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Rebuilding Government for the 21st Century: Can China Incrementally Reform the Public Sector?*

Christine Wong

ABSTRACT After three decades of spectacular economic successes, China is facing a significant challenge. The string of recent scandals – environmental degradation, melamine-tainted milk powder, fake drugs and chemicals – have all pointed to government weakness in protecting public safety, exposing an enormous gap between China’s growing economic prowess and its capacity to govern. With the leadership now focused on improving the regulatory regime, will China “catch up” and build the public institutions needed? This article argues that the reactive, incremental retrenchment of government in the 1980s and 1990s, combined with inadequate finance, had broken the intergovernmental fiscal system and created large distortions in the incentive structure facing government agencies and public institutions (*shiyew danwei* 事业单位). Until the intergovernmental fiscal system is repaired and incentives are fundamentally reformed for the public sector, the top-down programme to redirect China’s development and build a service-oriented government will have limited effect.

Over the past three decades, China has undergone a spectacularly successful transition to a market economy. Though far from complete, this transition has been remarkable for sustaining a high rate of economic growth that is virtually unprecedented in world history, bringing structural adjustments to the economy, raising productivity and living standards in all regions and sectors, and transforming China from “sick man of Asia” to economic powerhouse.¹

This record of achievement is marred, however, and the government faces significant challenges ahead. Inequality has risen sharply across regions, sectors and

* This study draws from research that was partially funded by the Smith-Richardson Foundation. I thank Frank Pieke and Carl Riskin for helpful comments on an earlier draft.

1 There is a veritable cottage industry of articles and books explaining China’s economic successes. For comprehensive treatments of China’s economic development over the past three decades, see Barry Naughton, *The Chinese Economy* (Cambridge, MA: MIT Press, 2007) and Loren Brandt and Thomas Rawski (eds.), *China’s Great Transformation: Origins, Mechanism, and Consequences of the Post-Reform Economic Boom* (New York: Cambridge University Press, 2008).

45 social groups.² Corruption is rampant. During the 1990s popular protests grew in
 46 size and frequency, as citizens (mostly farmers) protested against excessive fees
 47 and levies and, increasingly, illegal land takings and evictions. While many of
 48 these may be reflections of social dislocations of China's rapid growth and urban-
 49 ization, the country has also been rocked by a series of scandals in recent years, of
 50 which the long-running saga of tainted milk powder from Sanlu during 2007–08,
 51 then the largest and most reputable milk producer in the country, was only the
 52 latest in a string that went from fake infant formula causing the death of hun-
 53 dreds of babies in 2004,³ the 2005 chemical spills into the Songhuajiang that con-
 54 taminated water supplies to major population centres in the north-east,⁴ to the
 55 mislabelling of exported chemicals that turned toothpastes, pet food and pharma-
 56 ceuticals into deadly poisons, and so on. These are worrying signs of government
 57 weakness and outright failure to perform the core functions of ensuring fairness,
 58 public safety and consumer protection. Some observers have pointed to the recent
 59 trend of violent protests as indicative of a growing "crisis of confidence," where
 60 the public is increasingly distrustful of government and public institutions.⁵

61 To the government's credit, it is responding. Premier Wen Jiabao has admitted
 62 "the government was partly responsible for the tainted milk scandal," and vowed
 63 to take corrective action.⁶ Strengthening public sector performance is clearly seen
 64 as a critical component of the reforms needed to ensure an effective and credible
 65 government leading China into the 21st century.

66 In fact, since 2000 the government has implemented numerous programmes of
 67 public sector reform, including budget reform, treasury reform, procurement
 68 reform and streamlining of rural government. These have brought improvements
 69 and made government more transparent. New programmes under the call to
 70 build a "harmonious society," such as the drive to provide free rural education,
 71

72
 73 2 See, for examples, Vivienne Shue and Christine Wong (eds.), *Paying for Progress in China: Public*
 74 *Finance, Human Welfare and Changing Patterns of Inequality* (London: Routledge, 2007); Martin
 75 Ravallion and Shaohua Chen, "China's (uneven) progress against poverty," World Bank Policy
 76 Research Working Paper, No. 3408 (2004); and UNDP, *China Human Development Report 2005*
 77 (New York: UNDP, 2005).

78 3 Chinese media reports said that around 200 babies in Anhui alone were fed formula milk of little nutri-
 79 tional value. An initial inquiry showed 45 types of substandard powder were on sale in Fuyang city,
 80 Anhui, produced by 141 factories across China, Xinhua said. BBC news online, "China fake milk scandal
 81 deepens," <http://news.bbc.co.uk/1/hi/world/asia-pacific/3648583.stm>, 22 April, 2004, accessed
 82 19 October, 2008.

83 4 In November 2005, a chemical plant explosion in Jinlin province caused a leakage of benzene into the
 84 Songhuajiang River. As a result, water supplies to Harbin, the tenth largest city in China, with a popu-
 85 lation of 5.5 million, were cut off for a number of days.

86 5 See, for examples, Jianrong Yu, "Emerging trends in violent riots," *China Security*, Vol. 4 No. 3 (2008),
 87 pp. 75–81; and Joseph Fewsmith, "An anger-venting mass incident catches the attention of China's lead-
 88 ership," *China Leadership Monitor*, No. 26 (2008). Both are about an incident on 28 June 2008, where
 at least 10,000 people, and perhaps as many as 30,000, according to some reports, participated in the riot
 in Wengan county in south-western Guizhou, the poorest province in China, to protest against a sus-
 pected police cover-up over the death of a girl. In the riot, police cars were overturned and burnt
 and the Public Security Bureau building set on fire. Yu, in particular, has studied the trend toward
 crowd volatility over the past few years as a significant new social phenomenon in China.

6 "China detains 22 in milk case," *New York Times*, <http://www.nytimes.com/2008/09/30/world/asia/30iht-30milk.16573403.html>, 30 September 2008, accessed 16 August, 2009.

89 the new rural co-operative medical scheme and the introduction of the rural mini-
 90 mum living stipends (*nongcun dibao* 农村低保), are transferring substantial new
 91 resources to funding services at the grassroots levels and improving fairness.

92 In this article I assess the prospects of these public sector reforms in China,
 93 drawing from two decades of studying China's fiscal system, and especially
 94 from several World Bank studies in which I participated during 2003–08.⁷ The
 95 first section reviews the retrenchment of government during the 1980s and
 96 1990s, highlighting the highly constrained nature of the process which precluded
 97 substantial downsizing of government, services or departments. The following
 98 sections trace the roots of the current problems of inequality and weak govern-
 99 ance to the legacies of the incremental cutbacks and concessions made by the
 100 government during this period. They include discussions of the impact of this
 101 retrenchment, both the direct, measurable changes on the economy and the
 102 longer-term impact on the shape of economic system and incentives. In con-
 103 clusion I highlight the difficulties of imposing a top-down reform of the public
 104 sector under the present intergovernmental structure and system of incentives
 105 facing local governments, public service providers and civil servants.

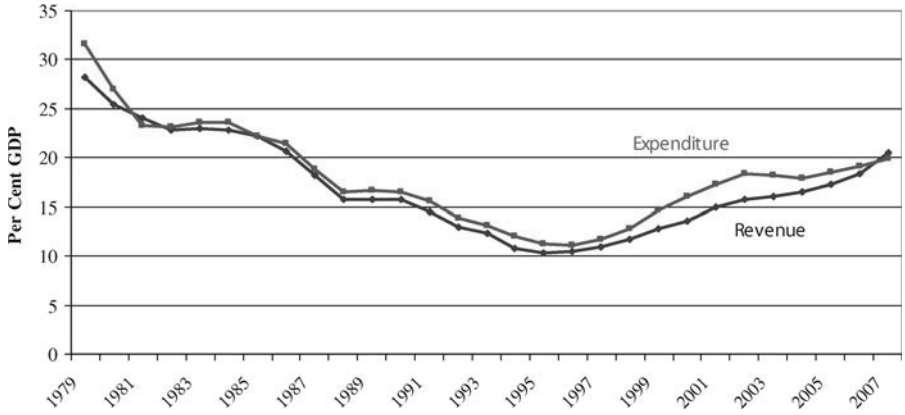
108 **Withdrawal of Government: 1980s–1990s**

109 By definition, market reform means reducing the reach of government and turn-
 110 ing economic management over to market forces. In the process, the government
 111 share of GDP shrinks, as more resources are left in private hands. In China mar-
 112 ket reforms had been preceded by more than a decade of political strife and econ-
 113 omic stagnation caused by the ultra-leftist policies of the Cultural Revolution.
 114 Dissatisfaction with centralized management and state control was rife, and
 115 the relaxation of administrative controls and curtailing of government was wel-
 116 comed. In fact, however, the government's control over resources fell more
 117 swiftly and further than expected, and revenue constraints began to dictate the
 118 pace and depth of reform from the mid-1980s onward.

