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

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## **Abstract**

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 (HSP). Two interrelated aspects of public finance are highlighted: First, whether the government has enough resources to meet the public expenditure needs of upgrading services in the rural sector to meet the inclusive goals of the HSP. Second, whether the central government has the capability to manage the effective use of these resources to achieve these goals. The paper provides a brief history of fiscal reform, reviews the legacies of fiscal decline in the 1980s and 1990s, and assesses the current HSP. An alternative, more fully funded HSP is then presented, and the paper shows that it is well within the central government's financing capacity. However, the challenges lie in the government's ability to manage the delegated system of policy implementation and assuring that resources reach the rural sector.

## **Biography**

Christine Wong is a Senior Fellow in Chinese Studies at the School of Interdisciplinary and Area Studies and the Said Business School. Before joining Oxford University in September 2007, she was the Henry M. Jackson Professor of International Studies at the University of Washington's Henry M. Jackson School of International Studies. She has also taught in at the University of California, Santa Cruz; University of California, Berkeley; and Mount Holyoke College (Massachusetts), in the economics departments. Outside of academia, she has held positions as Senior Economist in the World Bank Office in Beijing, and Resident Scholar at the Asian Development Bank (Manila). She received her Bachelor of Science degree from the Massachusetts Institute of Technology and her Ph.D. from the University of California, Berkeley, both in Economics.

Christine's research focuses on issues of public finance and public sector reform in China. She has published widely on economic reform, fiscal reform, rural industrialization, and the problems of intergovernmental relations in China. Her most recent publication was *Paying for Progress in China: Public Finance, Human Welfare and Changing Patterns of Inequality* (co-edited with Vivienne Shue), London, Routledge, 2007. She has worked on numerous World Bank studies of fiscal policy issues, including *China: Public Services for Building The New Socialist Countryside* (2007); *China: Extending Public Finance to Rural Areas* (2006); and *Reforming Intergovernmental Finance in China: a Study of the Northeast* (2007). She was principal author of the World Bank report, *China: National Development and Subnational Finance, a Review of Provincial Expenditures* (April 2002). She is also editor and principal author of two previous books on China's public finance: *Financing Local Government in the People's Republic of China*, Oxford University Press, 1997; and *Fiscal Management and Economic Reform in the People's Republic of China* (with Christopher Heady and Wing T. Woo), Oxford University Press, 1995, 1996.

## **Fiscal Management for a Harmonious Society: Assessing the Central Government's Capacity to Implement National Policies<sup>1</sup>**

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). 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,<sup>2</sup> 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.<sup>3</sup> 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.

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.”<sup>4</sup> Earlier, Premier Wen Jiabao had promised to make rural compulsory education once again “free of charge... within the next 1-3 years”. 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.<sup>5</sup>

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<sup>1</sup> This paper draws 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).

<sup>2</sup> 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.

<sup>3</sup> For recent studies of these disparities, see Ravallion and Chen (2004), Shue and Wong (2007), and World Bank (2007a).

<sup>4</sup> “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.

<sup>5</sup> “Chinese government decides to subsidize all rural poor,” 24 May 2007, Xinhua News Agency (English).

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 21<sup>st</sup> 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 whether the central government has the capability 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.<sup>6</sup>

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 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.

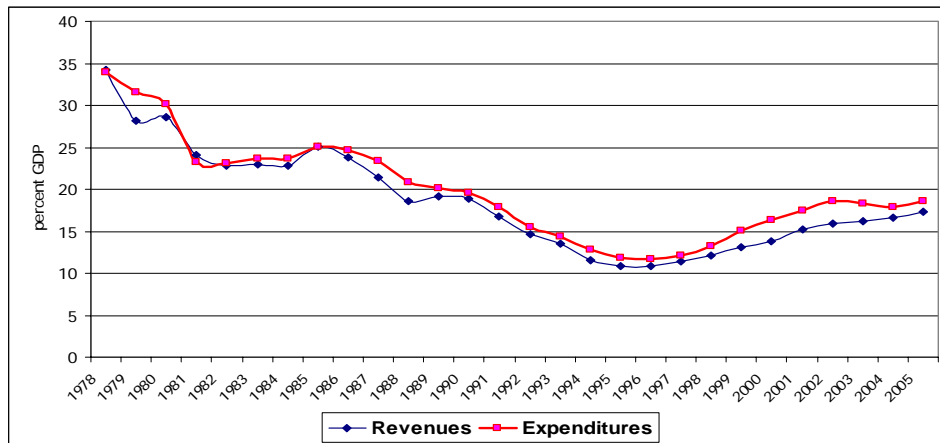
Phase II began around 1998, and is marked by an upturn in several key indices – total revenues, central revenues, and discretionary central resources. This upturn was followed by a renewed effort at improving equalization, as well as the beginnings of efforts to reform public expenditure management.<sup>7</sup>

