

Chapter 2

Fiscal Responsibility System

The 30 years following the reform and opening may be divided into two periods (15 years for each) marked by the adoption of the tax-sharing system. During the first 15 years, the success in rural reform and prosperity of township enterprises were coupled with the first upsurge of industrialization following the reform and opening up, which was basically driven by the responsibility system. This has been a significant reform on the rural production management system starting from practices of the joint contract responsibility system in rural areas. The contract system is characterized by a separation between ownership and use rights, whereby the use rights and usufruct are transferred to users on the premise that the ownership shall remain unchanged in nature. This has been a strategy typical for gradual reform, which not only maintains the public or collective ownership, but also arouses the enthusiasm of individuals effectively. From early 1980s to the mid-1990s, the responsibility system played a key role in China's reform. Any reform-related problem confronted by the country throughout the 1980s was solved neatly. First implemented in rural areas, it was gradually adopted by enterprises, and introduced to facilitate the interaction between the central government and local governments.

2.1 Connotation and Evolution of the Fiscal Responsibility System

The fiscal responsibility system was put into trial use in 1980. After several trials, it was implemented across the country in 1988. According to the basic principle of this system, the central government contracts out local fiscal revenues and expenditures to provincial financial units, entitling local governments to a pre-determined percentage of the surplus revenue. However, the central government will reduce the subsidy for unbalanced revenues and expenditures caused by a decline in revenues,

or even offer no subsidy at all. This was basically consistent with the principle of fixing farm output quotas for each household and the fiscal responsibility system applied to enterprises.

In the previous chapter, it is noted that devolution was realized by gradually delegating the authority over distributing materials vital to national economy and over enterprises management. The central government achieved the regulation of national economic operations by means of subtly devoluting and re-taking powers. Under this system, the regional administration system dominated by local governments was often fragmented by the direct vertical administration by the central government, leaving the local governments neither complete authority over economic administration nor interests independent from the central government. This was obviously manifested by the fiscal system between the central government and local governments. Although adjusted correspondingly during the devolution process, neither sharing-in-revenue by category nor the fixed sharing system provided stable stimulus to local governments, for under the planned economic regulation system, modifications were frequently made to the fiscal system as the authority over materials distribution and enterprises management shifted back and forth between vertical control and regional administration, despite of the considerations given to this issue by the central government. The central government usually did not fulfill its promise to local governments during policy making, and it has also been difficult for local governments to negotiate with the central government. Therefore, the fiscal system provided extremely limited incentives to local government to enhance their respective revenues. In this sense, these practices shall be referred to as devolution of powers, rather than decentralization.

The fiscal responsibility system has been a step forward decentralization. The general idea in this system is “responsibility”, which stood on the premise of a clear separation of authority over revenues and expenditures between the central government and local governments. The responsibility delegated to local governments was based on the total revenues and expenditures, rejecting any intervention in the entitlement of local governments to gains from revenues growth and in expenditures reduction. This responsibility “package” actually vested local governments with relatively stable authorities over supplies distribution and enterprises management, and thus gradually helped local governments to gain subject consciousness, preventing the regional administration system from being fragmented by vertical governance.

The fiscal responsibility system can only be truly implemented on the premise that the State should no longer rely on the vertical and regional administration systems for regulating economic operations. Therefore, although it is the correct approach to dealing with the relationship between the central government and local governments explicitly chosen as early as the beginning of the 1980s, the fiscal responsibility system actually experienced a tortuous process in gradual improvement and stabilization, as the national economic administration system remained unchanged and the vertical and regional administrations still played a role. From 1980 to 1984, the fiscal system was constantly adjusted by the central government. For example, as a result of the decline of revenues turnover to the central

government, the promise of principally maintaining the fiscal system with a designated scope of revenues/expenditures and responsibility contracts at various levels for 5 successive years made in 1980 was actually broken in 1981, compelling many local governments to retake the sharing-in-total and proportion-based responsibility contract approach. In order to truly give full play to the contract system in the decentralization process, the planned economic system needs to be transformed into a market economic system.

The period from 1980 to 1993 can be divided into three stages according to the evolution of the responsibility system.

2.1.1 Pilot Stage (1980–1984)

As early as in 1977, the central government piloted the fixed-ratio based sharing system in Jiangsu Province, where the percentage of turnover was determined as per the proportion of total final expenditures to total revenues in 1976 (the turnover and retention percentages were 52 and 48% in 1977, respectively.), and should remain unchanged for 4 successive years in revenues sharing. This was actually what the fixed revenue sharing-in-total system would imply. During these four years, from every 1 yuan in the revenues pool, the central government and the provincial government of Jiangsu took 0.58 and 0.42 yuan, respectively. The retention should be subject to the decision of the provincial government. Theoretically, as long as the proportion is fixed, the absolute retainable amount would increase along with the growth of fiscal revenues. However, as some expenditure items of the central government were included under the expenditure responsibility of Jiangsu Province, they were partially returned to the central government in order to relieve the burden of the provincial government, and correspondingly, the retention percentage was lowered. Since 1978, the turnover and retention percentages were changed to 61 and 39%, respectively.

Since 1980, the central government implemented a fiscal system characterized by designated scope of revenues and expenditures and multi-level responsibility contracts in 15 provinces. Compared with the revenue sharing-in-total system, this was based on a fixed sharing ratio, similar to the sharing-by-category system implemented from 1953 to 1958. The key to this system was to draw a responsibility base according to the respective scope of fiscal revenues and expenditures of the central government and the provincial government, and correspondingly determine the turnover and retention percentages, which should remain unchanged for five successive years. However, faced with a fall in fiscal revenues, the central government embarked on modifying this system in 1981. By the end of June 1982, of the 15 provinces, 10 recovered the sharing-in-total system; and by 1983, it was horse and foot, making the multi-level responsibility system a shadow, except that the all-round responsibility system was adopted by Guangdong and Fujian (deficit-ridden as it was), to which the key was a shift from proportional turnover and proportional subsidy to quota turnover and quota subsidy, respectively.

