

**Maintaining Stability in Rural China:  
Challenges and Responses**

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## **Introduction: Implications and Sources of Rural Unrest**

A stable China is crucial for the regional as well as global interests of the United States. Major social and political chaos and dislocation in China will interrupt the regional order in Asia, where half a million Americans live and work and US businesses make more than \$500 billion in trade each year. Turbulence in China could also exert an unfavorable impact on the economy of major US allies in the region: Japan, South Korea and Taiwan. With China's growing involvement in the global political and economic order, effective governance in China is in the best interest of the United States and the international community.

Then, how stable is China? While unemployment in urban areas, corruption scandals and *Falun Gong* protests may be seen by many as major threats to the country's stability, the situation in the countryside warrants no less attention. With 75 percent of the population still residing in the countryside and the agricultural sector continuing to make a significant contribution to the buoyant economy, the question of rural stability has deservedly aroused the attention of China watchers in recent years. Mounting reports of rural unrest prompt genuine concerns among policy makers at home and abroad. In recent years Beijing has responded to growing rural tension with a series of political, administrative and fiscal reforms. However, China's leadership overlooks the fundamental cause of the problem: the paucity of resources for effective governance at local levels.

In providing this analysis, this paper first presents an overview of rural unrest in China, followed by a critique of thus-far inadequate central government reform measures. Specifically, this paper argues that recentralization of fiscal discipline may actually exacerbate current tensions in the countryside. This paper also suggest a number of opportunities for the international community to assist Beijing in its social reform efforts.

## Overview of Rural Unrest

While the Chinese government rarely divulges the details of rural discontent, Hong Kong and mainland media regularly report outbreaks of peasant protest and resistance. *Zhengming*, a Hong Kong based magazine, reported that in 1993 alone, 6,230 cases of turmoil occurred in the Chinese countryside. In some serious cases, county and township level Party, government and even public security offices were targeted and burnt down by angry peasants. These cases of unrest resulted in some 8,200 injuries or deaths of officials and peasants, as well as 200 million yuan in damage (Bernstein and Lu, 2000). According to the same report, between winter 1996 and spring 1997, another wave of rural rebellion broke out in 36 counties (in nine provinces and autonomous regions) with the participation of nearly 380,000 peasants (FBIS-CHI, 1997:273:1). In some extreme cases frustration resulted in suicidal acts. For instance, in 1994, a peasant in Shandong blew himself up injuring a number of police in the ultimate act of defiance (FBIS-CHI, 1994:20:30-1).

Tensions in the countryside have shown few signs of abating in recent years. Police and military forces reportedly clashed with peasants in Ningxiang county, Hunan province, where 3,000 peasants staged a demonstration in 1999. About 1,500 armed personnel were dispatched and the confrontation led to one death and 100 casualties (*Inside Mainland China*, 3/1/1999:1). Even in southern China, where economic development proceeds apace, rural governments are not immune to rising peasant discontent. According to one report, in early 2002, thousands of villagers gathered in front of the township government in Dongguan, and industrial municipality in Guangdong, deliberately obstructin the village's main transportation route in protest against poor administration (Ming Pao, 1/7/2002).

The escalation of peasant resentment can also be observed in less violent manifestations. For instance, the number of petitions to higher levels of authority have been on the rise in recent years. In most cases, representatives of farmers present letters signed by hundreds or even thousands of fellow villagers to the county, municipal or central government in order to articulate their grievances against the abuses and

corruption of local officials (O'Brien and Li 1995, Zhao 1998). This practice resembles the traditional way of righting the wrongs inflicted by local mandarins, by appealing to a higher level of administration. The peaceful and subservient style of the petitions certainly inflict less damage on the regime, but the determination and collective nature of these moves strongly indicate the intensity of peasant frustration.

Although nationwide statistics are not available, the trend of rural discontent is on the rise. According to one report:

In a Hebei county, for instance, there were 193 collective complaints against village cadres in 1992, while in the first seven months of 1993 the number of complaints jumped to 243...In one Hubei county alone, collective *shangfang* (i.e. petition to higher authority) reportedly generated more than 500 visits to county offices in 1988 -- a 28 per cent increase over the previous year -- and nationwide. The number of times peasants seek audiences are too many to count (Ibid: 765).