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<sup>6</sup> See, for examples, World Bank (2006), Wallich (1994), and Bird, Ebel and Wallach (1995).

<sup>7</sup> For an overview of China's budget reforms through the 1990s, see Wong (2005).

**Figure A. Trends in Budgetary Revenues and Expenditures.**

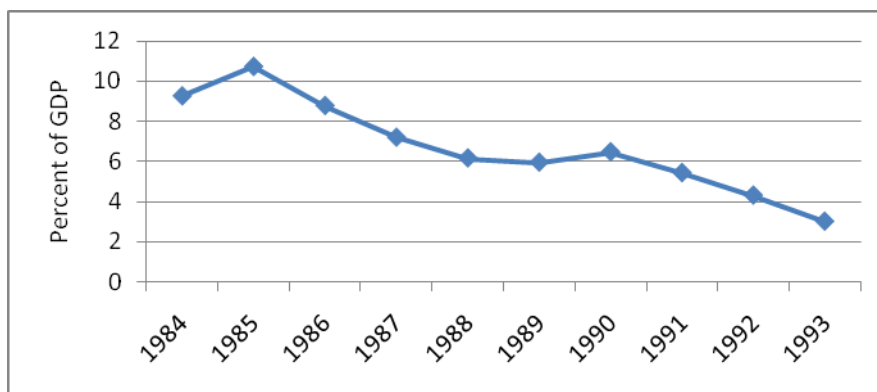


Source: CSY, with data adjusted to international definition.

*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 just 3 percent of GDP (see Figure B).

**Figure B. Central Revenues as a Share of GDP**

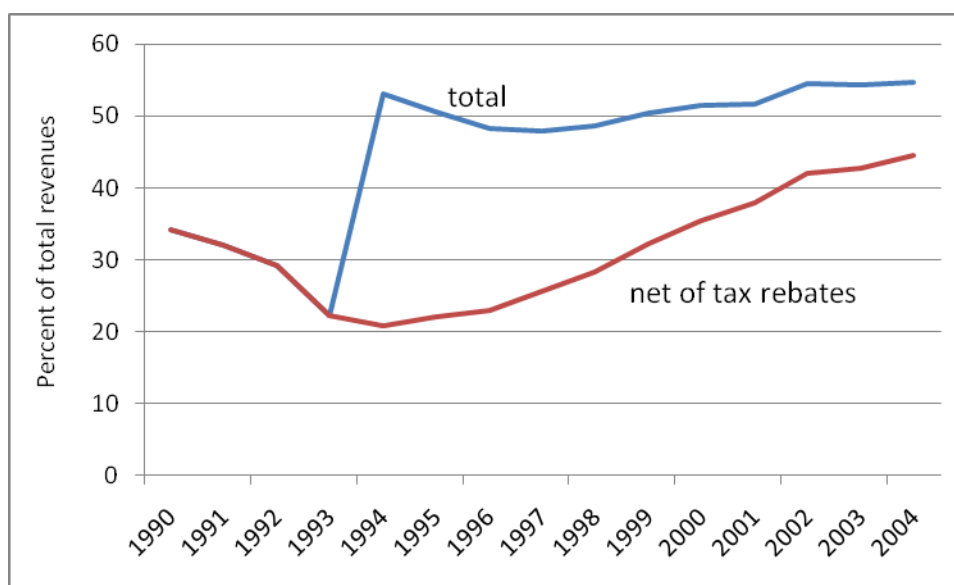


Source: CSY.

