

Fiscal Management for a Harmonious Society:
Assessing the Central Government's Capacity to Implement National Policies¹

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¹ Due to time constraint, this draft is not properly referenced – sources and citations will be added in the revision. Many findings draw from work that was carried out under the World Bank studies *China: Public Services For Building The New Socialist Countryside (2007)*; *China: Extending Public Finance to the Countryside (2006)*; and *Reforming Intergovernmental Finance in China: a Study of the Northeast (2007)*.

Entering the 21st century, China has adopted a new development paradigm that emphasizes the building of a “Harmonious Society” with more balanced development across regions and across sectors. The paradigm adopts a “scientific view of the development process” (科学发展观) that emphasizes sustainable growth and “putting people first” (以人为本). This is laid out in some detail in the Eleventh Five-Year Plan and also explained in Wen (2004).² Under this new development paradigm, the government has substantially increased its commitment to pro-poor, pro-rural programs. This is reflected in numerous official statements,³ and the many new programs introduced over the past few years.

This is a timely shift in policy to redress the large disparities that have emerged in the course of China’s remarkable economic growth, especially over the past decade.⁴ The greatest disparities are those between urban and rural residents. By virtually all estimates, the average urban income per capita is now more than three times that of the average rural income per capita, a gap that is among the largest in the world. In addition, rural citizens enjoy public services that are far inferior to those provided to their urban counterparts. Reducing these differences would be a critical step toward building a Harmonious Society that includes all citizens.

² Wen Jiabao, “Firmly Establish and Resolutely Implement a Scientific Development View,” closing speech at the specialized research course for provincial-level cadres on establishing and implementing a scientific development view, February 21, 2004.

³ Since 2003, the first document issued by the State Council each year, popularly known as the “Number One Document” where the top emphasis of the government is laid out, has been devoted to rural issues.

⁴ For recent studies of these disparities, see Ravallion and Chen (2004), Shue and Wong (2007), and World Bank (2007a).

Whether intended or not, by adopting the goal of building a Harmonious Society, the Hu Jintao - Wen Jiabao administration has committed itself to a program of large increases in public spending and a huge agenda of reform of government and its institutions since, unsurprisingly, the Harmonious Society program has opened the door to calls to address the many current inadequacies in social services as well as the unfairness of their distribution. At a May 2007 conference on health care policy, for example, the Vice Minister of Health Wang Longde argued that, “Without a fair and equitable system of health care, building a Harmonious Society is impossible.”⁵ Earlier, Premier Wen Jiabao had promised to make rural compulsory education once again “free of charge... within the next 1-3 years”.⁶ Other announcements include providing a safety net for the rural populace under a rural minimum living stipend scheme to be set up in all counties by the end of 2007.⁷

This paper examines China’s public finances to address the question of whether the government has sufficient “fiscal power” to implement the Harmonious Society Program (hereafter HSP), whose achievement is intended to help create the bedrock foundation for supporting China’s rise as an economic power in the 21st Century. In this paper I will focus on two interrelated aspects of public finance: first, whether the government has enough resources to meet the public expenditure needs of upgrading services in the rural sector sufficiently to meet the inclusive goals of the HSP. The second aspect concerns

⁵ “Grasping rules and regulations to guide the reform in health services”, speech given at the Westlake Forum on China's Health Policy, May 10-11, 2007; Hangzhou.

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⁷ “Chinese government decides to subsidize all rural poor,” 24 May 2007, Xinhua News Agency (English).

whether the central government has the capacity to manage the effective use of these resources to achieve these goals.

The paper is organized as follows: Section I will present a brief history of fiscal reform. Section II reviews the legacies of fiscal decline; Section III assesses the current Harmonious Society Program. Section IV presents a more fully funded HSP and assesses its affordability. Section V turns to the delegated system of policy implementation in China and the challenges in reaching the rural sector. Section VI concludes.

I. A Brief History of Fiscal Reform

The transition from a planned economy to a decentralized, market-oriented economy has required a thorough revamping of the public finance system – from tax policy, tax administration, revenue sharing with local governments, expenditure assignments, to budgeting processes, treasury management, and the provision of public services. This process of building a new public finance system to support a modernizing, market economy has been a core part of the transition in all former Soviet-type economies.⁸

In China this process of reforming the system of public finance has lagged far behind other changes in the economy. Although many changes have been introduced over the past quarter century, the system is still in transition (Wong and Bird, forthcoming).

