms, the lack of experience of new staff and the frequent adjustments in tax law and policy, the standard of administration is low. Low compliance rates amongst enterprises and individuals are exacerbated because there is no nationwide network to keep track of records.

**Figure 4**  
**Tax to GDP ratio**



Source: ZTN, *China Statistical Yearbook* (1999).

### *Limits to government power*

Budget maximisation is a common phenomenon in democratic regimes, provided that the welfare of the politicians and bureaucrats is positively related with the budget (Niskanen, 1975). The reason why this tendency has not led to the proliferation of tax or non-tax levies lies in the constraints on government power to implement levies, such as the media, elections, political opposition and legal procedures. In China, there is no competition for votes which means that the influence of public opinion is not as direct as in most Western countries. In addition, because the media are under state control, they are at best a dampened reflection of public opinion. The political restraints on government power are also weak. For instance, the People's Congress represents no obstacle to

imposing most non-tax levies because these are administrative charges that do not need the permission of the legislature.<sup>9</sup>

The immobility of the population has considerably reduced the function of the 'voting by moving' mechanism. Two factors hinder the mobility of individuals. One is the household registration system; the other is the absence of a nationwide social security system. It is still difficult to change registration, especially for rural residents who want to get city registration, although market-oriented reform has provided much greater flexibility in migration (Mallee, 1998; Knight and Song, 1999). Migrants face a complex set of rules, and all these regulations require the payment of fees (Hare, 1999). Most of the time, registration fees are high enough to discourage compliance (Zhao, 1995). This means that there is a high proportion of migrants in big cities who have not followed official registration procedures and, hence, still have to pay various levies to the government where they are registered even if they no longer live there. Moreover, they tend to pay higher charges to the local government of the area to which they have moved than residents who have registered. The mobility situation of enterprises is worse than that of individuals because non-tax levies are imposed on the plant, which is difficult to move, and thus cannot be avoided.

### **Implications of rising non-tax revenue**

On the positive side, non-tax revenue has reduced fiscal pressures and provided financial flexibility for many localities as well as contributing to local infrastructure and economic development. However, negative implications are also evident. First, implementation has been chaotic and non-transparent. Fees and charges are implemented more or less on an ad hoc basis. For example, one survey in Hunan Province found that TVEs were subjected to more than 100 different types of fees, paid to 60 odd administrative units and agencies (Furukawa, 1990). A study in Guangxi found that there were 1,481 different charges, 1,131 of which were directed at SOEs. These random charges, which mainly came from arbitrary fund-raising, fines and requests for donations, are worth 250 million RMB per annum.<sup>10</sup> A recent survey by the State Planning

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9. In stating this, it is important to stress that we are not suggesting that Western 'democracies' are truly representative nor that 'democracy' is an ideal solution to constraining governmental power. We also do not want to be seen as depicting China as a 'totalitarian' state in contrast to some utopian notion of 'democracy' in developed countries. The reality is more complex than this. All we are suggesting is that the constraints on government power in a developing transitional country such as China and developed democratic countries differ in degree.

10. Xinhua News Agency, 7 January, 1998 in Summary of World Broadcasts (SWB) - FE /3119/S1/6, 8 January 1998.

Committee showed that there were more than 560 abnormal charges nationwide imposed on firms in the electricity industry alone (Lu, C., 1998).

Secondly, non-tax levies have imposed substantial financial burdens on enterprises and households. In some cases excessive fees levied on households have caused social unrest. In 1993 social discontent forced local governments in several areas to reduce them. To make up the revenue shortfall, local governments started to take higher shares of the profits from collective enterprises. One study found that taxes, profit remittances, fees and contributions absorbed 65-75% of the pre-tax profit of TVEs in Jiangsu Province, 35-45% in Guangdong, and 53% nationwide (Ody, 1992).

Thirdly, the proliferation of non-tax revenue has amplified regional disparities. Prosperous localities have greater potential to earn more revenue and therefore provide better public services and facilitate local economic development. Moreover, the shift from tax to non-tax sources of revenue has not only been a growing source of revenue leakage for the central government, but has also resulted in tax environments that vary greatly across provinces. Richer provinces with lower revenue retention rates and broader non-tax revenue bases are more generous with tax relief, which has resulted in the outflow of capital from poorer regions.