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.<sup>8</sup> The conventional view (including my own past work) has been that central revenues rebounded with the TSS. 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 tax rebates are netted out, the discretionary revenues of the central government grew far more slowly (Figure C). 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 C. Central Government Share of Revenues total and net of Tax Rebates**

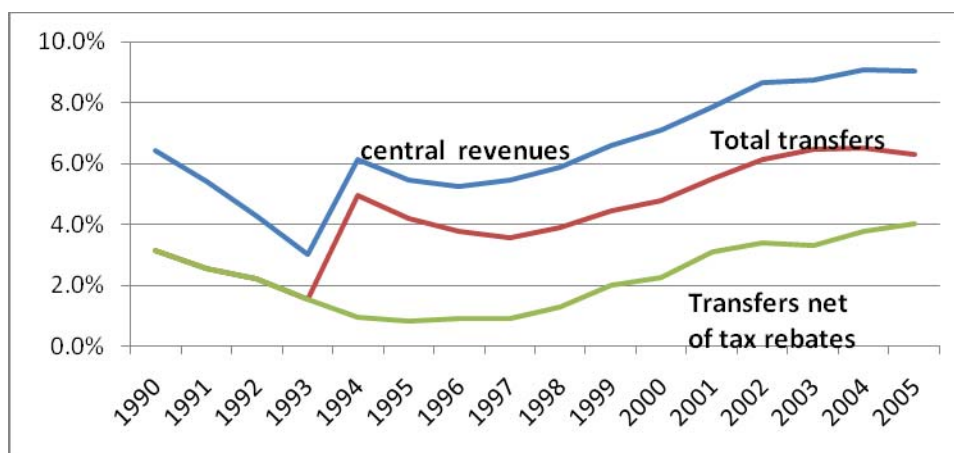


Source: CFY and Li and Xu (2006).

During this period, assistance to local governments in poor regions declined. This is shown in Figure D, 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 D *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.

<sup>8</sup> 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.

**Figure D. Trends in Central Revenues and Transfers**



Source: CFY and Li and Xu (2006).

### *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 – especially those in East Asia, 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 2007a).

## **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 most salient 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. As the shift to the TSS in 1994 had replaced the weakly redistributive system of revenue-sharing with tax assignments, without an offsetting transfer mechanism, the distribution of fiscal resources came to resemble more closely that of regional incomes, reinforcing the effect of income inequalities. The trend in Table 1 show that disparities in fiscal resources grew across provinces through the 1990s. The trend may have been stemmed since 1998 but not reversed, even with some recovery in central transfers.

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

	1990	1994	1998	2002	2004
Highest (1) Shanghai	609	1207	3337	5516	7875
Lowest (2) - Henan	104	130	362	680	899
Ratio of (1) to (2)	5.9	9.3	9.2	8.1	8.8
Average	254	374	861	1684	2066
Absolute gap	505	1076	2976	4835	6977
Coeff. of variation	0.57	0.71	0.75	0.75	0.75

\* Deflated to 1990 yuan, and excluding Tibet.