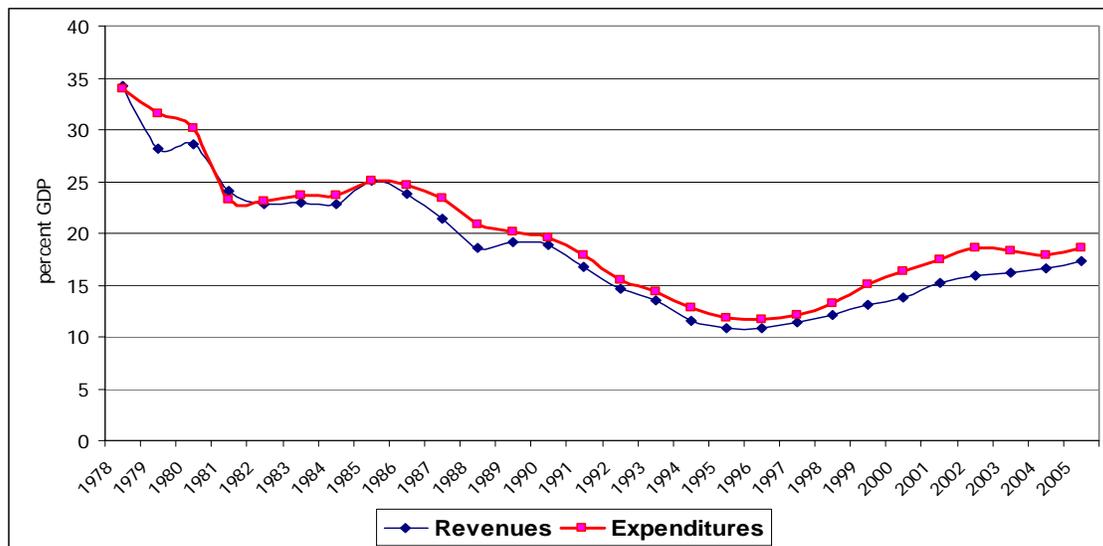
Briefly stated, fiscal reforms to date can be divided into two phases: the first phase began with the transition in 1978 and continued through 1997, and was dominated by a

⁸ See, for examples, Wallich on Russia, Bird, Ebel and Wallach on Eastern Europe, Martinez and ___ on Russia, Kazakhstan, etc.

steep fiscal decline, when budget revenues fell from about 35 percent of GDP to less than 11 percent in 1996 (Figure A). This was accompanied by a decentralization of revenues, when the central government's share slipped to 20 percent of the total.

Phase II began around 1998, and is marked by an upturn in several key indices – total revenues, central revenues, and discretionary central resources. This upturn was followed by a renewed effort at improving equalization, as well as the beginnings of efforts to reform public expenditure management.

Figure A. Trends in Budgetary Revenues and Expenditures.



Phase I: Steep fiscal decline and dwindling central control

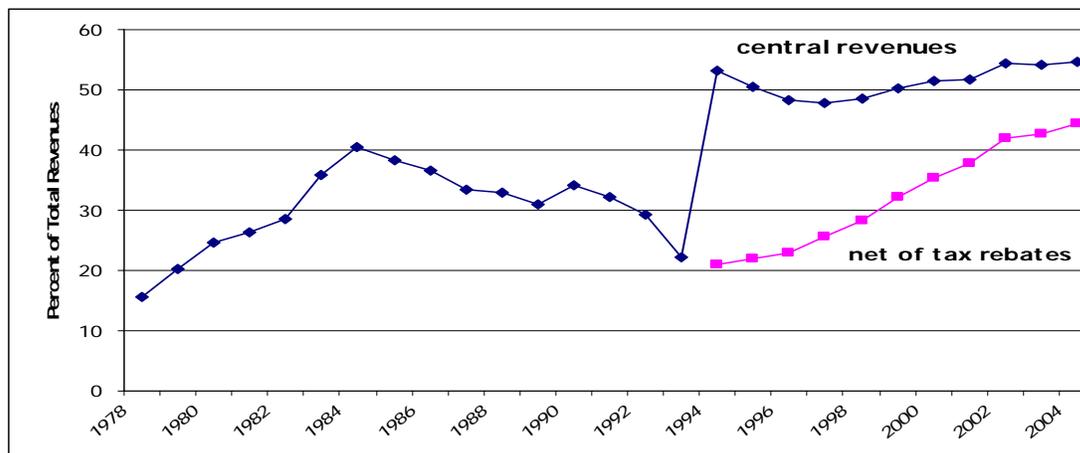
From the start of the transition in China, dismantling the planning apparatus led quickly to an erosion of the government's main revenue mechanism – SOE profits, and government revenues went into a steep decline. At the same time, decentralization had

caused central revenues to fall as a proportion of total revenues, reinforcing the decline of central control over resources. At the trough, the central government controlled a budget amounting to only 3 percent of GDP (see Figure C below).

In 1994 the Tax Sharing System (TSS) reform was introduced, which fundamentally overhauled the revenue sharing system by shifting to tax assignments. By assigning the biggest tax, the value-added tax (VAT), as a shared tax and claiming 75 percent of its receipts, nominally the central government reclaimed a majority portion of total revenues.⁹ The conventional view (including my own past work) has been that central revenues rebounded with the TSS (see Figure B). However, the government had committed to a program of tax rebates (税收返还), under which annually it returned to the provinces sufficient revenues to maintain their spending levels in the base year 1993, as well as a share of “the growth” in VAT and the excise tax (a central tax). When the tax rebates are netted out, the discretionary revenues of the central government grew far more slowly (Figure B). Because of the large rebates in the initial years, the central share had in fact continued to decline through 1994 and 1995, rebounding only from 1996 onwards.