Perhaps the most powerful evidence of the growing tension in rural China is in official responses to the problem. Central leaders in Beijing reportedly panicked over the spread of rural riots. Since 1992, the State Council and the Party Central Committee have jointly organized at least four rounds of national inspections and a number of case investigations into the rural situation (FBIS-CHI, 1998:209:1). The most vivid illustration of this sentiment was the public speech made by Wan Li<sup>1</sup> in 1993. In his farewell speech as outgoing Chairman of the National People's Congress, Wan exploded with his stern warning,

When conducting investigations and studies in the countryside, a democratic party member asked a peasant what they needed. The peasant replied: 'we need nothing but Chen Sheng and Wu Guang. This remark merits our vigilance...in many rural areas, peasants were forced to revolt against the officials. The situation in the countryside is desperate (FBIS-CHI, 1993:72:43).<sup>2</sup>

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<sup>1</sup> Wan Li served as Party Secretary of Anhui Province in the 1970s. During his term, Anhui experimented with the household responsibility system later endorsed by the Party and changed the political and economic landscape of rural China. Wan was later promoted the post of Vice-Premier and was in charge of agricultural production.

Wan's view has been echoed by other heavyweights in the leadership. For example, during his inspection trip to southwestern China in 1999, Vice-Premier Wen Jiabao<sup>3</sup> remarked that maintaining social stability in rural areas is of great significance to China's reform, development and stability (FBIS-CHI, 1999:31:1). And Premier Zhu Rongji also reiterated the primary importance of maintaining rural order in his latest government report delivered in the National People's Congress meeting in March 2002.

Notwithstanding the growing tension, there are several facets of rural development cushioning the threat of rural unrest. First, most confrontations in the countryside are short-lived and poorly organized, and there is no clear evidence of cross-community coordination. Second, there is no sign of these tensions spreading to cities. Given the general contempt felt by urban dwellers towards peasants and the administrative barricades against unsanctioned movement into cities, any rural-urban alliance of protesters is unlikely. Third, most of the peasants' demands are remedial in nature and hence do not constitute a direct and fundamental challenge to the legitimacy of the regime. Also, improvements in standards of living in the countryside have been significant in the last two decades. Nevertheless, this momentary breathing space is likely to be offset by the impact of China's WTO entry on rural incomes. The possible influx of imported grains and crops will put pressure on peasant incomes, and consequently will add fuel to an already volatile situation in the countryside.

What are the most important root causes of this situation, and what, then, is to be done?

The following sections evaluate the Chinese government's response to the crisis. While the combined approach of political, administrative and fiscal reforms may help to alleviate some tensions, it overlooks the fundamental cause of the problem: the paucity of sufficient financial resources for effective governance.

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<sup>2</sup> Chen Sheng and Wu Guang were the folk heroes who instigated the first large-scale peasant uprising in China's history.

<sup>3</sup> Wen Jiabo has been tipped by overseas journalists as the primary candidate to succeed Premier Zhu Rongji in 2003.

And for this reason, some reforms may have in fact, worsened, rather than improved the situation.

### **Rising Peasant Burdens**

What are the peasants' major grievances? Riots have been triggered off by conflicts over reasons such as misappropriation of land, population control regulations, and practice of lineage and traditional rituals (e.g. burials and ancestor worship). Nonetheless, most serious confrontations are ignited by anger over excessive financial extractions imposed by local governments. Better known as the "peasant burden" issue in the policy debate in China, it refers to the mounting tension attributed to the large array of formal and informal fees and taxes imposed by local administrations. Currently, peasants must meet the financial obligations imposed by three levels of administration: central and township governments, and village authorities. These are summarized in Table 1.

Table 1: Peasant burden

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I. Taxes	agricultural tax and surcharge; special product tax; farmland utilization tax; educational surcharge
II. Township levies	five general fees for: a. education b. militia training c. road construction and maintenance d. welfare for veterans e. family planning  5-10 days labor for state afforestation and water conservation, or its monetary equivalent
III. Village levies	contributions to village fund for: a. collective investment b. welfare c. cadre compensation

5-10 days labor on local flood prevention,  
road and school construction and  
afforestation, or its monetary equivalent

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The agricultural tax comprises the main tax burden shouldered by Chinese peasants. It is calculated according to the size of the contracted land and the level of normal agricultural output level per province. Regional variation in tax rate is around 3 percent in the countryside.