According to quota turnover and quota subsidy, local governments should be entitled to 100% of the portion in excess of the said base amount. These may be considered pilots of the quota-based system launched by the central government, and this fiscal system has been maintained in Guangdong and Fujian ever since.

2.1.2 Transition Stage (1985–1987)

At this stage, the responsibility system implemented by the central government and local governments was characterized by separate categories of taxes, designated scope of revenues and expenditures and multi-level responsibility contracts. During this period, although 17 provincial units still shared the revenues in total with the central government, a significant change occurred to the system, as the sharing ratio should be maintained for five successive years, rather than only one year. This was a great stimulus for local governments to enhance their respective revenues. Just like Guangdong, Heilongjiang also adopted the quota turnover-based all-round responsibility system, whereby the limit of turnover from surplus was CNY 6.5 billion. In addition, following the practices of Fujian, Jilin, Jiangxi, Shaanxi, Gansu, Hubei, and Sichuan adopted quota subsidy. So, the number of provincial governments embracing the quota-based contract system increased from two at the first stage to seven. Other minorities and frontier provinces implemented the budget management system, which was actually equal to the quota subsidy system.

2.1.3 Comprehensive Implementation Stage (1988–1993)

At this stage, the fiscal system of dividing revenues and expenditures between the central government and local governments and holding each responsible for balancing their respective budgets was relatively thoroughly implemented. Altogether 39 provincial units (provinces, autonomous regions, or municipalities directly under the central government or under separate state planning) adopted six different approaches to the responsibility system.

1. Designated revenues increase rate-based contract: The key to this approach was to determine the year-on-year revenues increasing rate and the retention/turnover percentages. Where the revenues growth rate exceeded the designated year-on-year increasing rate, local governments should be entitled to the premium portion and retentions by a pre-determined percentage within the designated rate, the remainder should be turned over to the central government. For example, for Beijing, the designated increasing rate and the retention percentage were 4 and 50%, respectively. So, if the revenues growth rate of Beijing exceeded 4%, 104% of the revenues of the previous year should be subject to a 50–50 sharing with the central government. Assume that the revenues in 1987

and 1988 were CNY 10 billion and 11 billion, respectively. According to the designated increasing rate, there was a premium of CNY 0.6 billion, which should be retained by the municipal government of Beijing; and the remaining CNY 10.4 billion should be 50–50 shared between the central and municipal governments. Therefore, the final turnover to the central government and retentions by the municipal government of Beijing should be CNY 5.2 and 5.8 billion, respectively. The following provincial units adopted this approach (each followed by their designated increasing rate and retention percentage, respectively): Beijing (4, 50%), Hebei (4.5, 70%), Liaoning (3.5, 58.25%), Shenyang (4, 30.29%), Haerbin (5, 45%), Jiangsu (5, 41%), Zhejiang (6.5, 61.47%), Ningbo (5.3, 27.93%), Henan (5, 80%), and Chongqing (4, 33.5%).

2. Sharing in total: This is basically the same with the previously-adopted revenue sharing-in-total system. Three provincial units embraced this approach, namely Tianjin (45.5%), Shanxi (87.55%) and Anhui (77.5%).
3. Sharing in total plus sharing in increase: According to this approach, the revenues may be divided into two parts, namely the portion within the base amount that should be subject to sharing in total and the portion in excess that should be subject to sharing in increase. Three provincial units adopted this approach (each followed by the percentage of sharing in total and the percentage of sharing in increase, respectively): Dalian (37.74, 27.76%), Qingdao (16, 34%) and Wuhan (17, 25%).
4. Designated turnover increase-based contract: In this approach, factors other than the year-on-year turnover increase would not be considered. Only two provinces adopted this approach (followed by their respective turnover amounts and designated increase rates): Guangdong (CNY 1.413 billion, 9%) and Hunan (CNY 0.8 billion, 7%).
5. Quota turnover: According to this approach, in case of any surplus (an excess of revenues over expenditures), the turnover amount should be fixed, rather than based on the year-on-year increase amount. Three provincial units adopted this approach (followed by their respective quotas): Shanghai (CNY 10.5 billion), Shandong (CNY 0.3 billion) and Heilongjiang (CNY 2.9 billion).
6. Quota subsidy: According to this approach, in case of deficit, the subsidy amount should be fixed, rather than based on the year-on-year decrease amount. 16 provincial units adopted this approach.

Complicated as it may be, the responsibility system can be basically divided into the following four categories:

1. Sharing in total, whereby the sharing percentages should be subject to yearly recalculation;
2. Fixed ratio-based sharing, whereby the sharing percentages usually remain constant for several successive years;
3. Proportional turnover or subsidy whereby, based on the responsibility system, any surplus should be subject to ratio-based turnover, or any deficit may be

relieved by a subsidy. The said ratio might be either fixed or include a year-on-year increase rate; and

4. Quota turnover or subsidy, commonly known as the all-round responsibility system, whereby the surplus may be wholly retained by local governments as long as their revenues exceed the quota.

Approaches (1–4) have presented a continuous spectrum of enhancement in encouraging local governments to increase their respective revenues. As the first embracer of the quota turnover-based all-round responsibility system, Guangdong Province was the fastest in economic development and thus the highest in fiscal revenues, standing as a perfect model for other provinces. The responsibility system has related local economic development to fiscal revenues of the local government. Therefore, local governments had to accelerate local economic development in order to enhance their respective fiscal revenues. As the all-round responsibility system was adopted by more and more provinces, regional economic development competition became increasingly intense. Under the responsibility system, for the revenues of local governments were directly linked to economic development, such competition achieved not only political purposes but also economic benefits, and as a result of fiscal decentralization, provided sustainable stimulus to local governments.