Figure B. Central Government Share of Revenues

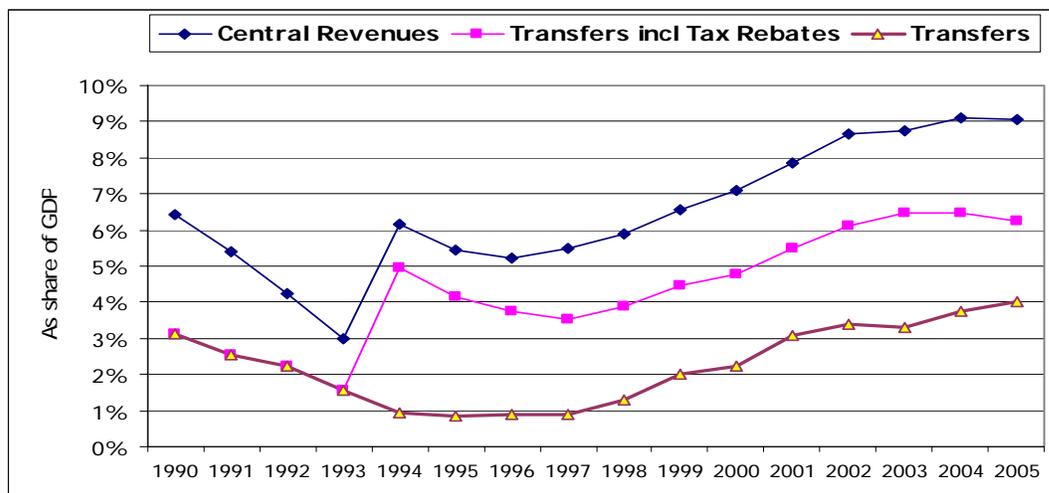
⁹ The VAT accounts for nearly half of all tax revenues in China. It is also a reliable tax whose revenues go up with GDP regardless of profitability, and thus less cyclical than income or profit taxes.



During this period, assistance to local governments in poor regions declined.¹⁰ This is shown in Figure C, where discretionary transfers (defined to exclude tax rebates), fell to 1 percent of GDP in 1994 and remained at that level through 1997. In fact, this trend of declining support to poor regions had begun in the mid-1980s as central revenues dwindled (Wong 1997 and 2003). Moreover, the decline in transfers depicted in Figure C *significantly understates* the dramatic drop in redistribution, since the definition of transfers changed with the revenue-sharing system in 1994. Previously, most transfers were hidden under the system of negotiated revenue sharing, and what was called “transfers” were only the additional injections to those poor provinces that could not meet minimum expenditure needs even after being assigned 100 percent of own revenues.

Figure C. Trends in Central Revenues and Transfers

¹⁰ This trend began from the mid-1980s, see Wong (1997 and 2003).



Phase II: Fiscal recovery, reform and increased effort at equalization

The TSS reform succeeded in rebuilding the revenue mechanism by introducing new tax types and strengthening tax administration, and revenues began to rebound from the mid-1990s. Helped by buoyant economic growth, the budget is now reaching 20 percent of GDP – a level comparable to that in the 1970s when account is taken for the portion of capital investment spending that has been moved off the budget. Moreover, since social security is not included in Chinese budgetary data, this level of spending is not far below that in some OECD countries (*check*), and is roughly in line with China’s income level.

With fiscal recovery, the government began, belatedly, to undertake reform in public expenditure management, with changes to the budgeting and treasury management processes introduced in the late 1990s. However, progress has been slow, and some critical reforms have yet to be undertaken, most notably in revamping central-local fiscal relations, as well as clarification of the public role in the new economy. With the rebound in its own revenues, the central government also began to devote more resources

to transfers, which grew to 4 percent of GDP in 2004. More effort also went into making the transfers more equalizing (World Bank 2007).

II. Legacies of Fiscal Decline

The long period of fiscal decline had forced many adjustments on China's public finance, some with long-lasting and negative effects. Three of the best-known were a) the emergence of large horizontal fiscal disparities across regions, b) the growth of vertical imbalances, and c) the accelerated growth of extrabudgetary activities and commercialization of the public sector.

a. Growing horizontal imbalances

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 exacerbated the already large income differences among provinces. The shift to the TSS in 1994 had replaced the weakly redistributive system of revenue-sharing with a tax assignment system, so that the distribution of fiscal resources came to resemble more closely that of regional incomes, reinforcing the effect of income inequalities. Table 1 shows that through 2004, even with some recovery in central transfers, this effort was not enough to prevent the continuing growth of disparities in fiscal resources across provinces.