119 From the start of market reforms, dismantling the planning apparatus had
 120 led quickly to an erosion of the government's main revenue mechanism –

123 7 The studies were: "China: public services for building the new socialist countryside," World Bank,
 124 Report No. 40221-CN (2007), [http://www-wds.worldbank.org/external/default/WDSContentServer/
 125 WDSP/IB/2008/01/16/000020953_20080116091210/Rendered/PDF/402210CN.pdf](http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2008/01/16/000020953_20080116091210/Rendered/PDF/402210CN.pdf), accessed 16 August
 126 2009; Chinese version: *Gaishan nongcun gonggu fuwu (Improving Rural Public Service)* (Beijing:
 127 CITIC Press, 2008); Achim Fock and Christine Wong, "Financing rural development for a harmonious
 128 society in China: recent reforms in public finance and their prospects," World Bank Policy Research
 129 Working Paper, No. 4693 (2008), [http://www-wds.worldbank.org/external/default/WDSContentServer/
 130 WDSP/IB/2008/08/14/000158349_20080814090712/Rendered/PDF/WPS4693.pdf](http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2008/08/14/000158349_20080814090712/Rendered/PDF/WPS4693.pdf), accessed 16 August
 131 2009; World Bank, "Reforming subnational finance: lessons from northeast China," unpublished
 132 draft (2006); and World Bank, "China: deepening public service unit reform to improve service deliv-
 133 ery," Other Public Sector Study, No. 32341 (2005), [http://www-wds.worldbank.org/external/default/
 134 WDSContentServer/WDSP/IB/2005/08/01/000012009_20050801102726/Rendered/PDF/32341rev01CHA.
 135 pdf](http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2005/08/01/000012009_20050801102726/Rendered/PDF/32341rev01CHA.pdf), accessed 16 August 2009. I am indebted to the many colleagues with whom I worked on these
 136 studies, most importantly Achim Fock, Dana Weist and Zhang Chunlin.

Figure 1: Trends in Budgetary Revenues and Expenditures



Source:

National Bureau of Statistics, *Zhongguo tongji nianjian (Chinese Statistical Yearbook, CSY)*, with data adjusted to international definition.

state-owned enterprise (SOE) profits – and government revenues went into a steep decline, falling from 35 per cent of GDP in 1978 to less than 20 per cent by the end of the 1980s. This decline continued into the 1990s, and indeed accelerated from the mid-1980s onward, reaching a nadir of just 11 per cent in 1996. Throughout this decline, the government appears to have exercised remarkable fiscal discipline by cutting expenditures largely in line with revenues and keeping deficits small, as shown in Figure 1. (However, it should also be noted that the painful adjustment was ameliorated by rapid economic growth, as the budget grew in absolute terms throughout the 1980s and 1990s even as its share in GDP plunged: see Table 1.)

This discipline was illusory, however. In fact, the retrenchment was implemented with neither a clear strategy nor a consensus for redrawing the public–private divide in the new market economy that China would become. A perusal of official documents from the 1980s and early 1990s revealed no sustained discussion of how to identify areas or services where the government’s role could or should be reduced. In the 1980s nearly all discussion was centred on reviving the profitability of SOEs. By the early 1990s, the focus turned to reining in local governments to prevent them giving unauthorized tax concessions to local SOEs and thus depressing tax collections. Throughout these two decades, nearly all attention was focused on the revenue side of the budget, of how to revive collection.⁸ There was, at least in the public finance literature, little discussion of opening up public services such as education, health, and even sports and

8 See Wang Bingqian, *Wang Bingqian lun caizheng (Wang Bingqian on Public Finance)* (Beijing: Chinese Finance and Economics Press, 1994). Wang was Minister of Finance during 1980–92.

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Table 1: **Changes in Central and Local Budgets, 1978–2006**

	1978		1988		1995		2006	
	Central	Local	Central	Local	Central	Local	Central	Local
I. Budgetary expenditures								
Total (billions yuan in 1978 prices)	57.7	66.1	60.8	109.8	103	128.7	212.8	649.3
Investment	29.6	29.7	32	14.2	15.4	25.7	41.8	127.9
Industry, transport and commerce	1	0.8	0.7	1.5	0.9	1.7	2.9	9.5
Agriculture	0.2	7.5	0.8	8.1	1.2	9.7	4.1	41.8
Social	1.3	11.9	3.5	26.4	3.7	36.1	20.5	201.5
National defence	16.1	0.7	12.2	0.1	15.9	0.1	62.6	0.7
Government administration	0.4	4.5	2.2	11.3	1.8	20.2	13.9	105.8
Debt servicing	0	0	4.3	0	22.2	0	20.7	0
Subsidies	4.5	7.1	10.7	32.5	10.8	13.7	12.3	20.9
Others	3.5	3.9	2.2	15.1	31.1	21.5	33.9	141.2
II. Shares of total budgetary expenditures (%)	46.6	53.4	35.7	64.3	44.5*	55.5	24.7	75.3
III. Budgetary expenditures as % GDP								
Total	15.8	18.1	7.1	12.9	6.7	8.4	4.8	14.5
Investment	8.1	8.1	3.8	1.7	1	1.7	0.9	2.9
Industry, Transport & Commerce	0.3	0.2	0.1	0.2	0.1	0.1	0.1	0.2
Agriculture	0.1	2.1	0.1	1	0.1	0.6	0.1	0.9
Social	0.4	3.3	0.4	3.1	0.2	2.4	0.5	4.5
National Defense	4.4	0.2	1.4	0	1	0	1.4	0
Government Administration	0.1	1.2	0.3	1.3	0.1	1.3	0.3	2.4
Debt Servicing	0	0	0.5	0	1.5	0	0.5	0
Subsidies	1.2	1.9	1.3	3.8	0.7	0.9	0.3	0.5
Others	1	1.1	0.3	1.8	2	1.4	0.8	3.2

Note:

* The central share in 1995 was inflated by exceptionally large outlays in debt servicing, which absorbed more than one-fifth of central revenues.

Sources:

CSY (various years), *New China 55 Years Statistics*, and Ministry of Finance dataset for 2007.

221 research, to private participation. Privatization of public service providers was
 222 not proposed until the late 1990s.

223 This was not surprising under the gradualist approach adopted in China's tran-
 224 sition, which depended on building support for market reforms by proceeding
 225 incrementally while preserving the status quo – protecting vested interests and
 226 avoiding creating “losers.” In the absence of a clear strategy, the retrenchment
 227 proceeded without cutting personnel or government departments.⁹ Instead, the
 228 government sought to defer spending on maintenance and new investments,
 229 and select cuts that inflicted the least pain. After those were exhausted, cuts
 230 were distributed more or less across-the-board. The resultant changes can be
 231 seen in Table 1.

232 First to go was investment spending, especially for new projects. The budgetary
 233 items of capital construction, working capital, technological upgrading, geologi-
 234 cal prospecting, and urban maintenance and construction are grouped together in
 235 Table 1 under the heading “investment spending”; this category had accounted
 236 for a combined total of 16.2 per cent of GDP in 1978 in the central and local gov-
 237 ernment budgets. Between 1978 and 1988 the government shed 11 per cent of
 238 GDP from budgetary expenditures by requiring SOEs to borrow from the
 239 banks for investment as well as for working capital, and deferring new invest-
 240 ments.¹⁰ National defence spending was also cut during this period, from 4.6
 241 per cent of GDP to 1.4 per cent, saving another 3 per cent. These cuts were rela-
 242 tively easy because they were mostly congruent with reform objectives. For
 243 example, moving enterprise investment expenditures off the budget was consist-
 244 ent with reforms that sought to wean SOEs from direct government control.
 245 Similarly, cutting defence spending was acceptable given the implied friendlier
 246 international climate that had underpinned the Open Door policy, a core part
 247 of market reform in China.

248 For other expenditure items, not only were cuts harder to implement but, on
 249 the contrary, there were great pressures to increase spending. For example, the
 250 demand for social services and safety net programmes had greatly increased
 251 under market reforms as many economic risks were being transferred from the
 252 state and enterprises to individuals. Price and enterprise loss subsidies rose
 253

254 9 Most famously, the planning commission remains a powerful agency in China 30 years after the start of
 255 market reform, where it is “first among equals” among the super-ministries. Although its name has
 256 changed to the National Development and Reform Commission (NDRC), to shed the “planning”
 257 label, its core mission remains that of allocating capital investments financed by the budget, even though
 258 the share of budgetary funds is now a minor portion of total investments. The Price Commission,
 259 another powerful agency under the planned economy, was never abolished, although demoted to a
 260 department under the NDRC. Even a lowly agency like the Loudspeaker Team, which was in charge
 261 of maintaining the loudspeakers for broadcasting propaganda and instructions to the fields under col-
 262 lective agriculture before radio and television became widely available in rural China, remains in exist-
 263 ence as a government agency today. While there have been several rounds of downsizing campaigns for
 264 civil servants, they have been notably unsuccessful.