Township and village levies are another major financial obligation. State agricultural law stipulates that these two extractions should not exceed a maximum of 5 percent of the preceding year's average per capita net income. The arrangement itself is problematic on two counts. First, local governments hungry for more resources can simply fabricate growth statistics to justify their claims. Second, the notion of "average" simply implies that those with less income growth have to pay a bigger share than others; it is not only unfair but also dangerous, as this income group is certainly more vulnerable to, and resentful of, these taxes. However, it appears the tax level in the majority of localities significantly exceeded the 5 percent limit. One report estimates that in 1991, taxes reached the level of 7.94 percent (Bernstein and Lu, *op. cit.*). Although the figure has decreased since the mid-1990s, a report from the State Council Development Research Center acknowledged its rise in 2000 (Chen Xiwen, 2001).

More importantly, these are not the only fiscal obligations imposed on peasants. Which include additional fundraising contributions for specific projects (such as investing in new schools and infrastructure improvements), administrative penalties for non-compliance with state policies (i.e. birth control policies), and excessive charges for services. A survey conducted in 2001 estimated that these extra charges constitute about one-third of the total burden shouldered by Chinese peasants (Fu, 2001). For local government, the drop in formal taxes and levies since the mid-1990s is easily countered by an increase in extra fees.

However, the lack of transparency about these ad hoc charges irritates peasants. While state taxes and township-village levies are mostly subject to formal regulation and clear calculation, those ad hoc charges are arbitrary and

unpredictable. There are no explicit limits to these exactions, and the lack of accountability and transparency has expectedly prompted cynicism and mistrust among peasants towards local administrators.

Rural resentment should also be put in the historical context of rural governance in China. Chinese peasants are used to hidden taxation rather than explicit monetary obligations. In Mao's China, rural surpluses were mostly transferred to central coffers via compulsory procurement of grains and the price manipulation of agricultural and industrial goods. In addition, one should also recognize systematic discrimination against the rural population in China. While the level of financial extraction may seem acceptable by international standards, one should bear in mind that compared to their urban counterparts, Chinese peasants receive little welfare benefits other than guaranteed access to land.

The slowdown of income growth adds further fuel to peasant frustration. While rural China enjoyed average double-digit income growth on average over the first fifteen years of reform, the second half of the 1990s witnessed a steady decline. Real growth dropped from 4.6 percent in 1997 to 2.1 percent in 2000 (Zhang 2000, Chen Jianbo, 2001). It is alarming not only because it may imply a lower threshold of peasant tolerance, but it may also affect China's grain security as low economic returns on farming will discourage participation in grain production.

Looking ahead, a possible rise in rural income is clouded by several factors. Compensation from employment in local factories, the so-called township-village enterprises, now constitutes one-third of rural income per capita. Unfortunately, intensified competition, ownership restructuring and further credit squeezes have disrupted rural enterprise performance in recent years. The average annual growth rate of rural enterprises during the 1995 to 2000 period reached its lowest level since the advent of rural reforms. In 1997 and 1998 total employment had decreased by 10 million (Chen Xiwen, op. cit). Given the huge central budget deficit, it is unlikely that the national government will be able to reverse the downward trend of rural income growth by substantially hiking prices for agricultural products.

### ***Local Governments: The Major Culprit***



How can this problem with increased rural tensions be solved? Chinese authorities reacted swiftly in 1993 by forming a leading group comprised of representatives from the Ministry of Agriculture, the Ministry of Supervision, the Ministry of Finance, the State Planning Commission, and the State Council's Bureau of Legislative Affairs. Its major task was to conduct a comprehensive review of directives for imposing new charges on peasants with a goal to reduce their burden. Consequently, more than fifty charges were removed (FBIS-CHI, 1993:103:68-9). Top leaders like Jiang Zemin, Li Peng and Zhu Rongji also issued high-profile statements calling for a reduction in the peasant burden. However, in addition to this high level single-issue campaigning and the mobilization of the state's propaganda machinery, the Party also tries to address its genuine concern for rural stability through a more sustained effort. For the Party, greed and abuse of power in local administrations are the root causes of the crisis. Among the major indictments of local officials are (1) over-staffing bureaucracy and poor fiscal discipline (leading to an insatiable drive for revenues); (2) arbitrariness in imposing fines and charges; (3) individual corruption and misappropriation of funds; and (4) insensitivity to local sentiments. Thus, as far as the central government is concerned, local administration, in other words, is the major culprit.

For Beijing, the solution lies in tightening control over rural officials, through a combination of political, administrative and fiscal reforms.