Table 1. Growing Disparities in Per Capita Budgetary Expenditures by Province*

	1990	1994	1998	2002	2004
Highest (1) Shanghai	609	1452	3211	5307	7936

Lowest (2) - Guizhou	104	157	347	655	906
Ratio of (1) to (2)	6	9	9	8	9
Average	254	450	829	1620	2082
Absolute gap	505	1296	2863	4652	7031
Coeff. of variation	0.57	0.71	0.75	0.75	0.75

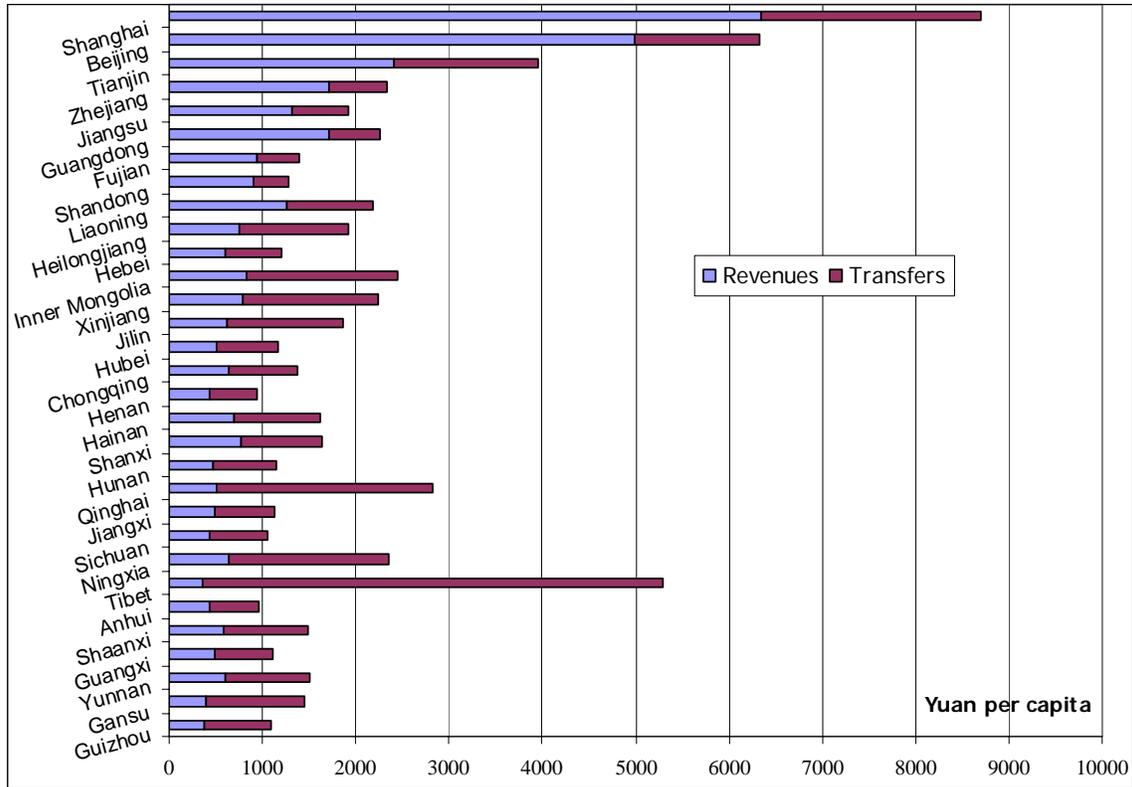
* excluding Tibet.

Source: MOF Compendium of Local Fiscal Statistics, and CSY.

A more important problem is that the current transfer system is not equalizing. This is illustrated in Figure D, which lists the 31 provincial level units by per capita GDP in a descending order, and shows their receipts of own revenues and transfers in 2004 – transfers appear to have no discernible effect in alleviating fiscal disparities. This finding has been replicated with data on county level units (World Bank 2006).¹¹

Figure D. Sources of fiscal resources by province (2004, yuan per capita)

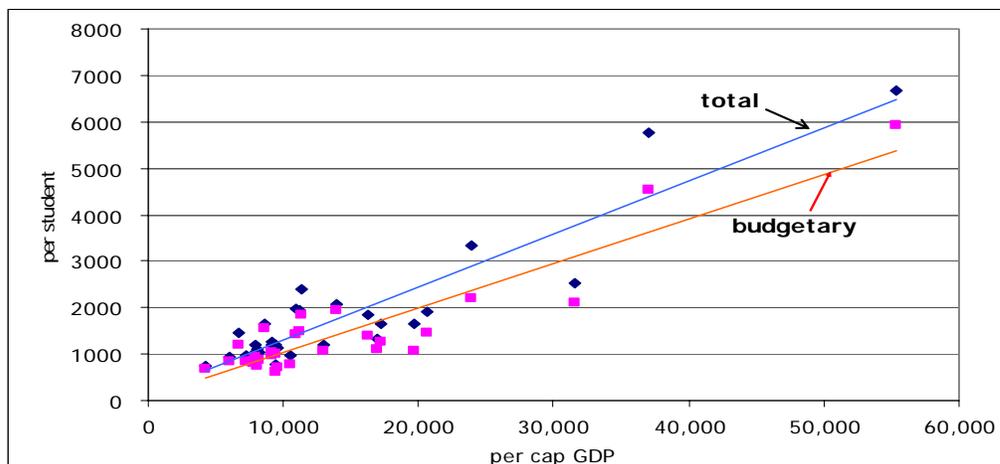
¹¹ Other studies have also found that at the county level, low income is not a significant factor in attracting transfers (see, for examples, Shih and Zhang 2007, Tsui Kaiyuen *passim*)