262 10 Christine Wong, “Central–local relations in an era of fiscal decline: the paradox of fiscal decentraliza-
 263 tion in post-Mao China,” *The China Quarterly*, No. 128 (1991), pp. 691–715. The figures cited in this
 264 paper differ somewhat from those in the earlier paper because the GDP data have been revised by the
 Chinese government. The figures used here are based on the updated GDP series.

265 rapidly during the early and mid-1980s, as government tried to cushion the
 266 impact of price liberalization and keep SOEs afloat. Even government adminis-
 267 tration had to expand: not only did costs rise with the wage increases that fol-
 268 lowed the redistribution of factor incomes under market reform, but the
 269 market also imposed new administrative requirements. For example, a whole
 270 new layer of government was added when the 1985 State Council decision called
 271 for setting up township governments to take over administrative tasks formerly
 272 performed by the agricultural people's communes and their subordinate brigades
 273 and teams. As these costs were shifted from the agricultural collectives – which
 274 had financed them through “taxing” their members – to the public sector, the
 275 budgetary implications were substantial. The task of collecting agricultural
 276 taxes alone had expanded from a taxpayer roll of 6 million production teams
 277 to one with more than 200 million rural households. As can be seen in
 278 Table 1, through the fiscal decline, social spending fell from 3.7 per cent of
 279 GDP in 1978, to 3.5 per cent in 1988 and 2.6 per cent in 1995. Government
 280 administration increased, but only slightly, from 1.3 per cent to 1.6 per cent in
 281 1988 and 1.4 per cent in 1995.

282 283 **Outcomes of Retrenchment**

284 The cost of retrenchment was felt everywhere. Pushing capital spending off the
 285 budget but keeping SOEs from bankruptcy created contingent liabilities in
 286 the financial sector that necessitated a huge clean-up some 20 years later through
 287 the creation of asset management companies to mop up bad debts. This section
 288 highlights four outcomes that followed directly from the long fiscal decline and
 289 expenditure cuts: the collapse of redistribution; decentralization by default that
 290 fundamentally de-linked revenue and expenditure assignments; the underprovi-
 291 sion of social services; and the growing reliance of the public sector on user
 292 charges and “business incomes.”

293 294 *Collapse of redistribution*

295 Fiscal decline during the 1980s and early 1990s obviously eroded the central gov-
 296 ernment's ability and willingness to provide assistance to local governments in
 297 poor regions. The first significant policy decision on the reduction of support
 298 came in 1987, when the government announced that budgetary transfers to
 299 poor provinces (then called quota subsidies) would for the next few years remain
 300 frozen at the 1986 level of 8.6 billion yuan.¹¹ Because of the high rates of inflation
 301 then prevalent, by holding the subsidies constant in nominal terms the govern-
 302 ment in effect allowed them to be quickly eroded in value. In constant 1986
 303 yuan, the subsidies were worth 8.0 billion in 1987, 6.8 billion in 1988 and 5.7 bil-
 304 lion in 1989. By 1994, they were equivalent to only 3.5 billion in constant
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308 11 State Council, “State Council Decision on implementing local fiscal contracts,” Beijing, 1988.

309 1986-yuan.¹² The effect of this on Guizhou, the poorest province in per capita
 310 GDP terms, can be seen in Figure 2, where the share of provincial expenditures
 311 financed by transfers is shown to fall from 60 per cent at the outset of transition
 312 to only 18 per cent in 1993.

313 Nationwide, data available for all transfers are shown in Figure 3, revealing a
 314 steep decline that followed the trend for central revenues. At the nadir, net trans-
 315 fers had fallen to 1 per cent of GDP in 1994, and remained at that level for several
 316 years of the mid-1990s.¹³ The upturn started only after 1997, when central reven-
 317 ues began their recovery.

318 In reality, the collapse of transfers was far more drastic than that depicted
 319 above, since measured transfers were only a small part of the redistribution
 320 that took place under the previous regime, and the definition of transfers had
 321 changed with the revenue-sharing system introduced under the Tax Sharing
 322 System reform in 1994. Previously, most transfers were hidden under the system
 323 of negotiated revenue sharing, where poor provinces were allowed to keep a
 324 higher proportion of revenues collected in their regions, while rich provinces
 325 were obliged to turn over more to the central government. For example,
 326 Shanghai, the richest provincial unit, annually remitted 80–85 per cent of its col-
 327 lections. In 1987, Jiangsu remitted 55 per cent, Zhejiang 39 per cent and
 328 Guangdong only 8 per cent, even though the three provinces had roughly com-
 329 parable per capita incomes.¹⁴ These different remittance rates were the net results
 330 of different policy considerations or hidden transfers made to the three provinces.
 331 Under the revenue sharing system, only eight provinces regularly received what
 332 were called “subsidies,” since they could not meet minimum expenditure needs
 333 even after being assigned 100 per cent of their collected revenues.¹⁵ The other
 334 transfers – “earmarked subsidies” and “final account subsidies” – were designed
 335 to implement central programmes and compensate for policy changes. They were
 336 not tied to equalization concerns, and were in the aggregate not equalizing.¹⁶

337 The Tax Sharing System introduced in 1994 brought two significant changes to
 338 revenue sharing between central and local governments: a reassignment of reven-
 339 ues that saw the central share rise from 22 per cent to more than 50 per cent of the
 340 total, and a shift from the sharing of general revenues to a system of tax
 341

342 12 These figures are based on quota subsidies of 8.6 billion yuan and deflating them by CPI. In fact the
 343 reported total rose slightly because of other adjustments in the system that are unrelated to equalization
 344 objectives.

345 13 Net transfers are calculated as total transfers minus tax rebates.

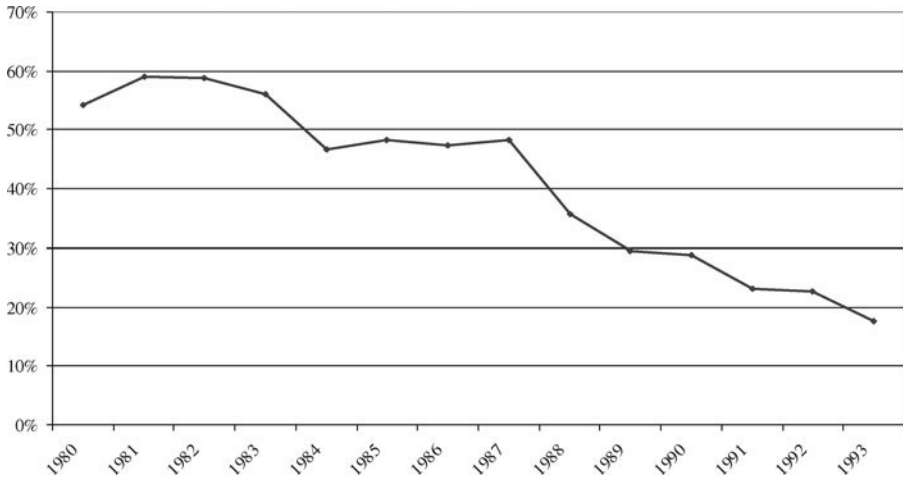
346 14 For a discussion of the detailed workings of this revenue sharing regime, see Christine Wong,
 Christopher Heady and Wing Thye Woo, *Fiscal Management and Economic Reform in the People's
 347 Republic of China* (Hong Kong: Oxford University Press, 1995), pp. 85–99.

348 15 The eight provinces were: Guangxi, Guizhou, Inner Mongolia, Ningxia, Qinghai, Tibet, Xinjiang and
 349 Yunnan, all with high proportions of ethnic minority populations. The term “transfers” (*zhuan yi zhifu*)
 was adopted by the Ministry of Finance only over the past decade or so. Previously, they used the term
 “subsidies” (*butie*).

350 16 Loraine West and Christine Wong, “Equalization issues,” in Christine Wong (ed.), *Financing Local
 351 Government in the People's Republic of China* (Hong Kong: Oxford University Press, 1997). World
 Bank, *China: National Development and Sub-national Finance – A Review of Provincial Expenditures*,
 352 Report No. 22951-CHA (2002).