Local governments below the provincial level also adopted the same approach as that implemented between the central government and provincial governments, namely the responsibility system. Here we take the relationship between governments at the county level and governments at the township level as an example for explanation. Index or task-based package responsibility is the most typical of the responsibility system, based on which, governments at the township level would be either rewarded (in case of surplus) or punished (in case of deficit) according to their balance of revenues and expenditures. This system should be subject to adjustment every 3–5 years, which has mainly focused on the surplus reward/deficit punishment measures and expenditure liability, as the case may be. The following is a discussion of this system from perspectives of task allocation, surplus and deficit.

Under the responsibility system, a “target” is usually referred to as a “base”, and surplus and deficit are held relative to the “base”. The bases for different governments at the township level within the same county might be different. As the major component was tax revenues under budget control, it has been known as “revenues base”. It should be determined as per normal tax. In adjusting the fiscal system (if necessary), the revenues base should be determined based on the average revenues of the previous cycle or the previous three years, floating as per the tax base during the corresponding cycle. For example, should an enterprise be introduced into or established in a township in a definite cycle, the increase in tax would be considered in the determination of a new base for the following cycle which, once determined, should remain unchanged. For example, if determined as CNY 1 million, the base should remain constant for the coming 3–5 years. However, a great number of counties were found in much more complicated situations, and for some relatively developed townships, the county government would usually assign a target in addition to the base. Although the base remained unchanged within the

corresponding cycle, the target amount would increase by a certain percentage. Therefore, this would be a double-responsibility system combining a fixed base and a year-on-year increasing target amount.

Should the actual revenues exceed the base, the township would obtain a beyond-base surplus; should it also exceed the target amount, there would also be a beyond-target amount surplus; should it exceed the base but fall short of the target amount, the township would obtain a beyond-base surplus but no beyond-target amount surplus; and should it even fail to reach the base, there would be a deficit. In order to encourage townships to enhance their respective revenues, reward and punishment measures were usually included in the county/township fiscal system, including:

Sharing in surplus: Any beyond-base/target amount surplus would be shared by the governments at the two levels as per a pre-determined proportion. In most cases, the portion retained by the government at the township level exceeded that turned over to the county government. It is also found that the percentages of sharing in beyond-base surplus were different from those in beyond-target amount surplus.

Retaining total surplus: In this approach, the township may retain the beyond-base surplus and the beyond-target amount surplus wholly. In some cases, only the beyond-target amount surplus could be retained wholly, while the beyond-base surplus should be shared with the county government.

For any township maintaining surplus in successive years, its total revenues (or actual revenues) would consist of three portions: base + beyond-base revenues + beyond-target amount revenues. According to the surplus distribution approaches, the fiscal responsibility system implemented between governments at the county and township levels might be preliminarily divided into two categories, namely sharing in surplus and retaining total surplus. Thus, how was the base distributed between governments at the county and township levels? And how did those deficit-ridden townships fill the gap?

This will be illustrated by introducing the expenditure liability of the government at the township level. Any surplus would be shared by the township as a fiscal reward granted by the county government and thus may be used freely. The portion within the base should be shared with the county government based on the expenditure base, determined as per the daily expenditures of the township. Generally speaking, the fiscal expenditure liability can be understood as insurance for salary, operation and construction. Salary insurance guarantees the payment of due salaries to the staff of administration and business sectors; operation insurance covers the daily office expenses of administration and business sectors, including costs of office supplies/conference, travel/entertainment expenses, etc., usually determined as per the size of manning within the fiscal scope; construction insurance includes the routine public maintenance and construction projects. In most of the townships in Midwest China, only two of the three items of insurance have been basically fulfilled, namely salary and operation insurances. In fact, in most regions, the base was determined mainly as per total salary and daily operation costs; and in financial difficulty-ridden counties and townships, the operation insurance was even hardly fulfilled, and daily expenses were also excluded from the expenditure base.

In case of any surplus, the revenues base would be usually higher than the expenditure base. Under the fiscal system of most counties/townships, such difference would be included in the revenues of the county government and thus subject to turnover which, together with the part from sharing in surplus, has been referred to as “turnover within the system”. In such a way, the actual revenues of a surplus township may be divided into two parts under the above-mentioned system, namely turnover within the system comprising the excess of the revenues base over the expenditure base and revenues retention comprising the expenditure base and the retentions from sharing in surplus.

Deficit-ridden governments at the township level would be faced with more complicated situations. As the expenditure base would be higher than the revenues base, a subsidy should be granted to such governments in order to guarantee due payments of salaries and operational expenses, referred to as “subsidy within the system”. The amount of such subsidy should be equal to the difference between the expenditure base and the revenues base. In case of any surplus in a certain year, the excess of revenues over the base should be subject to sharing-in-surplus or retaining-total-surplus, and the subsidy within the system would be fully granted; in case of deficit, the subsidy within the system would be also fully granted, but the gap would not be covered by the county government as a punishment for the deficit. So the actual amount received by a township government would be equal to the sum of its actual revenues and subsidy within the system, and the total amount would hardly catch up the expenditure base, for the gap would not be covered by the county government and remain for its own makeup.

From the above analysis, we can see that the fiscal responsibility system implemented between governments at the county and township levels included various modalities. All these modalities provided a great stimulus to the governments at the township level. A surplus-achieving township could be entitled to all the excess of actual revenues over the base; and for a deficit-ridden township, it has been unnecessary to satisfy the expenditure base as long as it reached the revenues base. This system helped us a lot to understand the behaviors of the governments at the grassroots level.