MOF Compendium of Local Fiscal Statistics and CSY.

Since social services are financed by local governments, the outcomes are large regional disparities in spending and provision (Figure E).

Figure E. Per student expenditure in primary schools by province (yuan, 2004)



Source: China Education Finance Yearbook 2005.

b. Growing vertical imbalances

During the long fiscal decline, evidence suggests that higher level governments tended to “grab” revenues and “push down” expenditures, resulting in a trend of growing vertical imbalances as revenues became increasingly concentrated at higher levels while expenditure trends went in the opposite direction (see Table 2).

Table 2. Fiscal trends differ for subnational governments

Revenues	1993	1998	2000	2002	2004
Central Government	22%	49.5%	52.2%	55.0%	54.9%
Provinces	13%	10.5%	10.7%	11.7%	11.2%
Municipalities	34%	19.7%	17.4%	16.3%	16.6%
Counties	19%	11.5%	12.0%	11.0%	12.0%
Townships	13%	8.8%	7.7%	6.1%	5.2%
Expenditures					
Central Government	34%	28.9%	34.7%	30.7%	27.7%
Provinces	11%	18.8%	19.1%	19.6%	18.7%
Municipalities	29%	24.1%	20.0%	21.0%	22.2%
Counties	16%	19.9%	18.9%	21.9%	25.2%
Townships	11%	8.3%	7.3%	6.8%	6.1%

Sources: Wong (1997), World Bank (2002), MOF Compendium of Local Fiscal Statistics, various years.

c. growing extrabudgetary activities and the commercialization of the public sector

As fiscal support to local governments and public services declined, especially in the 1990s, local governments and service providers were encouraged to “diversify” their funding sources. Extrabudgetary activities grew rapidly as local governments and public service units sought to develop new revenue sources (Wong and Bird, forthcoming), and user charges proliferated. Under the market-like incentives that were offered as motivation, the practice of supplementing staff salaries from “self-raised funds” came to be routinely accepted throughout the public sector.¹²

Social outcomes

Given that the TSS had recentralized revenues but left expenditure assignments unchanged, many local governments were left with inadequate resources for financing their expenditure responsibilities, and had little help from central transfers. As a result, many defaulted on their responsibilities and were unable to provide services mandated by law/regulation. Although the Education Law called for nine years of compulsory education for all children, for example, in 2004 some 17 percent of rural counties could not provide it, all of them in remote rural areas.¹³ One scholar has estimated that during

¹² Until they were shut down under Zhu Rongji, all central ministries ran businesses to generate revenues for “staff welfare” needs -- MOF and SPC had large investment companies, the SPC owned the Xinhua Airline, etc.

¹³ Information from MOE.

1985-2000, as many as 150 million rural youths did not receive nine years of schooling, due to the combination of undersupply and the high school fees that were often charged.¹⁴

Likewise, the urban-rural gap in public services is large, with stark consequences for the rural population. For example, for 2003 China's human development index was estimated to be 0.81 for urban and only 0.67 for rural areas. Aside from the differences in income, this reflects the lower life expectancy in rural areas (which, at 69.6, was 5.6 years less than in urban areas), as well as differences in levels of education. The share of the population between 15 to 64 years of age without any formal education was 8.7 percent in rural areas – more than three times the urban rate (Census 2000). Rural-urban differences in service delivery are also reflected in funding, access, and quality. For example, the per capita recurrent expenditure on education is three times higher in city districts than in the rural communities; and health expenditures were almost three times as high in urban areas compared to those in rural (2003 figures; UNDP, 2005). For health services the number of doctors per 1000 persons was 5.2 in urban areas, but only 2.7 in rural (2002 figures, MOH, 2004). Similar urban-rural differences exist with respect to infrastructural services such as water, sanitation, roads, and information and communication technology.

III. The Current Harmonious Society Program

The 11th Five Year Plan document lays out broad objectives for the HSP that include:

- Reducing inequalities across sectors and regions

¹⁴ 张玉林, 分级办学制度下的教育资源分配与城乡教育差距 —关于教育机会均等问题的政治经济学探讨, 中国农村观察, 2003 (1).