### *Political Reforms*

The Party leadership views the introduction of village-level elections as key to enhancing transparency and accountability in rural governance, and hence, reducing peasant resentment. According to China's Constitution, villages should be administered by self-government, as the state apparatus does not extend below the township level. Two major bodies compose the formal structure of village authority: villagers' assembly/villagers' representative assembly and the villagers' committee.

In principle, the villagers' assembly ranks as the highest decision making body in villages. It is a form of direct democracy in that all residents are entitled to participate in the meetings. The assembly examines and approves social and economic development plans, matters relating to the use of collective resources like land, water, energy and machinery, birth control, and any other issues affecting village interests. In some localities where direct democracy is made impossible by population size or physical constraint, a more manageable form of representative democracy is adopted: the villagers' representative assembly. The villagers' representative assembly performs almost the same role as the villagers' assembly, and usually consists of representatives chosen by every 10 to 15 households, plus villagers who hold public office in the party or government.

Neither the villagers' assembly nor the villagers' representative assembly meet frequently and the day-to-day administration of village affairs in practice is in the hands of a small standing body of 3 to 5 executives: the villagers' committee. First established by the 1982 Constitution, the number of villagers' committee reached 734,715 by 2000 (China's Statistical Yearbook 2001:12:3). However, what is most remarkable about the innovation is the legal requirement of direct election. The 1987 Organic Law stipulates that the executive of the villagers' committee is elected directly by villagers. By 1998, rounds of direct elections to villagers' committees were practiced in all provinces except Tibet. Understandably, the experiment of grassroots democracy in an authoritarian regime like China has aroused strong interest and expectations from abroad. The Chinese authorities also make use of these changes for propaganda purpose. Ex-US President Clinton, for example, was invited to a model village during his visit to China in 1998.

It may be premature to come to any conclusion as to whether democracy can really take root in the countryside. Villagers' committee elections do, however, lead to substantial personnel changes in the local leadership. The percentage of incumbents defeated in elections in some provinces can be in the region of 20 to 30 percent (Pastor and Tan, 2000:504). The possibility of being voted out of office may help to deter abuse of authority and bring greater accountability and encourage improved responsiveness by villagers' committee executives.

Nonetheless, three major obstacles will slow further progress. First, in practice, there is still no national or standardized approach for the organization of elections across the countryside. The revised Organic Law of Villagers' Committee, passed in 1998, may have solved part of the problem by imposing a more detailed clarification of election procedure, yet the actual implementation still relies on the passage of corresponding measures and cooperation at provincial levels.

Second, the relationship between the unelected village party secretary and the elected villagers' committee chairman is also a very delicate development. Empowered by the support of villagers, the latter is in a better position to negotiate with or even confront the party boss if necessary.

Third, the relationship between township government and villagers' committee also needs to be evaluated. The principle of villagers' self-rule implies that the elected villagers' committee should not be subordinate to township officials. Nonetheless, township administrators are motivated to intervene in village affairs. Villagers' committees are after all, entrusted to enforce state policies such as those governing birth control, healthcare and education. And disturbances at the village level are surely a liability for township officials whose individual performance appraisals are directly affected by such occurrences. Thus, they are not ready to respect the right of villagers to "make the wrong choices" and will intervene directly in village affairs whenever they suspect incompetence or any form of unacceptable behavior by elected village leaders. All these hindrances can certainly be reversed by the Party leadership. Yet, there is little indication of a determined effort to accelerate grassroots political reform. Instead, the Party branch is still stressed as the village "leadership core" (*lingdao hexin*) in most official documents concerning village democracy.

### *Administrative Reforms*

Downsizing rural administration is another possible strategy to reduce the peasant burden. It is premised on the assumption that the budget deficit is primarily attributed to over-staffing of local bureaucracies and the main driving force behind increased demands for revenue extraction by local governments.

The irony is that in spite of the process of decollectivization in post-Mao China and its relaxation of control over the rural economy, the size of bureaucracies at the township level have increased in the last two decades. Notwithstanding the central government's downsizing efforts, the size of township bureaucracies have continued to expand. In 1995 alone, about one million new staff were added to the state payroll and this figure does not even include new recruits paid with local resources.

Higher authorities are not completely innocent in this expansion. Many local officials at the township level are culpable for bureaucratic expansion as they are keen to make their mark during their brief term in office by improving infrastructure or initiating business projects. The appearance of achievement is crucial not only for satisfying one's personal pride, but also important for career ascendancy. In many cases, these are attempts to meet targets and standards set by higher levels; failure to meet these benchmarks would be detrimental to one's career.