Theoretically, this system provided a stimulus similar to that in enterprises management. As the core of the micro operating mechanism of “corporatism of local governments” proposed by Jean C. Oi, this was one of the primary impetuses behind the corporatization of local governments. In local practices, the governments at the township level were not blindly aimed at revenues maximization in their pursuit of maximum disposable revenues. Under the fiscal responsibility system, a rapid increase in the revenues of a certain cycle would enhance the revenues base and the target amount of the following cycle, leading to magnified difficulties in satisfying the target of the following cycle as well as reduced revenues. Therefore, the behavior strategy of governments at the township level should be understood in the context of the tenure system for officials thereof. An official might try his/her best to increase the fiscal revenues during his/her tenure in order to achieve rapid promotion; however, should it be expected that he/she would hold the office for quite a long time, he/she might exert moderate control over the revenues growth

rate. For governments at the county level, such periodic adjustments made to the base and the target amount would not only intensify the incentives for governments at the township level to enhance their respective revenues, but also guarantee the fiscal revenues at the county level would not decrease significantly and even achieve rapid growth in the following period. In addition, by adjusting the proportion of sharing in surplus, the county government provided incentives to those townships that had witnessed a too high or too low growth rate of revenues. For example, an enhanced proportion of the retainable would encourage the governments at the township level to increase their revenues; however, by lowering this proportion, the revenues obtained by these governments may be centralized or used for planning “Robin Hood”.

2.2 The Fiscal Responsibility System and Township Enterprises

Having noticed the impact of the relationship between the central government and local governments on the behaviors of the latter and China’s economic growth, many scholars have devoted much time to furtherize empirical studies. It is revealed that the fiscal responsibility system has been a decentralized system from the perspective of the relationship between governments at the two levels since the mid-1980s, which has greatly promoted China’s economic growth by means of fiscal decentralization-based regional competition. Lin Justin Yifu and Liu Zhiqiang validated the evident relation between the fiscal responsibility system and local economic growth based on available data at the provincial level in this phase. Others also reached a similar conclusion although they utilized different measurement indices.

Although it directly established the connection between fiscal decentralization and local economic growth, the quantitative analysis did not properly cover the underlying mechanism. The implicit mechanism behind such a connection was that fiscal decentralization encouraged the regional competition among local governments and gave impetus for promoting economic growth, and regional economic growth was indeed realized. The key to this mechanism lied in how fiscal decentralization stimulated local governments and how local governments enhanced economic growth. The first question has been answered in the above analysis, while the latter needs to be studied in depth. There are many approaches to promoting economic growth. Although it has been verified that fiscal decentralization could actually promote economic growth, the empirical study did not reveal how it was achieved, which, however, is vital to our understanding of their connection.

Some scholars believe that the answer is industrialization, especially the rise and prosperity of township-run enterprises. How did township-run enterprises become so successful? The academic circle has offered numerous answers. Bearing most distinct Chinese characteristics, township-run enterprises are mainly characterized

by two features: (1) They were established in rural areas, rather than urban areas relatively more developed in terms of the performance of scale economy, and farmers entitled to land use constituted the main force; (2) They were owned by the township or village collectively, which is a common ownership structure. Township-run enterprises flourished in the 1980s and rapidly grew into a force at core in promoting China's economic development. Researchers discovered some characteristics of such enterprises from the perspective of ownership, and scholars held that the key to their success lied in the industrial structure, rather than the unique ownership structure. Jean C. Oi et al. put more emphasis on the positive role played by local governments in local industrialization and proposed the concept of "corporatism of local governments" in explaining the reasons behind the rise of township-run enterprises and local industrialization. She held that under the fiscal responsibility system established in the mid-1980s, local governments could obtain not only revenues beyond the responsibility base, but also extra-budget profits from turnover by township-run enterprises. And this played a significant role in stimulating the rise of township-run enterprises.

How did the increase in fiscal revenues stimulate the rise of township-run enterprises? This question should be answered based on a full understanding of the tax system. Since the substitution of tax payment for profit delivery in 1983, tax has become a major component of fiscal revenues. Thereby, it was the mass of not only budgetary fiscal revenues, but also the contractual base. The base did not provide percentages of different types of taxes, so a package contract should be adopted and maintained for several successive years. The greater the extra-base portion was, the more the retainable by local governments would become (in some regions, it was even 100% retainable). Therefore, the increasing rate of taxes was the key to satisfying or even over-fulfilling the base.

The tax system adopted the traditional classification method that had been implemented since the founding of the People's Republic of China. In this method, enterprises have been the major source of taxes. The business income tax and the turnover tax (mainly including the product tax and the value added tax as imposed later) have been classified in accordance with affiliation and territoriality, respectively. The turnover tax, as the major component under the tax system, should be equivalent to 2–4 times of the income tax in terms of value. In such a way, the industrial and commercial taxes and the fiscal revenues of local governments may be closely inter-connected. Therefore, the economic aggregate and fiscal revenues may both achieve rapid increase as long as local government-run enterprises proliferate.

The product tax has been the largest in amount among all items of industrial and commercial taxes. Since 1984, it has been imposed on almost all industrial products based on the sales gain, subject to the State's adjustment according to the positions of different products in the production/sales chain in view of inter-enterprise equity. The costs and profits of the enterprises should not be considered as it has been levied as per the sales gain. In 1986, China determined that some taxation items should be transferred from the scope of the product tax to that of the VAT as derived from the product tax, the number of which had increased to 174 as of April

1991, excluding only 86 items, such as cigarettes, alcohol, etc., among the 260 items of industrial products in total that were originally included in scope of the product tax. The calculation formula of the VAT is:

Tax to be paid by an ordinary taxpayer = current tax amount of offset items – current income tax amount.