- Strengthening the social safety net
- Improving public services, including environmental protection
- Strengthening the rule of law, etc.

The main thrust of the HSP is redistribution and rebalancing of the economy, aimed at reversing some of the inequalities that have emerged, addressing social grievances and relieving tensions.

Under the new Harmonious Society paradigm, officials have called for closing the gaps, and many new programs have been rolled out. Among them, free rural basic education, new cooperative medical insurance for farmers, building the “new Socialist Countryside,” rural *dibao* (minimum living stipend), training and job placement support for rural out-migration, and social security schemes for farmers. These programs represent major steps forward in improving public services in the rural sector and increased commitments of government support. Table 3 offers some details of the programs.

Table 3. Key New Programs for Rural Education and Health

Program	Launch Date	Policy Objective	Policy Content
“Two-exemptions and one subsidy”	2003	To reduce financial costs of schooling to families for nine years of compulsory education in order to expand access.	Government provides funding to replace revenues from the textbook and miscellaneous fees and provides a subsidy to boarding students from "poor" families.

Free Rural Compulsory Education	2006-2007	To take on nine years of compulsory education financed by public resources; to reduce financial costs to families in order to expand access.	Government provides funding to replace revenues from "miscellaneous fees" (<i>zafei</i>) at an average of RMB140 per student p.a. for all rural primary school students, and RMB180 per student p.a. for all rural junior middle school students. By 2007 this will cover 150 million students.
New Rural Cooperative Medical Scheme (NCMS)	2005	To provide risk-pooling for major illnesses, to reduce the financial risks of farmers falling into poverty due to illness.	Designed mainly for in-patient services; run at the county level, scope of coverage and reimbursement rates are stipulated; participation is voluntary and on a household level; counties are permitted to set up a NCMS when 70 percent of households agree to participate. The minimum funding is set at RMB 50 p.a., with cost-sharing: Center RMB20; subnational governments RMB20-40 per participant toward the annual premium; RMB10 by the participant.
Rural Dibao (minimum living stipend)	2005	To provide income support to the poor	All households with incomes below the local stipulated minimum will receive a "top-up" from the government. To be rolled out in all counties by year-end 2007.

Source: adapted from World Bank (2007b).

Under China's highly decentralized fiscal and administrative systems, all of these programs are largely implemented by county and township governments, and the current intergovernmental fiscal system constitutes the main obstacle to their implementation.

Illustrative example

The New Cooperative Medical Scheme is typical of the new HSP initiatives introduced in recent years. Under the program, the Central government calls for all rural counties to

set up a community-based risk pooling system to provide medical care for their residents, whose participation is on a voluntary basis. It has set the minimum contribution at RMB 50 per person enrolled.¹⁵ Of this, the central government contributes a subsidy of 20 yuan per participant, and asks provinces and municipalities to help with the 20 yuan “local” contribution that is specified, leaving a personal contribution of only 10 yuan. This program imposes substantial burden – and perhaps even the majority portion, of financing costs on the counties, which bear the administration and collection costs as well as all of the financial risks of the program, in addition to some part of the 20 yuan local contribution.¹⁶ To contain costs and avoid overspending, county governments are designing very conservative plans that limit coverage and benefits, sometimes even adopting measures highly unfavorable to the people the scheme is designed to help. In one county visited last November, we learned that the plan was so conservative that it had paid out only 40% of the pooled funds – which were themselves very low – had been paid out in reimbursements during the first 18 months of the scheme. One county even decided to carve up the inpatient care fund among subordinate townships based on enrollment shares, and ask the townships and health institutions to share the costs in event of overspending. The schedule was:

- County would cover only up to 5% of overspending
- Overspending by 5-18% would be shared 20:20:60 among the county, township, and hospital
- Overspending in excess of 18 percent would be the sole responsibility of the hospitals

¹⁵ This standard was RMB 40 yuan initially.

¹⁶ Local governments are prohibited from using collected premiums to defray administrative costs.

In response, township and hospital officials reported that they planned to contain costs by transferring patients to hospitals at the county and municipal levels, where the reimbursement rates are lower.¹⁷ In effect this pushes the financial risks right back to the patients (World Bank 2007b).

Under the free rural compulsory education program, the central subsidy also covers only a portion of the revenue loss from abolishing miscellaneous and other fees, leaving large gaps to be filled by local governments – the central subsidy standard is RMB 140 p.a. per primary school student, and RMB 180 for junior middle school students, far less than the average levels of current collection.¹⁸ The problem, moreover, is that the rural fiscal gap has grown in recent years as more and more new programs are being introduced, all of them representing partially funded mandates. Even though transfers have grown rapidly in total, they are not keeping up with increases in expenditure needs.