Figure 2: The Share of Provincial Expenditures Financed by Transfers in Guizhou

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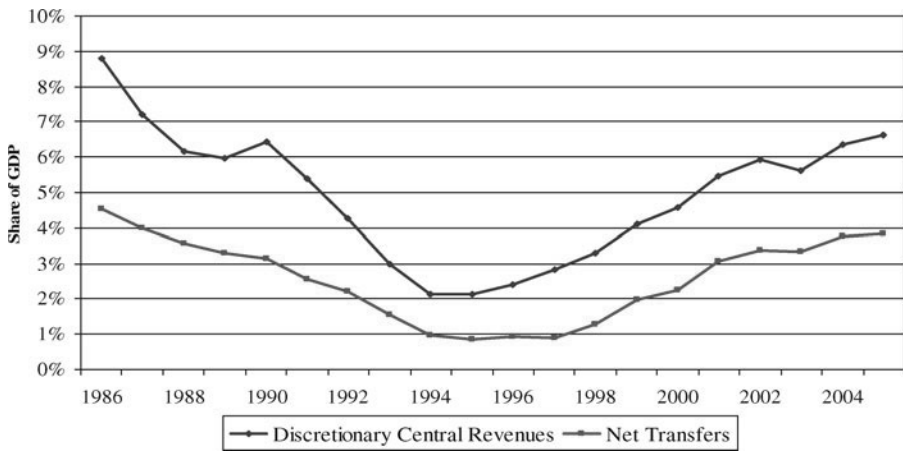


Source:
Calculated from data from author interview with Guizhou Finance Department, 1997.

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Figure 3: Trends in Central Revenues and Transfers (as % GDP)

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Sources:
Christine Wong (ed.), *Financing Local Government in the People's Republic of China* (Hong Kong: Oxford University Press, 1997);
Ministry of Finance, *Zhongguo caizheng nianjian (Chinese Fiscal Yearbook)* (Beijing: China Public Finance Economics Press, various years); and Li Ping and Xu Hongcai (eds.), *Zhongguo zhengfujian caizheng guanxi (China: Intergovernmental Fiscal Relations)* (Beijing: China Public Finance Economics Press, 2006).

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assignment and tax sharing. Under the new system, central and local governments each had clearly assigned “own revenues,” and all transfers became explicit. This expanded the scope of “transfers” and, *ceteris paribus*, should have substantially increased transfers. Indeed, from 1994 onward, all provincial

397 units, including Shanghai and Beijing, became recipients of central “transfers.”¹⁷
 398 In this light, the collapse of redistribution towards poor regions can be seen as
 399 precipitous.

400
 401 *Decentralization by default and the de-linking of revenue and expenditure assignments*
 402

403 Judging by expenditure shares, China was already quite decentralized at the out-
 404 set of reform in 1978, with local (subnational) governments accounting for 53 per
 405 cent of budgetary expenditures. As shown by figures in Table 1 (panel II), the
 406 process of ad hoc retrenchment described above had produced a further decentra-
 407 lization of expenditures throughout the 1980s and 1990s, and by 2006 local gov-
 408 ernments accounted for three-quarters of the total. I call this process
 409 decentralization by default, because it had occurred by incremental, reactive
 410 changes on the revenue and expenditure sides that were largely unco-ordinated.

411 On the expenditure side, under the current division of assignments, the central
 412 government is mainly responsible for economic development (including invest-
 413 ment expenditures), national defence and diplomacy; local governments are
 414 mainly responsible for day-to-day administration and the provision of social ser-
 415 vices. This division of labour meant that in the 1980s, most of the easy expendi-
 416 ture cuts were made in the central government budget, while most of the pressures
 417 for expenditure increases fell on local governments, which also had to absorb the
 418 additional burden of services being devolved from SOEs, including pensions,
 419 schools and health institutions.¹⁸ This dynamic drove the fiscal system toward
 420 decentralization, as expenditure shares shifted to local governments, even as
 421 expenditures were falling for both central and local governments in terms of
 422 GDP shares.

423 On the revenue side, worry over the erosion of central control over resources
 424 led to a progressive de-linking of revenue assignments from expenditure needs
 425 considerations. Through the early and mid-1980s, the government had inter-
 426 preted its fiscal problems as being problems of SOEs, so reviving SOEs’ profit-
 427 ability and finding more efficient means of taxing them were the focus of
 428 reform efforts.¹⁹ When this proved ineffectual, the government began to suspect
 429 local governments, especially in rich regions, of colluding with SOEs to avoid
 430 remittances to the centre.²⁰ To stop the haemorrhage and lock in revenues for
 431 central coffers, in 1988 the central government retreated to a system of fiscal
 432

433 17 The rich provinces receive mostly tax rebates based on increased VAT and excise tax collections. Since
 434 around 2003 the Ministry of Finance has attempted to exclude tax rebates (around 40% of total trans-
 435 fers) from the reporting of “transfers,” but statistical reports continue to count them.

436 18 This was the subject of my paper in this journal in 1991. In that paper, I showed that the ongoing fiscal
 437 decentralization did not benefit local governments, as was widely perceived, because the pressures emer-
 438 ging from fiscal decline and expenditure needs of the changing economy were distributed asymmetri-
 439 cally, and were falling more heavily on local governments. See Wong, “Central–local relations in an
 440 era of fiscal decline.”

439 19 Christine Wong, “Fiscal reform and local industrialization: the problematic sequencing of reform in
 440 post-Mao China,” *Modern China*, Vol. 18, No. 2 (1992), pp. 197–227.

440 20 Wong, Heady and Woo, *Fiscal Management and Economic Reform*.

441 contracts for revenue sharing with the provinces. The contracts stipulated a lump
 442 sum remittance (or subsidy) for each province, to increase annually by an agreed
 443 rate that left a progressively higher portion to local governments. In exchange,
 444 these contracts turned over responsibility for meeting expenditure requirements
 445 to the provinces, to be financed from their “own,” retained revenues. When
 446 this failed to halt the decline in revenues, especially in central government revenues,
 447 the government finally pushed through a drastic recentralization of revenues
 448 under the Tax Sharing System reform in 1994.

449 Through this process of expenditure decentralization and de-linking of revenue
 450 assignments from expenditure needs considerations, the Chinese fiscal system was
 451 altered fundamentally. By severing the link between revenue and expenditure
 452 assignments, it turned the system from one based on a delegation of responsibilities
 453 to real decentralization. That this fundamental change to the fiscal system
 454 was slipped through without public comment is a clear indication that it was
 455 an ad hoc, reactive reform made with little deliberation.

457 *Underprovision of social services*

459 In the initial years of the transition, the government increased spending on public
 460 services, designating as priorities education, health, poverty alleviation, environ-
 461 mental protection and social insurance. In education, public spending on recur-
 462 rent expenditures rose from 1.8 per cent of GDP in 1978 to 2.2 per cent in
 463 1982. In health, it rose from 1 per cent to 1.3 per cent during the same period.
 464 As fiscal decline took hold, however, this effort to increase public spending on
 465 social sectors became a lost cause: even as the proportion of budgetary resources
 466 devoted to education more than doubled from 5.8 per cent to 13.1 per cent during
 467 1978–95, its share in gross domestic product fell, to 1.5 per cent in 1995.²¹ Public
 468 health spending showed a similar trend, declining to 0.64 per cent of GDP in
 469 1995.²² Elsewhere, while China strove hard to increase spending on pollution
 470 control, from 0.4 per cent of GDP in 1980 to 0.67 per cent in 1992, this was
 471 far from adequate in the face of rapid industrialization.²³

472 As a result of these funding problems, China’s public spending on social ser-
 473 vices is low. Compared to other Asian countries, or even to other lower-middle
 474 income countries, its expenditure on education, hovering around 2–2.5 per cent
 475 of GDP throughout the 1980s and most of the 1990s, was far below the levels
 476 of its Asian neighbours, and below the average for lower-middle income countries
 477 worldwide.²⁴ It also fell short of the goals set in the Education Law (1986), which
 478 had called for reaching 4 per cent of GDP by 2000. Likewise, China’s public
 479

480 21 Calculated from data from CSY 1998 and 2006. These figures are based on the new GDP figures, which
 481 had raised GDP estimates by more than one-third.

482 22 Calculated from National Health Statistics.

483 23 World Bank, *The Chinese Economy: Fighting Inflation, Deepening Reforms* (Washington, DC: World
 484 Bank, 1996).

24 OECD data.

485 spending on health, at 1.9 per cent of GDP, is one-quarter below the “predicted
 486 value” of 2.4 per cent based on international comparisons, where a strong corre-
 487 lation between per capita GDP and health spending is commonly observed.²⁵ In a
 488 1996 report, the World Bank estimated that China faced a spending gap in criti-
 489 cal social services that was equal to nearly 5 per cent of GDP.²⁶

490
 491
 492 *Increased reliance on user charging and “business incomes”*

493 With budgetary resources dwindling, and with government unwilling to cut ser-
 494 vices, departments or employees, the only solution was to allow local govern-
 495 ments and service providers to seek supplementary income by levying user
 496 charges and using their assets creatively. Even today, the vast majority of public
 497 services in China are provided by publicly owned entities that are attached to
 498 government at various levels, known as public service units (*shiyew danwei* 事业
 499 单位, PSUs). They include schools, agro-technical extension stations, cultural
 500 centres, health clinics and hospitals. Budgetary support for public services is
 501 channelled through PSUs, and available data show that the share of public fund-
 502 ing fell sharply across all services. Figure 4 illustrates the situation for education,
 503 where budgetary resources in total funding fell from the mid-1980s throughout
 504 the 1990s, to just 53 per cent of the total. Yet, there was little or no discussion
 505 of privatizing the PSUs. Since private providers and NGOs were prohibited
 506 until very recently, PSUs are monopoly providers in many services including edu-
 507 cation, hospitals and agricultural services.