### **‘Top-down’ solutions to the issue of non-tax levies**

Dissatisfaction with the system of non-tax levies is pervasive. To taxpayers it is burdensome, and to the central government it is a system that has been eating into central revenue. On the surface, local governments and other local administrative units seem to be the only winners, but on closer inspection it is not clear that even local agencies and governments will be long-term beneficiaries. Most local governments face tight budgets, and non-tax revenue does not represent a stable and sustainable financial resource. Moreover, the existence of numerous non-tax levies has also damaged the reputation of local governments. As non-tax levies do not have a clear legal basis, most people consider them to be unfair. This section describes some short- and long-term options in the light of the earlier discussion.

In the short run one solution to address the issue of weak limits on government power is market-preserving federalism (Qian and Weingast, 1996, 1997). Market-preserving federalism suggests that, when countries do not have a good chance of introducing sustainable democracy, a more favourable political environment can be created for initial development by promoting competition between local governments. It is argued that this introduces checks and balances between the central and local governments, which in turn provide improved protection for individual property rights. However, critics such as Wang and Chang (1998) stress that market-preserving federalism has a number of

limitations. For instance, short of constitutional protection, there are no guarantees that the central government will not reverse the power arrangement between different levels of government. Given this shortcoming, a more effective approach to limiting government power is to introduce legal procedures for setting government charges and fees. This entails submitting all of the intended charges and fees to the Department of Finance and presenting them to the People's Congress of the same level, before the final decision is made with the introduction of formal procedures for arbitrating complaints.

Budget reform is a medium- to long-term solution. As long as EBR and NBR continue to be accepted as part of the fiscal system, it will be difficult to make it open and transparent, because almost half of the government's financial activities are in 'black boxes'. Consolidation of the budget would have to be introduced in a series of stages. In the first stage it is important to cancel the functional department's power of collecting revenue. Under the current arrangements the guiding principle is 'who levies, benefits'; the units therefore have strong incentives to expand the levies. To cancel the functional department's power of collection would mean that it could still standardise the fees for the service that it provides, but the fiscal department at the same level would collect and redistribute the revenue.

In the second stage, the structure of fees and charges would need to be re-examined. The aim should be to abolish the levies collected for the 'small treasury', while the rest is classified into taxation, user charges and capital revenue. The levies that are in fact taxes should be treated like other taxes, while user charges should be retained by the local government to finance local public services and capital revenue should be assigned according to the ownership of capital. Once these steps have been put into place all extra-budgetary and non-budgetary items should be reflected in the formal budgetary system, thus cancelling EBR and NBR. At the same time, all revenue sources outside of the budgetary system should be made illegal and the head of the charging unit should be responsible for illegal fees.

### **Obstacles to 'top-down' reform**

These solutions depend on the co-operation of local governments. Without an analysis of state-local relationships in 1990s China and an acknowledgment of the powerful centrifugal forces in the country, these proposals for central government intervention sound somewhat naïve. A number of commentators have suggested that the central government's economic and political control of the provinces has weakened since fiscal decentralisation was first introduced nationwide in 1980 (see for example Shirk, 1990; Breslin, 1996). This is reflected in the rising prominence of 'localism'. Since the 1980s a new phenomenon known in China as 'duke economies' has emerged. This refers to

local economic protectionism in which provinces, acting as individual actors, restrict the flow of imports through the use of various non-tariff barriers. With the increasing importance of non-tax revenue in financing localities, government reliance on enterprises has grown as well. To maximise non-tax income, local governments protect local enterprises. To protect enterprises, localities help them to keep competitors out of local markets as well as tolerating or even encouraging illegal activities, such as forgeries.<sup>11</sup>

In this context it is logical for local authorities to resist, or attempt to avoid, central directives to abolish fees. In an attempt to address the issue of irregular levies, the Central Committee and State Council proposed in 1997 the 'Decision on Tackling the Problem of Levying Unreasonable Charges, Fines and Apportionments on Enterprises'. This announced that all charges and levies on state-owned enterprises had to be reported to the central government and be fully accounted for. It also called for a 'uniform cut' in the number of charges and levies. The problem with implementing the 'Decision' document was that, although it stated that a small number of charges could be retained, local governments continued to impose a number of charges with a view to resubmitting them for approval at a later date.

The difficulty that the central government faces in obtaining local co-operation for reform is also reflected in China's recent 'tax-for-fees' programme designed to convert unofficial charges and fees into taxes (*fei gai shui*). This was based on a joint proposal released in 1998 by the Ministry of Finance and the State Development and Planning Commission to reduce about 80% of local fees. If the plan had been fully implemented, total fees levied by local governments would have been reduced from more than 400 billion RMB to 80 billion RMB at most. The plan called for converting into taxes fees that do not give users a direct benefit. One notable example of tax-for-fees was to replace road tolls and vehicle fees with a fuel tax. The objective of this law, which was debated but not passed at the Standing Committee of the Ninth National People's Congress in two separate sittings in October 1998 and April 1999, was to replace 216 fees levied on road users with a fuel tax and a vehicle purchase tax (see Lee, 1999).