IV. Is There Enough Money? Assessing Central Government Financial Capacity

Improving the delivery of public services to the rural populace is, and should be, a core component of China's strategy of building a Harmonious Society and a "New Socialist Countryside." Public services such as education, health care and social protection are essential to efforts to reduce the gap between urban and rural residents, by enabling rural

¹⁷ World Bank 2007b. The reimbursement rates for covered care in this county were 65% in the township hospital, 35% in the county hospital, and only 20% in the provincial hospital.

¹⁸ In one junior middle school visited, students had paid fees totaling nearly RMB 1000 p.a. before the new program was rolled out.

citizens to acquire the human capital needed for participation in China's economic success. The financing needs of improving rural public services are huge given the enormous size of the rural population and the currently large deficits in rural services and service quality.

Rather than tackle the thorny issues of how much equalization is achievable or desirable in a huge country such as China, and even though top leaders have implied, if not outright called for, bringing rural services up to the level of urban services,¹⁹ in this section I will focus on calculating the costs of remedying the critical shortfalls in just a few key rural services in the short-run.

These are five national programs that are already being implemented, albeit at varying levels of funding in different localities: 1) rural compulsory education, 2) the new cooperative medical insurance scheme for farmers, 3) the rural dibao (minimum living stipend) scheme, 4) a village investment fund to support rural infrastructure, and 5) a training program to support rural out-migration. Table 4 presents the estimated costs of scaling up these programs to provide a more adequate level of funding for each. The total adds up to RMB 205 billion yuan. This is an amount that is well within the financing capacity of the central government – equal to only 12 percent of central revenues of RMB 1.65 trillion yuan in 2005, or 16 percent of discretionary central revenues (RMB 1.25 trillion yuan after deducting tax rebates). Moreover, the net additional cost to the central budget will be smaller, since most of the programs are

¹⁹ For example, at the National Conference on Health in January 2007, both Hu Jintao and Wen Jiabao called for building a health care system that “covers both the urban and rural populace”. MOH website, January 30, 2007.

already being funded, and other costs can be absorbed by revamping and replacing some of the current transfers of more than RMB 700 billion yuan (excluding tax rebates).

Table 2. Cost estimates for a Start-up HSP.

	Assumptions	Cost (billions RMB)
Rural compulsory education	Provide funding to cover 2 times the gap in 2005 between total and budgetary expenditure in RCE for central and western provinces – to replace all fees and other nonbudgetary revenues, and to provide a 20-25 percent increase in funding to improve teaching conditions	50
New Cooperative Medical Scheme	100 yuan subsidy per participant for rural population in the central and western provinces	65
Rural dibao (minimum living stipend)	Nationwide rural dibao line at dollar-a-day with 100% overhead	40
Village investment funds	100,000 yuan per village in 148,000 villages to help fund infrastructure	14.8
Support for labor transfer	20 million rural workers at 1750 per worker for basic training and job placement	35
Total cost		204.8
	<i>As a share of central revenues</i>	<i>12%</i>
	<i>As a share of discretionary central revenues</i>	<i>16%</i>

Source: author calculations and World Bank 2007b (poverty assessment).

V. Not just a matter of money, but how central policies are implemented

Since the central government accounts for less than 10 percent of budgetary expenditures on social services such as education, health, and social relief, its control over social outcomes in the rural sector is at best attenuated, and compliance with central policies is not always assured at the local levels. Even when the central Government injects

resources to support local services, these resources pass through provinces and municipalities before reaching counties. Leakages can occur at each level, and at present the central Government has few levers for holding local governments accountable.

Under China's highly decentralized systems of fiscal management and administration, the central government employs extensive delegation of authorities and responsibilities in a nested, hierarchical setting. The central government delegates authorities to the provinces, and depends on the provinces to carry out their responsibilities. The provinces in turn delegate to the municipalities, and depend on them to 'deliver' on their assigned responsibilities, and so on downward through the hierarchy (Figure F). This decentralized administration can be an asset for cost-effective service delivery, if local governments can be held accountable for performance. At present, though, the accountability relationships are weak at multiple levels, with the result that compliance with central policies is not always assured at the local levels, and central transfers are not always used as intended.

Figure F. Hierarchical delegation in China



Likewise contributing to the often low effectiveness of public expenditures is the weak accountability relationship between service providers – which are mostly public institutions – and local governments. Just as the central Government has few levers to enforce compliance by local governments, local governments often lack effective levers over public service units (PSUs). Finally, the downward accountability of these service providers and local governments to citizens is also weak and, despite recent improvements, most services are provided without significant participation by citizens or communities.

These are largely legacies of the long fiscal decline, during which incremental reforms had focused narrowly on reviving revenue collection, especially central revenues. In the process revenue and expenditure assignments were de-linked, and the withering away of transfers led ultimately to a breakdown of the intergovernmental fiscal system – in the sense that decisions made at the top could not be implemented at the lower levels given the existing financial arrangements (Wong 1997, 2007). At present local governments are saddled with unusually heavy responsibilities, with neither sufficient assigned revenues nor a system of transfers to ensure the delivery of mandated services. Moreover, the current assignment of responsibilities across subnational governments is murky – with many programs requiring joint financing among subnational levels but no clear divisions, and local governments do not have clearly articulated roles and functions against which they can be held accountable.