As the VAT rate is fixed (17%), the tax payable should be equal to the product of this rate and the difference between sales gain and costs of raw materials. It corresponds to the value-added part, rather than products sales income. The product tax and the VAT, both included in the turnover tax, should be imposed on any in-operation or sales gain-producing enterprise (no matter profitable or not). The base of the VAT includes the costs of production and management, in addition to raw materials. The factory price would be certainly higher than the costs of raw materials, even if the enterprises are not profitable, because it includes the wages of workers, depreciation costs of production equipments, etc. In addition, the larger an enterprise is, the greater the turnover will be; as a result, the VAT and the product tax will be enhanced. Both items of taxation constitute the major part of not only the turnover tax, but also the total taxes. In the 1980s, the product tax and the VAT accounted for more than a third of the total tax revenues of China. However, the business income tax levied based on the net profit of enterprises accounted for only 19% of the total in 1991. Different from state-owned enterprises, township-run enterprises had been favored by relief policies before 1994, and allowed for various pre-tax profit distribution policies. This provided for tax avoidance and evasion. Therefore, high in value and easy in sales invoice-based collection as they might be, the product tax and the VAT should be attached with great significance in view of an opportunity for local governments to enhance their respective fiscal revenues.

A large proportion of the after-tax profits of township-run enterprises should be delivered to the government at the township or village level and included in extra-budgetary revenues. More specifically, the revenues of governments at the county, village and township levels were comprised by taxes payable by township-run enterprises, profits delivered by village-run enterprises, budgetary taxes shared with the county government, and extra-budgetary profits turned over by relevant enterprises. Therefore, the county government has been the most concerned about the size of township-run enterprises, rather than whether they were profitable or not, and in reality, the people's governments at the county level have always been the most efficient in facilitating access to credit.

The tax system and the fiscal responsibility system have greatly encouraged local governments to promote industrialization at the grassroots level. Under the tax system of the 1980s, the most direct and most effective approach to enhancing fiscal revenues was to establish local enterprises, and the product tax and the VAT payable by enterprises were the major components of increased fiscal revenues. From 1985 to 1991, the year-on-year increasing rates of total taxes, the product tax plus the VAT, and the business income tax were 7.7, 8 and 1.8%, respectively. The product tax and the VAT were related to the size of enterprises, while the business income tax was determined as per corporate profits. It can be seen that local industry, especially the rapid development of township-run enterprises, was an

important impetus in promoting the growth of national fiscal revenues, which has however been scarcely associated with the performance of enterprises.

Since the late 1980s, besides the Pearl River Delta, the Yangtze River Delta and Zhejiang where vigorous development of township-run enterprises was witnessed, Shandong, Hebei, Liaoning, and some other provinces in Central China also have embarked on starting undertakings, and some areas even called on every village to start undertakings and every household to participate in such undertakings. Township-run enterprises in these areas were mostly financed by local governments-summoned banks, credit cooperatives, and rural cooperative foundations, and thus immediately brought about an increase in the GDP and fiscal revenues, no matter whether they were profitable or not.

2.3 The Fiscal Responsibility System and State-Owned Enterprises

Another significant role in the industrialization at the first stage of reform and opening up was played by state-owned enterprises. Different from the vigorously developing township-run enterprises, state-owned enterprises have progressively explored their reform, accompanied by complex institutional changes. It involved the enterprise fund system, the profit retention scheme, substitution of tax payment for profit delivery, the responsibility system, the shareholding system, etc. In general, the reform has been extended from profit distribution to the management system, and then to the property right system. The reform of the property rights system took place at the second stage of the reform and opening up, while that of profit distribution and the management system was mostly completed at the first stage.

It is worth noticing is that the reform of state-owned enterprises was quite different from the practices of delegating or retaking powers in enterprises management. The reform at this stage focused on enhancing vitality and transforming the operation mechanism of enterprises, rather than simply delegating jurisdiction and administration authorities to local governments. To this end, the reform of in-enterprise distribution and the tax system was accomplished under the condition that market economy had not yet been established.

Before the reform, the increased fiscal revenues of China sourced from profit delivery by enterprises, rather than taxes. In fact, under the solid planned economic system, there were great differences in profit margin among different industries and different enterprises, subject to the State's decision based on the prices of fixed assets, raw materials and products. So it was difficult to absorb the profits of enterprises via taxation. Less and less important as it became, taxation was even excluded from the fiscal approaches to socialism during the Cultural Revolution. As most of the tax items have been consolidated since the end of 1972, state-owned enterprises are now only subject to industrial and commercial taxes, and only 44

(of originally 108) items are retained. In 1972, taxes levied on enterprises accounted for only 41.4% of the fiscal revenues of China, which has been the lowest in history.

After being piloted in several areas, the substitution of tax payment for profit delivery was first implemented in two steps across the nation in 1983, and then further improved in 1985. The basic idea was substituting the payment of business income tax and regulatory income tax payable by state-owned enterprises for profit delivery to the State or competent organs. Large and medium-sized state-owned enterprises should pay the business income tax at 55%; and in case of any inter-enterprise difference in profit margin, the regulatory income tax should be imposed. After this policy was officially implemented, the proportion of enterprise profit delivery to total fiscal revenues experienced a continuous decline, dropping from 40% in 1980 to 1.9% in 1986; in contrast, during the same period, the proportion of tax revenues increased from 52.7 to 92.5%.

In 1987, the central government started the reform of the responsibility system for enterprises. During the 5th meeting of the National People's Congress dated in early 1987, it was proposed in the *Report on the Work of the Government* to carry out various forms of the contract managerial responsibility system. By the end of 1987, 80% of large and medium-sized enterprises had completed the reform.

The responsibility system for enterprises was characterized by a fixed base and a guarantee for turnover to competent authorities. Under this system, any surplus/deficit should be retained /made up by the enterprises. This idea was basically similar to the responsibility system with remuneration linked to output for rural areas and the fiscal contractual system implemented between the central government and local governments. However, as these enterprises were owned by the State and involved in organized production activities, and a real market economy had not been established yet, coupled with the administrative pricing behaviors influential on the business and profits of enterprises, the reform of the responsibility system for state-owned enterprises actually zigzagged (unlike that of the responsibility system with remuneration linked to output for rural areas), and the results cannot be evaluated in indiscriminately.