508 Today all PSUs are only partially funded by the budget. On average,
 509 budget allocations account for roughly one-half of their total funding, and
 510 they raise the other half from fees and “other incomes.”²⁷ The budgetary portion
 511 varies across sectors and types of institution, though none is 100 per cent budget-
 512 financed, not even the police or fire departments.²⁸ For health institutions, in
 513 1998 government subsidies covered only 8 per cent of operating revenues for pub-
 514 lic hospitals nationwide. The rest came from user charges and drug revenues.
 515 Even for public health institutions such as epidemic prevention stations (later
 516 renamed centres for disease control) and maternal child health centres, in the
 517 late 1990s government appropriations covered only 40 and 30 per cent of operat-
 518 ing revenues, respectively.²⁹ Passing along costs to users and charging for services
 519 is so universal that in a 2004 field visit to one of China’s poorest villages in the
 520

521
 522 25 Peter Smith, Christine Wong and Yuxin Zhao, “Public expenditure and the role of government in the
 523 Chinese health sector,” *World Bank Rural Health in China Briefing Notes*, No. 5 (2005).

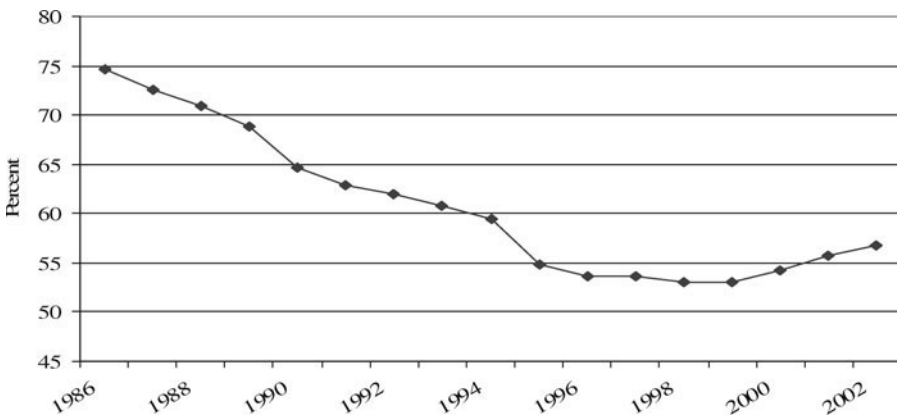
524 26 World Bank, *Fighting Inflation, Deepening Reforms* and World Bank, *Deepening Public Service Unit
 525 Reform*.

526 27 For details, see World Bank, *Deepening Public Service Unit Reform*.

527 28 In a 2004 paper, Nansheng Bai detailed how local police departments typically receive only budgetary
 528 support for salaries, but have to buy their uniforms, batons and other equipment from own revenues
 collected through fines and penalties. See Nansheng Bai, “A police story,” paper presented at the
 Conference on Rural Change in China, Peking University, 5–6 July 2004.

29 World Bank, *National Development and Sub-national Finance*, Table 7.8.

Figure 4: Share of Budgetary Resources in Total Funding for Education



Source:

1986–89, calculated according to data provided in National Education Commission Finance Department (ed.), *Zhongguo jiaoyu jingfei jiben shuju fenxi (Analysis of China's Basic Education Finance Statistics)* (Qingdao: China Ocean University Press, 1992); 1990–95, from National Education Commission Finance Department and Shanghai Institute of Knowledge Development (eds.), *Quanguo jiaoyu jingfei niandu fazhen baogao (Annual Report on Developments in Education Finance)* (Beijing: High Education Press, 1998); 1996–2002, from Ministry of Education, *Zhongguo jiaoyu jingfei tongji nianjian (China Education Finance Statistics Yearbook)* (Beijing: China Statistics Press, 1997, 1998, 1999, 2000, 2001, 2002).

south-west, I was astonished to find that not a single public service was offered free of charge to the residents, not schooling, health care or even police services.³⁰

Long-Term Legacies

The long period of fiscal decline had forced many adjustments on China's public finances, some with long-lasting and negative effects. This section discusses four of the most salient: the large fiscal disparities across localities; the breakdown of the intergovernmental fiscal system; the growth of extra-budgetary activities; and the commercialization of the public sector.

Growing disparities across regions

Over the past quarter of a century, China's economic growth has been regionally unbalanced, with much higher growth rates in the coastal provinces than in inland provinces. This, by itself, would have expanded the already large income differences among provinces. The disparities grew worse with the collapse of transfers in the 1980s and 1990s, as the government abrogated its vital responsibility in redistributing incomes. As a result, especially after the shift to the Tax Sharing System in 1994, the distribution of fiscal resources increasingly followed that of regional incomes.

30 World Bank, "Rural public finance in Ninglang county of Yunnan province," an interim report for the World Bank–Ministry of Finance Study, 2004.

573 During the 1990s disparities in fiscal resources grew across provinces, and these
 574 differences were transmitted directly to spending on social services.³¹ Citizens in
 575 rich localities enjoyed more and higher quality services, while those in poor
 576 regions faced low quality services, and often went without. To illustrate, data
 577 in Figure 5 show that in 2004, Shanghai spent 6,700 yuan per student in primary
 578 school, nearly 6,000 of it from budgetary appropriations. At the low end, the
 579 poorest province, Guizhou, spent only 745 yuan per student, of which 670
 580 came from the budget – about one-ninth as much as Shanghai. Even when the
 581 three provincial-level municipalities are excluded, Figure 6 shows the richest pro-
 582 vince – Zhejiang, spending 3,300 yuan, still 4.5 times the Guizhou level, and 3.3
 583 times its budgetary expenditure per student. These disparities are unusually large,
 584 especially considering that they represent *average* figures for very large units, as
 585 provinces in China have on average more than 45 million inhabitants and the lar-
 586 gest have nearly 100 million. Data are not publicly available at the county level to
 587 do a comparable analysis. In field work conducted in Liaoning province, a World
 588 Bank team found even larger disparities. In 2003, on average counties spent 1,229
 589 yuan per student, but the range was from 182 to 2,556 yuan among the 40
 590 county-level units.³²

591
 592

593 *Breakdown of the intergovernmental fiscal system*

594 In China fiscal decentralization goes below the provinces downward to all levels
 595 of the five-level system of government, with each level of local government
 596 assigned important roles in service delivery. In 2006, governments at the county
 597 and township levels together accounted for one-third of national budgetary
 598 expenditures, and municipalities accounted for nearly one-quarter. The high
 599 expenditure shares of these sub-provincial governments are because of the impor-
 600 tant and costly functions for which they are assigned responsibility – basic edu-
 601 cation, health care and social security. For example, the large numbers of
 602 students means that the provision of basic education is costly, and explains
 603 why the county and township governments (responsible for education in grades
 604 1 to 9) account for 61 per cent of the national budgetary outlays for education.
 605 Table 2 shows the high shares of subnational governments in the major social
 606 expenditures.

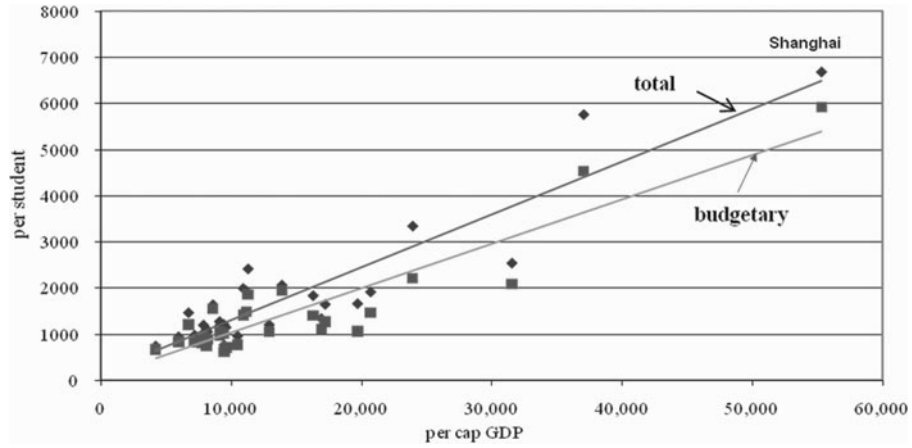
607 In a recent paper,³³ I called the intergovernmental system “broken,” by
 608 which I meant it is not able to support national policy implementation: the
 609 Chinese system depends on local governments to implement social policies,
 610

611
 612 31 Christine Wong, “Can the retreat from equality be reversed? An assessment of redistributive fiscal poli-
 613 cies from Deng Xiaoping to Wen Jiabao,” in Shue and Wong, *Paying for Progress in China*; and “Fiscal
 614 management for a harmonious society: assessing the central government’s capacity to implement poli-
 615 cies,” in Keun Lee, Joon-Han Kim and Wing T. Woo (eds.), *Power and Sustainability of the Chinese
 616 State* (London: Routledge, 2008).