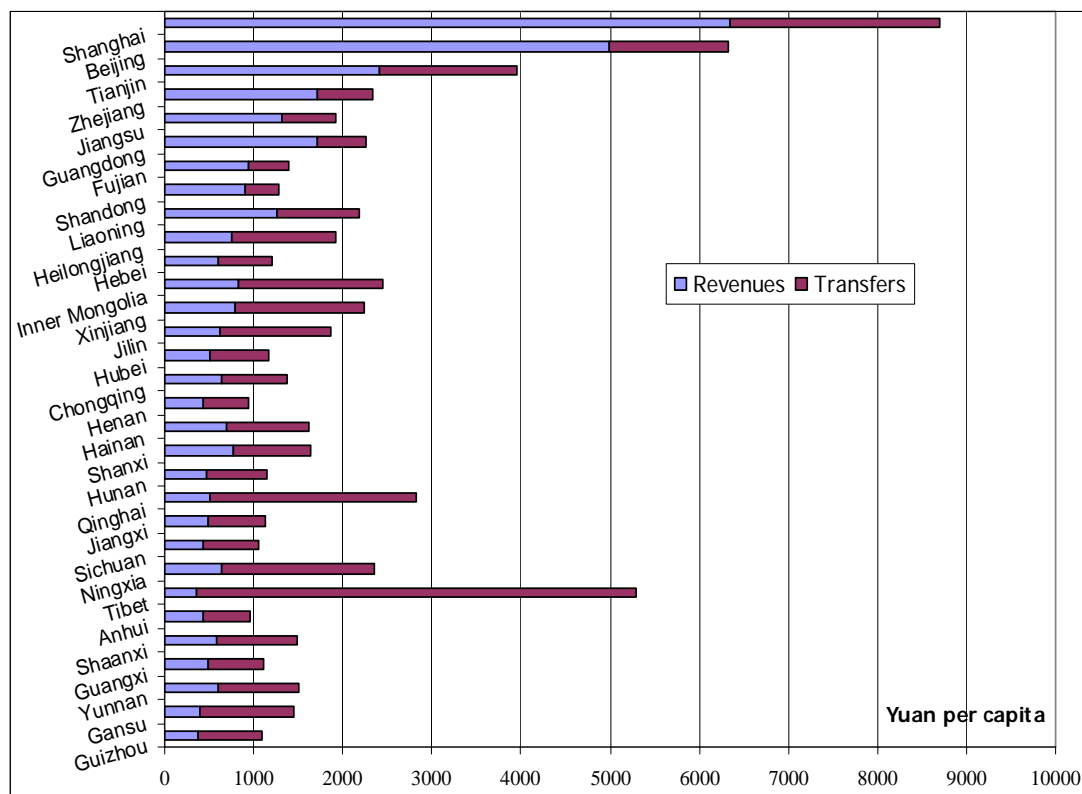
Source: MOF Compendium of Local Fiscal Statistics, and CSY.

A more important problem is that the current transfer system is not equalizing. This is illustrated in Figure E, 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 2006b).<sup>9</sup>

<sup>9</sup> 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 *passim*)



**Figure E. Fiscal resources by province 2004 (yuan per capita)**



Source: MOF Compendium of Local Fiscal Statistics and CSY.

*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**

<b>Revenues</b>	<b>1993</b>	<b>1998</b>	<b>2000</b>	<b>2002</b>	<b>2004</b>
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%
<b>Expenditures</b>					
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 and levy user charges. As incentive, they were allowed to retain a portion of their extrabudgetary revenues. Under generally lax management, the practice of supplementing staff salaries from “self-raised funds” grew, and gradually came to be routinely accepted throughout the public sector.<sup>10</sup> With local governments and public service institutions behaving like revenue-maximizing enterprises, extrabudgetary activities grew rapidly (World Bank 2005 and Wong and Bird, forthcoming).

*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.<sup>11</sup> One scholar has estimated that during 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 fees that were often charged by schools.<sup>12</sup>

Likewise, the urban-rural gap in public services is large. For example, in 2003 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 (UNDP 2005). Figures for 2002 show the number of doctors per 1000 persons was 5.2 in urban areas, but only 2.7 in rural (MOH 2004). Similar urban-rural differences exist with respect to infrastructural services such as water, sanitation, roads, and information and communication technology. These urban-rural differences produced stark consequences for the rural population. 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. It also reflects the differences in levels of education: the share of 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).

<sup>10</sup> 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.

<sup>11</sup> Information from MOE.

<sup>12</sup> 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).

### **III. The Current Harmonious Society Program**

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

- Reducing inequalities across sectors and regions
- 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.

In recent years senior 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, with increased commitments of government support. Table 3 offers some details of the programs.

**Table 3. Key New Programs for Rural Education and Health**

<b>Program</b>	<b>Launch Date</b>	<b>Policy Objective</b>	<b>Policy Content</b>
“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 to be implemented by county and township governments. To do so, they will need far more help than is provided by the current intergovernmental fiscal system. While the central government has injected additional funds into key programs, the level of funding provided to date is far short of what is needed.

### *Initial experiences*

The New Cooperative Medical Scheme is one of the principal components of the new HSP initiatives to which the central government has pledged support. The framework of how it is being implemented offers an illustration of some of the financial difficulties the program will face. 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.<sup>13</sup> Of this, the central government contributes 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. Under this formulation, the program imposes a 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.<sup>14</sup> To contain costs and avoid overspending, many 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 in reimbursements only 40% of the collected funds 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

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.<sup>15</sup> In effect this pushes the financial risks right back to the patients (World Bank 2007a).