The responsibility system has undoubtedly played a significant role in enhancing enterprises' vitality and independence in their business; however, whether their economic performance has been promoted is still a question. As shown in Fig. 2.1, the margin of profits declined obviously upon the implementation of the responsibility system. Despite the various factors behind such a decline, its positive impacts on economic performance can hardly be found.

A direct cause behind the sharp drop in profit margins was the mushroom of fixed assets as well as the resulting increase in production costs, as can be easily seen from the above figure. From 1984 to 1984, the total fixed assets of industrial enterprises witnessed an annual average growth rate as high as 20%, while profits decreased to almost only 1/3 of the original amount.

The increase in taxes levied on enterprises was related to the substitution of tax payment for profit delivery and, more importantly, the significant changes of the entire tax system during the mid-1982s. Although the policy of substituting tax

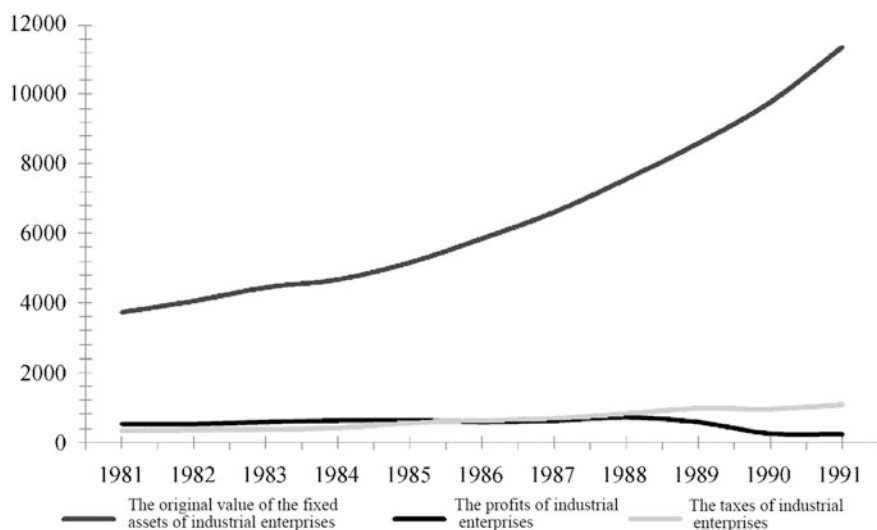


Fig. 2.1 Impact of the contract system on corporate profits (unit CNY 100 million). *Data source* Comprehensive planning department of the Ministry of Finance, ed., *Financial Statistics of China*, Beijing: Science Press, 1992

Table 2.1 Components of taxes levied on enterprises (Including the income tax and the turnover tax) (1985–1991) (unit CNY 100 million). *Data Source* Comprehensive planning department of the Ministry of Finance (ed.), *Financial Statistics of China*, Beijing: Science Press, 1992, p. 44

Year	Business income tax	Regulatory tax	Subtotal	Tax on products	VAT	Business tax	Subtotal
1985	513.8	82.04	595.84	594.6	147.7	211.07	953.37
1986	523.67	71.73	595.4	546.59	232.19	261.07	1039.85
1987	505.25	57.95	563.2	533.26	254.2	302	817.46
1988	514.54	56.39	570.93	480.93	384.37	397.92	1263.22
1989	519.21	64.38	583.59	530.28	430.83	487.3	1448.41
1990	543.1	61.02	604.12	580.93	400	515.75	1496.68
1991				629.41	406.36	564	1599.77

payment (including the business income tax and the regulatory income tax imposed on state-owned enterprises) for profit delivery had been influential on revenues growth, the profit-based taxes did not increase obviously as a result of the decline of profit margins in industrial enterprises, which is demonstrated by the Table 2.1.

From the table above, it can be seen that the income tax hardly increased from 1985 to 1990, suggesting that the growth of taxes levied on enterprises was not driven by the income growth. In contrast, the turnover tax achieved an annual average growth rate as high as 11.3%, playing a significant role to this end.

It can be seen from the analysis above that the expansion of fixed assets was accompanied by the growth of the turnover tax, but un-correlated to the increase of the income tax and even negatively correlated to the profits obtained by enterprises. Most items of the turnover tax were based on the output value or added value which were directly related to the size of enterprises. Under the fiscal responsibility system, the major approach for competent authorities or local governments to enhancing fiscal revenues and the GDP should be business expansion, rather than income promotion.

Thus, we can see the relationship between local governments and state-owned enterprises under the fiscal contractual system has experienced a basically similar evolution to that between the contractual system and township-run enterprises: business expansion was a major focus for local governments, attached with priority over the financial performance of enterprises and the GDP/fiscal revenues of local governments. The operation of the responsibility system for state-owned enterprises has also promoted the shaping of this situation. This was mainly related to the design of two key subsystems under the responsibility system.

One was the tax-inclusive contract subsystem, whereby the base quota included the business income tax and the regulatory income tax payable by the enterprises. It lasted from 1987 when the responsibility system was first implemented across the nation to 1993. Under this subsystem, the income tax should be paid at a rate of 55% lower than the base in case of any profits higher than the base quota, and should the income tax and the regulatory tax exceed the base quota, excessive taxes would be returned to the enterprises. In such a way, the business income tax and the regulatory income tax may be cut down as long as the actual output exceeded the base quota; and the greater the excess was, the less the actual tax payment would be. Thus the tax-inclusive contract became actually a tax-cutting contract. With a claim to both the income tax and the regulatory tax, local governments should never relay on the income tax to enhance their respective fiscal revenues.