617 32 World Bank, *Reforming Subnational Finance*.

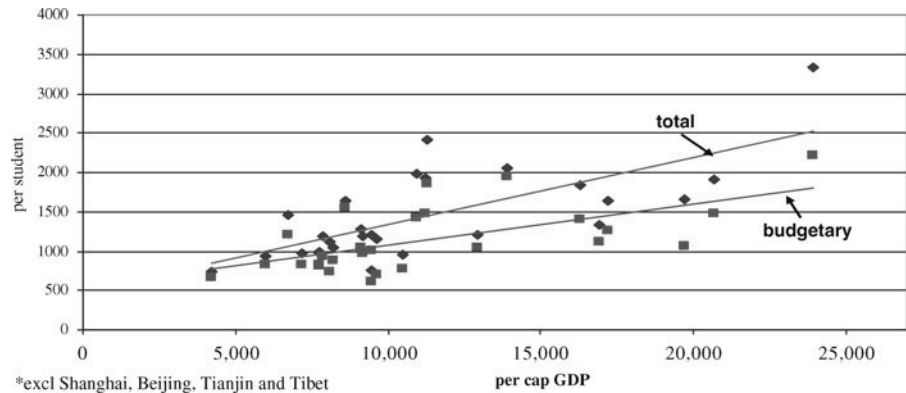
618 33 Wong, “Can the retreat from equality be reversed?”

Figure 5: Per Student Expenditure in Primary Schools, by Province (yuan, 2004)



Source: CSY and China Education Finance Statistics Yearbook 2006.

Figure 6: Per Student Expenditure in Primary Schools, by Province (yuan, 2004)



Source: CSY and China Education Finance Statistics Yearbook 2006.

but lacks mechanisms for ensuring that they have adequate financial resources to carry this out. Through the transition period, the piecemeal, incremental reforms had steadily chipped away the coherence of the intergovernmental fiscal system, and the recentralization of revenues under the Tax Sharing System reform in 1994 greatly exacerbated the mismatch between revenue and expenditure assignments. This is shown in Table 3, where, in 1998 counties and townships had a combined 20 per cent of total revenues but 28 per cent of expenditures. Although the gap – in the aggregate – was met by transfers,

Table 2: **Distribution of Budgetary Expenditures by Level of Government, 2006 (%)**

	Budgetary expenditures	Education	Health	Social welfare and relief
Central	25	6	3	1
Province	18	15	22	10
Municipalities	23	18	31	27
County + Township	34	61	44	64

Source:

Ministry of Finance, *Finance Yearbook of China* (Beijing: China Finance and Economic Press, 2008), pp. 147–48.Table 3: **Fiscal Trends for Government, by Level (%)**

	1993	1998	2002	2006
I. Revenues				
Central government	22	50	31	25
Provinces	13	11	20	18
Municipalities	34	20	21	23
Counties	16	20	22	29
Townships	11	8	7	6
II. Expenditures				
Central government	34	29	55	53
Provinces	11	19	12	12
Municipalities	29	24	16	17
Counties	19	11	11	14
Townships	13	9	6	5

Sources:

Wong, *Financing Local Government*; World Bank, *National Development and Sub-national Finance*; Ministry of Finance, *Compendium of Local Fiscal Statistics* (Beijing: China Finance and Economic Press, various years).

the assistance provided by transfers to poor localities was far from adequate to enable them to meet their responsibilities.³⁴

Moreover, the intergovernmental fiscal system has been characterized by distrust and mutual blame. Earlier I pointed to the central government's distrust of local governments to implement tax policy. During the long fiscal decline, local officials often complained of higher level governments "grabbing" revenues and "pushing down" expenditures. Data in Table 3 offer evidence in support of the local government complaints: while revenues were increasingly concentrated at higher levels, expenditures were going in the opposite direction. The growing vertical imbalances suggest that rural governments (that is, counties and townships), which are located at the lowest levels of the administrative hierarchy, were especially disadvantaged in their struggle for resources. This is a major cause of the glaring urban–rural inequalities that exist in China today.

34 *Ibid.* and World Bank, *National Development and Sub-national Finance*.

705 As the system of redistribution withered and then collapsed during the 1980s
 706 and 1990s, localities in the lower half of the income spectrum (where virtually
 707 all rural local governments are situated) were in chronic deficit. A growing num-
 708 ber of them defaulted on their responsibilities and were unable to provide services
 709 mandated by law or regulation. As a result, the intergovernmental system increas-
 710 ingly became a bottleneck to policy implementation: with local funding problems
 711 limiting services, the government has been unable to deliver on some priority pro-
 712 grammes such as universal basic education.³⁵

713
 714
 715 *The rise of extra-budgetary activities*

716 Another aspect of the breakdown of the intergovernmental fiscal system is
 717 the growth of off-budget financing of government, especially at local levels.³⁶
 718 The rapid growth of extra-budgetary funds during the 1990s can also be attribut-
 719 ed to the fiscal decline and especially the recentralization of revenues under the
 720 Tax Sharing System: allowing local governments to tap off-budget revenues was
 721 driven by the need for them to carry out their assigned functions. In the aggre-
 722 gate, in the late 1990s off-budget resources used by government and public
 723 agencies may have amounted to as much as between 19 and 27 per cent of
 724 GDP (in addition to the formal budget).³⁷ Reforms in the past few years have
 725 abolished many fees and levies – including, most famously, all rural levies
 726 under the Rural Fee Reform; others have been brought into the budget.³⁸ As
 727 fees and levies are abolished, however, local governments have grown increas-
 728 ingly dependent on revenues from land development, and these revenues were,
 729 during the 1990s, reported in neither budgetary nor extra-budgetary accounts.
 730 Since 1997 the government has required provinces to report land revenues in
 731 the “fund budget,” but compliance with this reporting requirement is spotty.

732 While the extra-budgetary revenues had undoubtedly played a positive role in
 733 aiding the provision of services during the period of fiscal decline, they also
 734 opened a “back door” financing channel outside the purview of the Ministry
 735

736
 737 35 Wong, “Can the retreat from equality be reversed?” and World Bank, *National Development and*
 738 *Sub-national Finance*.

739 36 Christine Wong, “Fiscal dualism in China: gradualist reform and the growth of off-budget finance,” in
 740 Donald Brean (ed.), *Taxation in Modern China* (New York and London: Routledge, 1998); Gang Fan,
 741 “Market-oriented economic reform and the growth of off-budget local public finance,” in *ibid.*; and
 742 Christine Wong and Richard Bird, “China’s fiscal system: a work in progress,” in Brandt and
 743 Rawski, *China’s Great Transformation*. In this article I use “off-budget” and “extra-budgetary” inter-
 744 changeably to refer to all non-budgetary resources controlled by government, rather than follow official
 745 terminology, which uses “extra-budgetary” to refer narrowly to a prescribed list of revenues by source
 746 and type.

747 37 The nature and size of extra-budgetary funds are explored in Christine Wong, “Converting fees into
 748 taxes: reform of extrabudgetary funds and intergovernmental fiscal relations in China,” in Richard
 Bird, Robert Ebel and Christine Wallich (eds.), *Shehuizhuyi guojia de fenquanhua: zhuangui jingji de*
zhengfujian caizheng zhuanyizhifu (Decentralization of the Socialist State: Intergovernmental Finance
in Transition Economies), Chinese edition (Beijing: Central Translation Press, 2001); and Wong and
 Bird, “China’s fiscal system: a work in progress.”

38 Reported extra-budgetary revenues have fallen to just 3.4% of GDP in 2003.

749 of Finance, providing local governments, especially in rich regions, with real
 750 autonomy. This too has contributed to “breaking” the intergovernmental fiscal
 751 system by weakening the central government’s ability to affect fiscal outcomes.
 752 As off-budget resources are generally more plentiful in rich regions than poor
 753 ones – whether “management fees” collected on enterprise gross turnover or prof-
 754 its, revenues from land transfers or user charges – this reliance on off-budget
 755 finance probably exacerbates regional disparities since, unlike budgetary reven-
 756 ues, they are not subject to redistribution through the intergovernmental fiscal
 757 system.

758

759

760 *Commercialization of the public sector*

761 During the 1980s and 1990s, the financing (though not the providers) of public
 762 services was increasingly privatized, with an increasing share of the costs passed
 763 to citizens and users. This applied to government bodies as well as PSUs, as they
 764 too came to rely increasingly on extra-budgetary resources.