However, the tax-for-fees programme has been postponed because it met with local resistance. Local governments complained that, if implemented, the programme would undermine their revenue base by changing local fees into central revenues. From a practical perspective, it is difficult for higher levels of government to limit the levy behaviour of the lower tier, when budgetary funds are insufficient to finance the expenditure of the latter. Some local government

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11. When enterprises try to sue those who use their trademark illegally, the biggest obstruction they meet always comes from the localities. National newspapers such as *Renmin fayuan bao* (*People's Court Daily*) have mounted campaigns against these developments, praising courts which resist local protectionism (see Lee, 1998: 285).

leaders such as Ruan Chongwu, the former governor of Hainan, made the further point that if the central government collects the fuel tax, local and overseas investors will have difficulty in recovering their investments. This could be problematical if the uncertain environment has an adverse effect on the number of new projects.<sup>12</sup>

In China local governments are well placed to resist central government attempts to convert local fees into central taxes for two reasons. The first is that local governments in China are much more independent than those in most other countries. As indicated above, decentralised reform, especially the fiscal contract system implemented from the 1980s, awarded local authorities great autonomy in local administration. The decentralised tax administration has opened up possibilities for local governments to develop additional financial sources. Several researchers have pointed out that this provides a strong incentive for localities to promote the development of local enterprises because most of their revenue comes from these firms (see for example Brown, 1998; Wong, 1992). Oi (1992) suggests that this has resulted in what she calls 'local state corporatism' which reinforces local power. As a result, local township and village leaders have taken on more significant roles as 'economic managers' in exercising ownership rights and directing resources, thus creating the phenomenon of cadre-entrepreneurs. For instance, local governments frequently impose levies on the retained profits of successful enterprises in order to repay bad loans of poorly performing enterprises (*tongshou huandai*) (Whiting, 1996: 92).

In addition, since the late 1970s, economic liberalisation has increased capital flows into China. The value of utilised foreign capital in China increased from US\$9.87 billion in 1985 to US\$63.2 billion in 1998 (ZTN, 1999: 594). An implication of decentralisation is that an increasing proportion of these funds is controlled at the local level. The share of foreign investment administered at the provincial level (as opposed to ministries of the central government) increased from 35% in 1985 to 68% in 1992 (Montinola et al., 1995: 62). Some local areas, such as the four special economic zones – Shenzhen, Zhuhai, Shantou and Xiamen – particularly benefited from capital inflows following decentralisation. This phenomenon helps to explain the concerns of provincial leaders, mentioned above, that if the central government collected the fuel tax, the uncertain business environment would have an adverse effect on new projects at the provincial level. The economic power that the development of TVEs and increased capital inflows have given to local governments has made it much more difficult for the central government to impose top-down directives about non-tax levies at the local level.

A second striking difference from other countries is the level of expertise and

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12. *Xinbao caijing xinwen*, 29 October 1998 in SWB-FED3371, 30 October 1998.

knowledge of lower levels of government in China. One important reason why local governments can resist central government attempts to extract more revenue is that flows of information are asymmetric. Qian and Weingast (1996) argue that because local governments control the assets of TVEs they have information that is not available to the central government. Ownership provides the local government with control rights over a firm's books and accounts, thus allowing it to receive unobservable revenues. This provides local governments with strong incentives to promote TVEs, as discussed above, and enables them to resist revenue predation by the central government in a credible fashion by hiding revenue. As Taubman (1998: 59) notes:

Flourishing collective rural enterprises try to veil their profits with the knowledge of the township governments, and township governments often assist them in tax evasion in order to share retained profits between the enterprises and their supervisory agencies.

## **Conclusion**

Fiscal decentralisation has given greater autonomy to local government and functional departments, but, at the same time, the central government has transferred more expenditure responsibilities to lower levels. Faced with tight budgetary constraints and mounting pressures on spending generated by local economic and social development, the lower authorities have turned increasingly to non-tax revenues. This has undermined the central government's revenue base and forced the centre to attempt to use its power to raise the central share. The methods that the central government has used have reduced local efforts to raise tax and driven localities to become more self-financing. As well as these internal driving forces, the absence of a strong legal framework to protect enterprises and individuals from fiscal predation has led to the abuse of government power and the proliferation of non-tax levies, despite the promulgation of a myriad of regulations. The weak limits to government power have also facilitated the expansion of administrative expenditure, which has, in turn, increased the demand for more revenue.