The other was the pre-tax repayment subsystem, whereby any loan should be deducted prior to the calculation of the income tax. This played two roles in practice. On the one hand, similar to that of the tax-inclusive contract system, it reduced the actual payment of the income tax. The bigger the increased loans were, the more would be deducted from the income tax. On the other hand, it actually encouraged the enterprises to increase their respective loans, because the increased profits from investment with such loans were spared from paying the income tax. Local governments had been highly motivated to help the enterprises to obtain new loans, for the investment with new loans may directly enhance the tax on products, VAT, business tax and other turnover taxes, as calculated based on the output value. This has led to a rapid business expansion with the support of new loans. From 1986 to 1990, bank loans granted to local enterprises increased from CNY 269.309 billion to CNY 668.377 billion, with an annual increasing rate of 37%.

The expansion of bank loans and the total fixed assets had led to a sharp decline of profit margins on the one hand and a rapid growth of tax payment by the enterprises on the other. It was the result of the interaction between the fiscal responsibility system and the responsibility system for enterprises. Under the latter system, the proportion of retentions by enterprises increased sharply, while payment of the income tax and the regulatory tax was basically maintained steady; under the former system, local governments and enterprises jointly promoted a continuous business expansion. This has played a significant role in the evolution of the relationship between the central government and local governments.

2.4 Impact of the Responsibility System on the Relationship Between the Central Government and Local Governments

The fiscal responsibility system has been closely related to the rise of township-run enterprises and the reform of state-owned enterprises. It can be seen from the foregoing analysis that under the stimulus of the fiscal responsibility system, local governments and local enterprises have gradually become an interests community. Based on a comparison with the situation prior to the reform, we can easily capture the following changes.

Firstly, the administration system fragmented by regional autonomy and vertical control or dominated by the latter has gradually become dominated by the former. Unlike the changes procured by the central government through directly delegating administration over enterprises and vital materials to local governments during the Great Leap Forward and the Cultural Revolution, this was achieved with the help of fiscal contracting, based on negotiations between the central government and local governments. Considering the obvious difference in the economic situation among different regions, various contract bases and surplus retention methods were adopted. Negotiations went held almost every year between the central government and local governments and/or between different local governments. Thus, the interest boundary of each concerned party was gradually defined. It is found in a study that the bargaining chip of local governments during such negotiations was the local economic development, and a basic logic of recurring to the fiscal responsibility system in view of local economic development was established, which helped local governments to obtain subjective consciousness gradually.

Secondly, in the interaction among the central government, local governments and local enterprises, the central government gradually abandoned its direct administration over enterprises via subordinate departments and thus became the trustor of local governments and enterprises. The reform of the tax system and the implementation of the responsibility system for enterprises also made local governments the trustor of enterprises and thus no more directly intervene with the production, operation and distribution of the enterprises. To a certain extent, this

has achieved separation of government functions from enterprise management. However, under the increasing pressure from the fiscal responsibility system, local governments and local enterprises were closely correlated to each other in interests and thus formed an interests community. Despite their renouncement of direct intervention with enterprises, local governments basically relied on enhancing the turnover tax by taking initiative to help enterprises obtain bank loans and thus achieve rapid enhancement of fixed assets and production scale, so as to accomplish their respective targets under the fiscal responsibility system. For enterprises, the expansion in fact made the enterprises a trump card, for they have become local governments' own business. Therefore, any loss of an enterprise would be covered by its competent local government. Meanwhile, the responsibility system for enterprises also provided an institutional guarantee for enhancing the retention proportion and even cutting down the income tax.

Finally, although significant changes had occurred to the relationship between the central government and local governments, and the latter had turned from direct intervention to facilitation-based stimulation, there were still obvious differences from a real market economy. By facilitation-based stimulation, it means local governments mobilized local resources by various administrative or semi-administrative facilitation approaches for the sake of business expansion, rather than by establishing a real market mechanism whereby enterprises may truly enhance their vitality in market competition. In fact, under the double-track pricing system (characterized by the co-existence of planned prices and market prices), on the one hand, enterprises became more prone to rent-seeking in their pursuit of business expansion; on the other hand, local governments were further inclined to rent-providing with the view of enhancing their revenues. Although both the local GDP and fiscal revenues might be rapidly enhanced in such a situation, local governments and enterprises had gone against market economy. In such a development model, local governments actually took a greater part in the interests chain and thus became more closely connected with the fate of enterprises, despite of its exit from business management. For state-owned enterprises, the loans, liquidity and profits of enterprises were basically all under the control of local governments. This contributed to the situation where loans granted to enterprises by banks had to be repaid from fiscal revenues of the competent government. Moreover, enterprises run by townships became even more closely related to and were virtually equivalent to those run by local governments.

The aforesaid changes were caused by the devolution of powers. In turn, the relationship between the central government and local governments were also affected. Local governments gradually obtained independent interests and strengthened their domination over the increased economic resources during their close interaction with local enterprises. It had directly led to a reduced control over the re-distribution by the central government and a tension between the central government and local governments.

According to the study of the academic circle, two proportions decreased sharply under the fiscal responsibility system, namely the proportion of fiscal revenues to

the GDP and the proportion of fiscal revenues of the central government to total fiscal revenues. The following is a careful analysis of these two proportions.

The proportion of fiscal revenues to the GDP corresponds to the revenues obtained from economic growth by means of taxation and charging. It is a reflection of the State control over redistribution by fiscal means. Generally speaking, taxes and charges are the major components of budgetary and extra-budgetary fiscal revenues, respectively. The calculated proportion of budgetary fiscal revenues to the GDP and that of total fiscal revenues (budgetary revenues plus extra-budgetary revenues) to the GDP were as shown in the Fig. 2.2.

The variation amplitudes of the two curves as shown in the above figure are basically identical. The proportion of budgeted fiscal revenues to the GDP decreased from 24% in 1981 to 12.3% in 1993, and that of total fiscal revenues to the GDP also decreased from 36% in 1981 to 27.2% in 1992, and then to 16.4% in 1993, as a result of a sharp drop of extra budgeted revenues.