The free rural compulsory education program will face similar difficulties, as the central subsidy currently provided also covers only a portion of the revenue loss due to the abolition of miscellaneous and other fees, leaving large gaps to be filled by local

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<sup>13</sup> This standard was RMB 40 yuan initially.

<sup>14</sup> Local governments are prohibited from using collected premiums to defray administrative costs.

<sup>15</sup> World Bank 2007a. 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.

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.<sup>16</sup> 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 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. As shown in the section above, however, the current level of funding provided by the central government is insufficient for achieving these objectives.

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,<sup>17</sup> 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 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. Some estimates are presented in Table 4 of the costs of scaling up these programs to provide a more adequate level of funding for each. Based on modest assumptions, the estimates add 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 of RMB 1.25 trillion yuan after deducting for tax rebates. In fact, the net additional cost to the central budget would be substantially smaller, since most of the programs are 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 annually (excluding tax rebates).

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<sup>16</sup> In one junior middle school visited, students had paid fees totaling nearly RMB 1000 p.a. before the new program was rolled out.

<sup>17</sup> 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.

**Table 4. Cost estimates for a Start-up HSP.**

<b>Assumptions</b>		<b>Cost</b> (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
<b>Total cost</b>		<b>204.8</b>
	<i>As a share of central revenues</i>	<b>12%</b>
	<i>As a share of discretionary central revenues</i>	<b>16%</b>

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

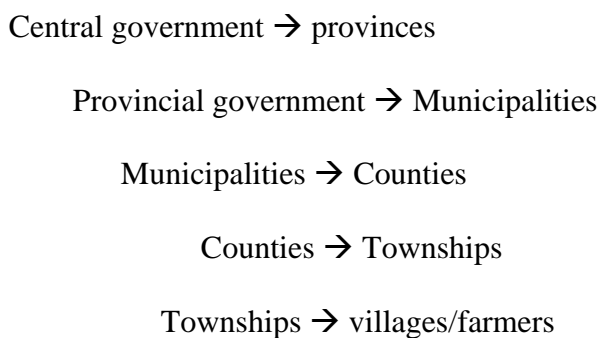
## **V. Not just a matter of money, but capability for policy implementation**

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 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 service providers. Finally, the downward accountability of both service providers and local governments to citizens is also weak, and most services are provided without significant participation by citizens or communities.

These are in part 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).

More importantly, they reflect the urgent need to repair the intergovernmental fiscal system. 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. 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, since the system still lacks mechanisms for ensuring that mandated services can be financed in poor counties. Moreover, the assignment of responsibilities across local governments is murky – with many programs requiring joint financing among the many levels but no clear divisions, and local governments do not have clearly articulated roles and functions against which they can be held accountable.



The accountability relationship with public service providers is similarly undermined by underfunding, as many of them are not adequately funded for their public service tasks. Instead, these providers are often expected to cross-subsidize their public service from money-making activities.

Weak accountability also stems from the weak information base for policy analysis in China, especially for rural public services, which 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 also exist for data reported by different levels of the administrative hierarchy. In 2004, for example, the sum of central and provincial expenditures on education exceeded the “national consolidated” figure by 22 percent (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 government<sup>18</sup> 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.<sup>19</sup>

In sum, piecemeal reforms to the system of public finance over the past 25 years have repaired the revenue mechanism, but left expenditure management in substantial disarray. As a result, the central government faces significant difficulties in implementing social policies through the present system of delegated governance.

## **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 not only on funding levels, but also policy implementation mechanisms to argue that because the government has delayed institutional reform in the public sector, the central government’s capacity to achieve

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<sup>18</sup> 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.

<sup>19</sup> These are just some examples of the “personal responsibility” assignments in schools today (World Bank 2007a).

stated social objectives is weak. Under the current intergovernmental arrangements, on average, local governments do not have the wherewithal to implement the HSP, nor do they have unambiguous incentives for doing so. Under these circumstances, even though the central government has the will and the ability to provide funds, it will find it difficult to channel 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 21<sup>st</sup> 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 on “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 public 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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