

**REFORMING INTERGOVERNMENTAL
FISCAL SYSTEM IN CHINA**

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Executive Summary

1. Robust local fiscal condition is critical for economic and social development in China. Local governments are responsible for funding public goods/services delivery and local administrative expenditures. They shape the local business environment as they decide land allocation, infrastructure construction, etc.
2. Local government expenditure reached RMB10.69 trillion in 2012. As a share of local of GDP, it increased from 8% in 1995 to 20.5% in 2012. However, local government's fiscal capacity is in question. While its expenditure accounts for over 80% of total government expenditure, its revenue only constitutes about 50%. The fiscal gap reached RMB4.5 trillion in 2012.
3. The 1994 fiscal reform adjusted revenue assignment without defining expenditure responsibilities for different levels of governments. Local governments have to fund compulsory education, healthcare services and social security. Expenditure on social services as a share of local government expenditure increased from 41% in 2002 to 56% in 2010.
4. The appointment, promotion and demotion of local officials are contingent on the officials fulfilling the requirements of upper level government for providing public services as well as ensuring economic development.
5. Local governments have strong incentives to generate revenue as their fiscal revenue is insufficient to do so. In response, many local governments employ off-budget revenue.
6. Central government increases general purpose transfers to improve local fiscal capacity. Central-local transfers increased 19 times between 1994 and 2012 to reach more than 8.7% of GDP in 2012 compared to about 4% of GDP in 1994.
7. However, current intergovernmental fiscal transfers have failed to improve local government's fiscal capacity due to an underdeveloped budget system.

Alternatively, budgetary local bond has been used to improve local fiscal capacity. Between 2009 and 2011, by issuing bonds, local government received RMB600 billion, which is not enough to cover the local fiscal gap.

8. Reform of central-local fiscal conditions was spelled out in the 12th Five-Year Program (2011-2015), which allows more general purpose transfers to equalize fiscal capacity. It will reform the budget system, improve the accountability of local budget and develop formal institutions for issuing budgetary local bonds.
9. Others issues include reforming cadre performance evaluation criteria; the need for a carefully designed budget system to monitor the behavior of local governments; and improving budget transparency and reducing off-budget revenue, which still account for a large part of local government revenue.