Despite significantly increased transfers and improved equalization since 1998, underfunding remains a fundamental obstacle to the central-local accountability relationship today, as the intergovernmental fiscal system still does not ensure sufficient

funding to counties and townships in the western and central provinces (World Bank 2007a). This is true for overall amounts as well as for specific programs. Furthermore, the intergovernmental fiscal system still lacks a mechanism for ensuring that mandated services can be financed in poor counties.

Under-resourcing has a significant detrimental effect on accountability, as well as for monitoring and evaluation – if tasks exceed resources, it is hard to judge performance failures or to hold local governments accountable for them. Likewise, public service providers must be financed adequately for their public service tasks, whether through budgetary appropriations, (regulated) user charges, or other subventions.

The information base for policy analysis in China is weak, especially for rural public services, and this undermines efforts to judge the performance of local governments and service providers. Even though a huge amount of information is routinely reported, China lacks a system for vetting and reconciling the data reported by the different ministries and agencies, and their figures can vary widely. For budgetary expenditures on rural compulsory education, for example, figures reported by the Ministry of Finance (MOF) are 10 percent greater than those from the Ministry of Education (MOE). Large discrepancies exist even for data reported by different departments of the same ministry, for example, the sum of central and provincial expenditures on education exceeded the “national consolidated” figure by 22 percent in 2004 (CFY 2005). Data on social indicators and service outputs are weaker still – figures for school enrollments, hospital bed usage, etc. are widely considered unreliable.

Enforcement of public service delivery often is not clearly assigned to any level of government²⁰ and relies heavily on the personal responsibility system using the performance reviews of government officials. The system of personal responsibility has been effective in the past to enforce selected objectives such as economic development and family planning, and service-orientation is being included in the performance evaluations of local officials in some pilot reforms. However, personal responsibility cannot overcome systemic constraints: school principals cannot be personally responsible for improving school conditions if funds are not available, nor can teachers take “personal responsibility” for preventing students from dropping out if their families cannot afford to pay fees.²¹

In sum, the central government faces significant difficulties in implementing social policies through the present system of delegated governance until it can fix the shortcomings discussed above, to strengthen the accountability relationships among the key stakeholders:

- clarifying and specifying responsibilities for each level of government and for service providers,
- ensuring adequate financing,
- building a robust information reporting system, and
- creating mechanisms for effectively enforcing responsibilities.

²⁰ Exceptions are made during national campaigns, such as the campaign to universalize nine years of rural compulsory education. Under this campaign, responsibility is assigned to the provinces and counties.

²¹ These are just some examples of the “personal responsibility” assignments in schools today (World Bank 2007a).

These reforms will be the essential building blocks for the effective management of a vast, decentralized economy, where the central government can delegate responsibilities to lower levels and have the wherewithal to ensure that policies are implemented. Until these building blocks are in place, central government efforts to improve rural public services will continue to be stymied by the unreliable transmission of policies and resources downward through the multiple levels.

VI. Conclusion

In Wong (2007) I had argued that rural interests tend to be left out in the competition for central transfers, so that Wen Jiabao's pro-rural policies will have an uphill struggle to get sufficient funding. In this paper I have reviewed the new Harmonious Society policies being implemented, focusing on not only funding levels, but also policy implementation mechanisms to argue that reforms of the public finance system have been uneven, and intergovernmental expenditure and revenues assignments are severely misaligned. Moreover, because the government has delayed institutional reform in the public sector, the central government's capacity to achieve stated social objectives is weak. Even when money is available, the government faces many difficulties in channeling them toward delivering services at the grassroots levels of Chinese society. This inability of the central government to implement policies in support of the national vision of a Harmonious Society points to a fundamental weakness in the foundation on which China is building its hopes for the 21st Century.

More worrisome is that the gap between government promises and its capacity to deliver is very large and growing rapidly on the many components of the Harmonious Society Program – on the environment, on health care and education reforms, and “tilting” toward the ethnic minority regions, etc. On every front, there are daunting institutional challenges. On the environment, the government will have to undertake large realignment of relative prices and significantly raise tax rates on energy resources, as well as tackle the issues such as giant SOEs such as Sinopec, CNOOC, power companies capturing huge economic rents that keep resource regions impoverished and production methods backward and inefficient. To improve health care and education, provider incentives will have to be fundamentally altered, etc.

The challenges are great. The government has shown willingness to acknowledge problems and seek solutions. The current piecemeal approaches, however, will unlikely suffice, especially since the central leadership remains stuck in the mindset that it can mandate policy changes, and spends too little effort building support for its programs. The ratcheting up of promises by top leaders in the past 2-3 years carries significant political risks, since they are building expectations that the machinery of government will not be able to deliver.

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