The second to be analyzed is the proportion of centrally controlled fiscal revenues to the total fiscal revenues. The proportions of fiscal revenues and expenditures of the central government to total fiscal revenues and expenditures

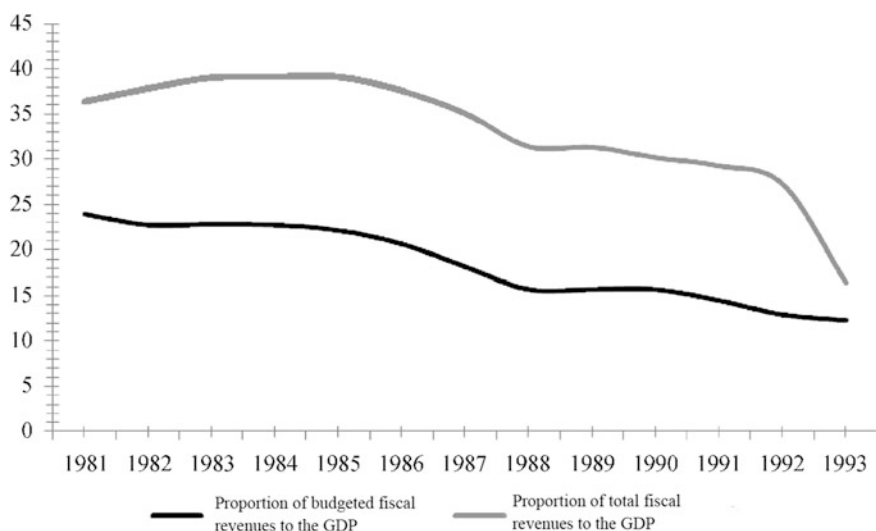


Fig. 2.2 Proportion of budgeted fiscal revenues to the GDP and proportion of total fiscal revenues (budgeted revenues plus extra budgeted revenues) to the GDP. *Data source* China monthly economic indicators publishing house, ed., *30 years of digital China—A compilation of statistical data for the 30 years since the reform and opening up*; Budget department of the Ministry of Finance, ed., *Statistical Data of Local Finance of China* (1999), Beijing: China Financial & Economic Publishing House, 1999

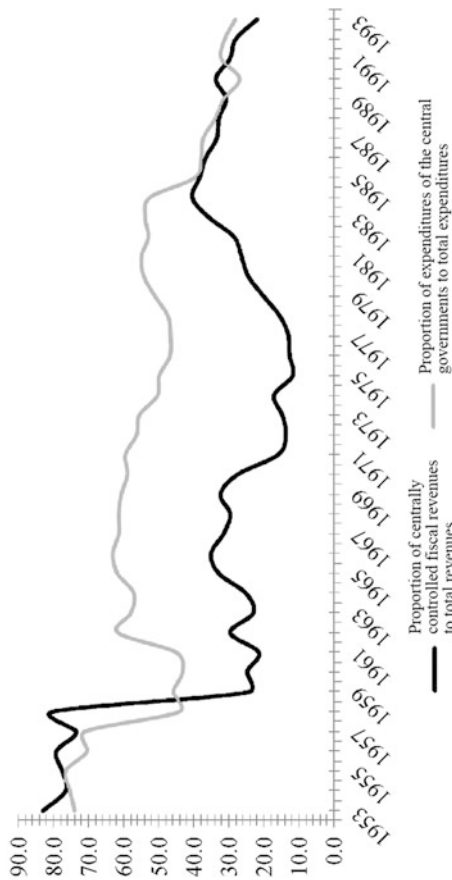


Fig. 2.3 Proportions of fiscal revenues and expenditures of the central governments to total revenues and expenditures respectively (1953–1993), *Data source* Lou Jiwei, ed., *Fiscal statistics for the 50 years since the founding of the PRC*, Beijing: Economic Science Press, 2000

respectively are listed in order to better understand the impact of the fiscal responsibility on their variations, and the time frame is extended to prior to the reform, as shown in the Fig. 2.3.

As shown in the figure above, the proportions of centrally controlled fiscal revenues to the total decreased significantly from 40.5% in 1984 to 22% in 1993. However, when put in a longer time frame, the proportions during this period were obviously not the lowest, but higher than those from 1959 to 1980. The control of the central government over redistribution, if understood based on these data, was still more centralized compared with the situation before the reform and opening up, despite of a slight decline. This was obviously to the opposite of the general course. Another key to the understanding of the situation is the proportion of fiscal expenditures of the central government to total fiscal expenditures.

Prior to the reform and opening up, there was a sharp difference between the low proportion of centrally controlled fiscal revenues and the quite high proportion of fiscal expenditures of the central government. It indicates that a large portion of fiscal revenues obtained by local governments were turned over to the central government for spending. Since the mid-1980s, there has been quite a turn-round as the central government has basically maintained a balance between revenues and expenditures. This avoided the necessity to cover the high expenditures with the large-volume turnover by local governments. Thus, retentions might be made to cover their respective expenditures. In short, the fiscal responsibility system has helped the central government and local governments to maintain their respective balance of fiscal revenues and expenditures.

As local governments were independently responsible for their respective revenues and expenditures, the proportions of fiscal revenues and expenditures of the central government decreased, while those of local governments witnessed a gradual creeping-up. This was mainly because a majority of the increment of State revenues was retained by local governments under the fiscal responsibility system. Based on the statistics for the period from 1984 to 1993, we can obtain:

Centrally controlled fiscal revenues = CNY 50.9 billion + $0.12 \times$ total fiscal revenues.

That is to say, every additional CNY 1 would be split between the central government and local governments as per CNY 0.12 versus 0.88. If this trend has continued, the proportion of centrally controlled fiscal revenues would continue to fall; and the responsibility system spared local governments from turnover to the central government. So, the proportion of expenditures would not witness any increase. This was basically why the central government attempted to substitute the tax-sharing system for the fiscal responsibility system.

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