765 While the original impetus for user charging and seeking other revenues came
 766 from budgetary shortfalls, their continuation into the 21st century appears to be
 767 driven increasingly by the self-interests of the PSUs and government agencies.
 768 Strong evidence for this was found in a 2005 World Bank study in which I partic-
 769 ipated.³⁹ First, we found that despite large additional injections of funds by the
 770 government in recent years, the collection of fees and other incomes continued.
 771 For the 2000–02 period, for example, budget appropriations for PSUs were raised
 772 from 362 billion to 659 billion yuan, an increase of 82 per cent.⁴⁰ However,
 773 during the same period, “self-raised revenues” and “service revenues” grew by
 774 43 per cent and 53 per cent, respectively. As a result, the overall proportion of
 775 PSU financing from budgetary resources rose only from 42 to 48 per cent; in
 776 the key sectors of education and health the effect was even smaller. More impor-
 777 tantly, the additional budgetary inputs were more than wholly absorbed by per-
 778 sonnel expenditures, which increased by 91 per cent, as a result of a combination
 779 of higher salaries and increased employment. The outcome was that the
 780 additional injections had little effect on reducing user fees except in a few sectors
 781 where fee reductions were administratively mandated.

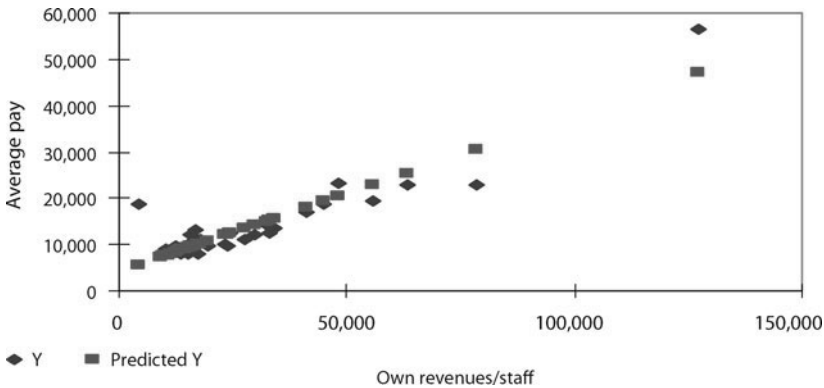
782 Seeking to explain what drove fee and other revenue collections at PSUs, we
 783 performed a series of regression analyses. Pooling PSUs by sector, by province
 784 and by tier of government, on a per employee basis, we found no correlation
 785 between budgetary inputs and the share of budgetary inputs, nor with total
 786 inputs. The only significant relationship was a very strong correlation between
 787 PSU “own” revenues (fees and other incomes) and average pay per employee.⁴¹
 788 The tight linkage between own revenues and staff remuneration is shown in
 789

790 39 World Bank, *Deepening Public Service Unit Reform*.

791 40 Since this was a period of mild deflation, these increases are approximately in real terms.

792 41 The coefficient is 0.34, and the R-square is 0.84.

Figure 7: Fitted Plot of Average Pay on “Own Revenues” by Province, 2002



Source:

World Bank, *Deepening Public Service Unit Reform*, Figure 1.5.

Figure 7, revealing that, on average, provinces with PSUs that collected more “own revenues” paid higher salaries than those collecting less.

These high-powered incentives for revenue-seeking were created when the budget was providing declining support to the PSUs, and a reform was implemented to “push PSUs into the market.” This reform gave PSUs greater managerial autonomy to expand the scope of services and permitted them to link managerial and staff remuneration to the revenues they raised. These concessions were made at a time when civil service salaries were low and there was widespread acceptance of the need to raise them. Over time, however, “topping up salaries” has become institutionalized and built into the remuneration structure, and they in turn influence how services are provided to the public. A notorious illustration can be seen in the “performance-based” remuneration system for doctors in a Chinese traditional medical hospital reported in 2003:

A local newspaper reported that a Chinese traditional medicine hospital implemented a new compensation system. Under this system, doctors receive on average 30 per cent of their regular salary as base pay. The remainder is made flexible and dependent on “performance.” A doctor in a “poorly performing” department receives 700 yuan per month while those in “better performing” departments may earn as much as 10,000 yuan. The best performing department turns out to be the Department of Occupational Injury Verification. Doctors also get a part of their pay based on the value of drugs and services they prescribe. For example, a doctor receives 11 per cent of the value of Chinese herbal medicines, 2 per cent for Western medicines, 10 per cent for chemical and physical tests, 13 per cent for injections, 17 yuan for each CT test, and 10 yuan for each Ultra Sound test.⁴²

Table 4 shows that in 2002, nationwide the “basic wage,” as stipulated by the civil service pay scale, accounted for only a little more than half of take-home pay for public employees. The rest was made up of “bonuses and subsidies” financed

42 Local newspaper report. See <http://news.sina.com.cn/c/2004-06-07/01593389284.shtml>, accessed 16 August 2009. Cited in World Bank, *Deepening Public Service Unit Reform*.

Table 4: **Composition of Remuneration of PSU Employees, 2002**

	Total pay (yuan p. a.)	Basic wage	Bonuses and subsidies	Share of basic wage in total (%)	Memo item: share of PSU funding from budget (%)
National average	11,045	6,238	4,807	57	48
By tier:					
Central	15,001	6,151	8,850	41	49
Provincial	13,199	6,320	6,879	48	44
Prefectural	13,604	6,951	6,653	51	38
County	9,508	6,030	3,478	63	53
Township	10,157	6,430	3,727	63	60

Source:

World Bank, Deepening Public Service Unit Reform, Table 1.2.

largely from own revenues. In fact, comparing the share of basic wage in total remuneration in PSUs across levels of government reveals another key feature of the current system: the lower-tier PSUs in the counties and townships drew a higher share from basic wages than higher-tier PSUs. This was surely not because budgetary resources were more plentiful at those levels, but that the lower-tier institutions had less authority and fewer opportunities to impose fees and levies on their clients, and had fewer state assets with which to generate income.

By “commercialization of the public sector,” I mean the (own) revenue-seeking orientation of both PSUs and government agencies, all of which are doing whatever they can to earn money. This is the motivation behind museums renting out space to advertising and product displays, libraries setting up photocopying centres and even pinball parlours, and the like. It is also the motive for public health institutions such as the centres for disease control and maternal child health stations vying to provide fee-paying services, despite receiving full budgetary funding, so that they can augment staff salaries. Following the Cultural Revolution legacy of educating students through hands-on labour, schools set up factories and workshops to earn extra income, and were given tax exemptions as added incentives. In 2002, these workshops and factories earned 5.4 billion yuan to contribute towards financing education.⁴³

Revenue-seeking behaviour is not confined to PSUs, but characterizes government agencies at the central and local levels as well, and it is driven by the same

43 Ministry of Education, *Yearbook of Education Finance Statistics*. The tragic story of an explosion in a rural primary school in Jiangxi that killed four teachers and more than 36 children in March 2001 was probably the result of this practice: reports of the accident indicated that parents had long complained that the school was using students to assemble fireworks for sale. See “Zhu Rongji zongli tan jiangxi wanzai xiaoxue baoza shijian” (“Premier Zhu Rongji’s talk on explosion incident in school in Wanzai county of Jiangxi province”), China News Online, <http://www.chinanews.com.cn/2001-03-15/26/78781.html>, 15 March 2001, accessed 16 August 2009.

881 incentives.⁴⁴ Xiaobo Lu has reported on abuses by government agencies impos-
 882 ing fines and fees to finance supplementary pay.⁴⁵ In the 1990s, government
 883 agencies also created money-making entities such as development companies
 884 and tourism “spots.”⁴⁶ Central ministries, too, were adding money-making activi-
 885 ties to their portfolios: the Ministry of Finance had an investment trust company,
 886 the then-State Planning Commission established New China Airlines, and the
 887 then-State Statistical Bureau had a for-profit Information Centre that sold data
 888 and provided data-processing services. Virtually all ministries created new jour-
 889 nals, magazines and yearbooks, for which subscription was often compulsory
 890 for subordinate units. An official report from the Fujian provincial
 891 Organization Department found that government departments at the sub-
 892 provincial levels were routinely using much, if not all, of their discretionary
 893 incomes from fees, levies and business ventures to top up cadre salaries, and
 894 that their unequal opportunities for generating their own revenues explained
 895 the large variation in average pay.⁴⁷ More recently, Yu Xie and Xiaogang Wu
 896 found in surveys conducted in Shanghai, Wuhan and Xian that “profitability”
 897 of the *danwei* 单位 is a key determinant of incomes in urban China, for both pub-
 898 lic and private sectors.⁴⁸

901 Conclusions

902 After three decades of spectacular economic successes, China is facing a
 903 significant challenge in strengthening its government apparatus to manage the
 904 increasingly decentralized, complex economy. The string of recent scandals –
 905 environmental degradation, lapses in public health, violations of safety
 906 standards, the prevalence of fake drugs and chemicals – have all pointed to the
 907 government’s weaknesses in protecting public safety, exposing an enormous
 908 gap between China’s growing economic prowess and its capacity to govern.
 909 This gap threatens to undermine the government’s legitimacy.