The growth of EBR and NBR has had two undesirable side-effects. First, it has been a major reason for the increasingly ad hoc nature of fiscal policy in China, as reflected in the titles of EBR charges such as 'staff welfare fund', 'transport management fee' and 'higher education fee'. With the increasing importance of EBR since the introduction of economic reforms, the fiscal system as a whole has become more ad hoc. As Wong (1997: 203) puts it: 'It has created a quasi-tax system which is increasingly beyond the central government's control and whose structure of fees and charges is extremely chaotic, non-transparent and often inequitable.' Secondly, it has accelerated the



decline of the formal tax system by providing an alternative outlet for local government tax efforts. Local governments can shift funds from the sector where they are 'taxed' (ie. subject to revenue-sharing) to the sector where they are not (off-budget revenue).

Taking into account the obstacles discussed in the previous section, is revenue instability inevitable? China's reforms are experimental, and adjustments, which are ongoing, make the economic system as a whole quite unstable. Each of the top-down solutions discussed in this article is likely to take quite a long time because of information asymmetries and local government control over local enterprises. This suggests that neither legal procedures nor central government directives to convert levies into taxes can provide viable solutions without proper compensation, since the proliferation of non-tax levies is the outcome of the mismatch between revenue and expenditure responsibilities at the local level. Lee (1999: 12) sums up the problem facing the central government in the 1998 tax-for-fees reform;

The central issue in the tax-for-fees reform is how to give local governments incentives for them to embrace the central government's attempt to convert off-budget fees and funds into budgetary revenues. With insufficient funds to meet their expenditure responsibilities and no power to create local taxes and to set local tax rates, local governments have no alternative but to thwart the new reform measure.

Top-down reform is not feasible if the central government does not give local governments reliable and controllable financial resources. As pointed out in the previous section, this is because local governments are well positioned to resist directives imposed by central government, given their expertise and independence. Hence, policies designed to cancel random government charges need to be co-ordinated with measures to fill the 'fiscal gap' facing local governments. Theoretically this can be achieved in one of four ways: (i) by reducing the expenditure responsibilities of local government; (ii) by making it easier for local authorities to raise revenue; (iii) by increasing the amount of revenue transferred from higher levels of government, or (iv) by greater local efforts to raise revenue without changing the revenue-raising authority (Bahl and Linn, 1992: 472).

In China, the potential for the first and third options is quite limited, as higher authorities also face tight budget constraints. The fourth option is not realistic, given that it is likely to result in the further imposition of charges and fees. Therefore the second option of making it easier for local governments to raise revenue is the only really feasible solution. Several avenues can be used to achieve this aim. First, a clearly defined local tax subject to local control is desirable. A tax would be both more transparent and more equitable than the current plethora of charges. A number of current fees and charges have tax

characteristics. Hence, as long as these levies are used for financing local pure public goods, they can be grouped into one or two local taxes administered by local governments. The central government could set the general rules for levying these taxes, while giving the localities freedom to set the rate and the base. This would also improve collection efforts because taxation revenue would remain at the local level.

A local tax, however, would meet only part of the financial needs of local government. A second option would be to give local governments power to set the price of public utilities. This would represent an improvement on the current arrangements, because, although the charges and fees for utilities are criticised as being excessive, the current price of most public utilities, including public housing, is too low to cover the cost (Wong, 1997). These utilities can be priced at more reasonable levels, which would ensure that the objectives of equity, efficiency and financial viability are consistent with each other (Ng, 1987). In addition to giving local governments power to price local utilities, a procedure for auditing the operations of public utilities would ensure effective supervision by local users.

As capital markets mature, a third alternative in the medium term would be to authorise local governments to issue bonds to finance local infrastructure. If this course is followed, local governments should follow standard procedures to borrow from the capital market. The problem with this option at the present stage, however, is that domestic capital markets are underdeveloped. The stock markets in Shanghai and Shenzhen are plagued by thin (low volume) trading, are volatile, and suffer from institutional irregularities such as churning and insider trading (Mookerjee and Yu, 1995). This suggests that a clearly defined local tax and local control over pricing of public utilities are better short-term options. Irrespective of which of these policies is followed, recent experience with tax reform indicates that, without measures that give local government an incentive to be an active partner in reform, it is unlikely that central directives will be successful in abolishing charges and fees imposed from above.

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