910 Are these simply “growing pains” of China’s extremely rapid economic trans-
 911 formation and integration into the global economy? With the leadership now
 912 focused on the need to improve its regulatory regime, will China finally “catch
 913 up” and build the public institutions necessary to govern a modern economy?
 914

915 44 One director general of a powerful central ministry told me that she spends a significant portion of her
 916 time looking for revenue-generating opportunities to augment “bonus pay” for her staff.

917 45 Xiaobo Lu. “From rank-seeking to rent-seeking: changing administrative ethos and corruption in
 918 reform China,” *Crime, Law and Social Change*, Vol. 32, No. 4 (1999), pp. 347–70.

919 46 One official in a medium-sized city in the south-west told me it began in the early 1990s, when Deng
 920 Xiaoping’s “southern tour” seemed to open the door to all entrepreneurial activities within and outside
 921 government (field visit in February 1998).

922 47 In the province’s Putian prefecture, for example, in 2000 the lowest annual incomes (5,722 yuan) were
 923 earned by the departments dealing with mineral extraction, while the highest (12,957 yuan) were in the
 924 departments dealing with finance and insurance. See *2003 China Investigation Report*. I am indebted to
 925 Frank Pieke for this reference.

926 48 Yu Xie and Xiaogang Wu, “*Danwei* profitability and earnings inequality in urban China,” *The China
 927 Quarterly*, No. 195 (2008), pp. 558–81.

925 The analysis presented in this article leads me to a pessimistic view that is sub-
 926 stantially at variance with those of many scholars. Most notably, Dali Yang
 927 has argued that changes since the mid-1990s have led to a “reconstitution of
 928 the sinews of central control [that] promised not only to furnish the fiscal prowess
 929 for the central state but also to provide the foundations for the pursuit of the
 930 American Progressive’s ideal of the regulatory state.”⁴⁹ Wang Shaoguang and
 931 Hu Angang are similarly optimistic in their recent assessments. Wang argues
 932 that after a “brief nightmare” in the 1990s, a flourishing counter-current has
 933 emerged in China to push towards a “social market,” where the government,
 934 through its redistribution mechanisms, is “decommodifying 去商品化” services
 935 related to people’s livelihood, such as education, health care and social protec-
 936 tion, to ensure that they reach all groups in society. He points to the emergence
 937 of the current social policies, though they need to be strengthened, as “a historic
 938 turning point ... [whose] importance cannot be overestimated.”⁵⁰ Hu traces the
 939 transformation of government from an “economic construction-oriented govern-
 940 ment” (*jingji jianshe xing zhengfu* 经济建设型政府) to a “public service-oriented
 941 government” (*gonggong fuwu xing zhengfu* 公共服务型政府), and concludes that:
 942 “the 11th Five-Year Plan marked a decisive step ... Although the process is not
 943 yet complete, we are confident that the Chinese government will by 2020 become
 944 a truly service-oriented government.”⁵¹

945 In this article, I have retraced the history of China’s fiscal decentralization,
 946 much of which has also been covered by other scholars.⁵² What is new in this
 947 article is that I have focused on the process of this evolution, highlighting the
 948 reactive, incremental retrenchment of government in the 1980s and 1990s to
 949 draw conclusions about the adverse long-term legacies of these changes. The
 950 ad hoc devolution of authorities and an unwillingness to shrink the scope and
 951 reach of government, combined with inadequate finance, led to a laissez-faire
 952 orientation that produced large distortions in the incentive structure facing gov-
 953 ernment agencies and PSUs. These, I argue, are the roots of the current problems
 954 of weak governance, regulatory failures and growing inequality in China.

955 In the first decade of the 21st century, the constraints in China to improving
 956 public services and consumer and environmental protection are, unlike the

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 958 49 Dali L. Yang, “Economic transformation and state rebuilding in China,” in Barry Naughton and Dali
 959 Yang (eds.) *Holding China Together: Diversity and National Integration in the Post-Deng Era*
 960 (New York: Cambridge University Press, 2004), p. 143.

961 50 Shaoguang Wang, “Dazhuanxing: 1980 niandai yilai Zhongguo de shuangxiang yundong” (“The great
 962 transformation: the two-way movement in China since the 1980s”), *Zhongguo shehui kexue* (*Social
 963 Sciences in China*), No. 1 (2008), pp. 129–48.

964 51 Angang Hu, “Zhongguo zhengfu zhuanxing yu gonggong caizheng” (“Government transition and pub-
 965 lic finance in China”), in Fang Cai (ed.), *Zhongguo jingji zhuanxing sanshinnian* (*30 Years of Economic
 966 Transition in China*) (Beijing: Social Science Academic Press, 2009), p. 151–92.

967 52 A very partial list would include Michel Oksenberg and James Tong, “The evolution of central–provin-
 968 cial fiscal relations in China, 1953–1983: the formal system,” *The China Quarterly*, No. 124 (1991),
 pp. 1–32; Wang Shaoguang and Hu Angang, *State Capacity of China* (New York: Oxford University
 Press, 1994); World Bank, *China: Revenue Mobilization and Tax Policy* (Washington DC: World
 Bank Publications, 1990); *National Development and Subnational Finance*; and Wong, “Central–local
 relations in an era of fiscal decline” and *Financing Local Government in the People’s Republic of China*.

969 previous two decades, no longer a shortage of money. Since the Tax Sharing
 970 System reform introduced a broad-based VAT and enterprise income tax, and
 971 revamped tax administration in 1994, the government's revenue mechanisms
 972 have been restored. The recent growth spurt has brought annually double-digit
 973 increases in revenue that have filled government coffers to overflowing, especially
 974 at the central government. Indeed, the Harmonious Society programmes have
 975 grown out of this prosperity and the recognition that more can and should be
 976 done for the less fortunate. The main challenges today are how to channel
 977 resources effectively to where they are needed, and motivate government agencies
 978 and PSUs to implement policies and enforce existing laws and regulations.

979 At present, the capacity of the central government to direct economic and
 980 social change is constrained by: the large regional disparities in economic devel-
 981 opment and human resources; a broken intergovernmental fiscal system that is
 982 unable to support national policy implementation; accountability mechanisms
 983 that are weak or non-existent throughout the administrative structure, having
 984 been severely eroded by long periods of inadequate finance during which local
 985 governments and public institutions could not be held accountable for results;
 986 an information system that is very weak from disuse; and a bloated bureaucracy
 987 where authorities are fragmented, and the transmission of policies and resources
 988 are complex and unreliable.⁵³ Most of all, the government is hobbled throughout
 989 the whole administrative apparatus by agents whose (own) revenue hunger dom-
 990 inates decision-making. The frenzied response by both central agencies and local
 991 governments to the fiscal stimulus programme in 2009 is both symptomatic of the
 992 revenue orientation of public bodies and indicative of the central government's
 993 uphill struggle to reorient China's development path.⁵⁴ The rush of local infra-
 994 structural (especially transport) projects stands in marked contrast to the
 995 wait-and-see posture of many local governments to the recent social spending
 996 programmes.

997 The problems of the intergovernmental fiscal system and distorted incentives
 998 were created when China muddled through the brutal fiscal decline without a
 999 strategy for reshaping the public sector. The structure and incentives are now har-
 1000 dened and deeply embedded, and undoing them will take time and a determined
 1001 effort. A programme of comprehensive reforms will be required to eliminate the
 1002 constraints listed above: building new accountability mechanisms and infor-
 1003 mation systems, reorganizing and streamlining government, and, most of all,
 1004 repairing the intergovernmental fiscal system. These are large and politically

1007 53 These problems were also explored from different perspectives in Wong, "Can the retreat from equality
 1008 be reversed?" and Wong, "Fiscal management for a harmonious society."

1009 54 A series of excellent articles in *Caijing (Finance)*, a bi-weekly magazine, document the mad rush of local
 1010 governments to raise funds for infrastructural spending under the fiscal stimulus call, grabbing bank
 1011 loans and creating new debt instruments. For example, Liuan, a county-level city in Anhui province,
 1012 had by March 2009 issued debts of 1.5 billion yuan through its urban construction investment corpora-
 tion and started work on projects totalling 4.8 billion yuan, even though its fiscal revenues were only
 3 billion yuan in 2007, *Caijing*, No. 239 (2009), p. 76.

1013 difficult reforms. Until revenue and expenditure assignments are realigned, and
1014 the revenue-driven orientation of government agencies and PSUs is fundamen-
1015 tally altered, pushing more money through the system will not solve the problems
1016 of weak governance, and is likely to have only limited effect on improving the
1017 government's capacity to ensure fairness, public safety and consumer protection.

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