However, in other instances, bureaucratic expansion is simply a response to new assignments from above. Local governments are frequently instructed to take up newly designated "core tasks" in addition to routine administrative tasks. These are policy priorities identified for immediate action or extra attention, such as the suppression of superstitious activities and improvements in public security. As a result, ad hoc offices are set up, but many soon become permanent and require extra staff. In other cases, new offices are set up as the central government develops new regulatory functions. This is a feature particular to the Chinese bureaucratic system: every central ministry or unit should have subordinate units at each level of administration. In other words, new policy objectives or bureaucratic restructuring of a central ministry may result in a corresponding increase in the number of new offices below. These local offices are in fact "outreach arms" under a specific line of vertical command and are quasi-independent from township control. Nevertheless, the staffing and operational expenses are in large measure financed by local budgets (Lu, 1997).

A major obstacle for expenditure reduction through administrative downsizing lies in the expenditure structure of township finances. While it is true that staff remuneration consumes a dominate share of township budgetary expenditure, it is noteworthy that 60 to 80 percent of it is spent on teachers' wages (Chen Xiwen, op. cit). Given the state's policy of nine years of compulsory basic education and the centrality of schooling in a developing country like China, it is doubtful whether much can be done here to reduce expenses, and hence there exists little room for reducing the local budget. Also, an estimated two thirds of the five million teachers in the countryside do not receive their wages from local governments on time (Mingpao, 6/20/2001). Thus, local budgets are under pressure from all sides to provide more services with fewer resources.

### *Fiscal Reforms*

The third central government strategy addresses the issue of arbitrary extraction of money from peasants. If the lack of certitude is a cause of peasant resentment and rural confrontation, the situation should, in theory, be improved through greater fiscal discipline and regulation. This is the rationale behind the 'tax-for-fee' experimental reforms since the mid-1990s.

Township revenues can be categorized into budgetary and non-budgetary income. All taxes are of the former category, the collection of which is tightly regulated by state laws and regulations. Moreover, use of this revenue falls under close budgetary scrutiny by local finance bureaus, which are under the direct control of the Ministry of Finance in Beijing. All non-tax extractions are classified as non-budgetary revenues. Profits from local collectively-owned enterprises, township and village levies, all sorts of administrative fees and charges and ad hoc fund raising contributions constitute the bulk of local non-budgetary income. As mentioned earlier, most of these extractions are unpredictable and subject to less rigid financial control from above. Thus, the whole idea of the tax-for-fee experimentation is to tighten up fiscal discipline by replacing township and village levies (see Table 1) and most administrative fees and charges with an increase in the agricultural tax. In Anhui province, the test-point for this new scheme, the

agricultural tax rate increased from 3 percent to 7 percent. In addition, tight restrictions are imposed on fundraising activities. In order to compensate for the loss of income from non-budgetary sources, a supplement is added but which should not exceed 20 percent of the total agricultural tax.

In addition to enhanced transparency and fiscal discipline, there are other merits of this system. First, the cost of revenue collection can be substantially decreased. In the past, levies and charges were collected by different departments and administrative units, the administrative cost involved was enormous and the nuisance of uncoordinated and regular encroachment often was a catalyst for confrontation. Second, the reform will surely help limit punitive extractions and should reduce the burden on peasants. In Anhui, the burden on peasants decreased by 30 percent in 2000 (Chen Xiwen, *op. cit.*).

However, an accurate reassessment of the agricultural tax would be a monumental effort. Determining the average output level is a daunting task. China has conducted three nationwide agricultural productivity assessments since 1949, the last one was completed in the 1970s. Calculation of the agricultural tax with reference to data collected three decades ago is hardly desirable. The paucity of updated information may invite arbitrariness and manipulation and, hence, defeat the purpose of the proposed change.

The new system may also lead to a new form of unfairness. Under the old practice, the dominant proportion of peasants' fiscal obligations was calculated on a per capita basis, as extra-tax funds were the most important component of peasants' contribution. Under the proposed change, the level of extraction will be a function of the contracted farm size. In other words, peasants in areas of high population density will be better off while those residing with more land per capita have to pay more. The irony is that empirically peasants in the former region are usually richer as alternative income opportunities in rural enterprises are available, and they have the option of abandoning farming all together. On the other hand, areas with low population density may primarily rely on farming activities and are, in general, poorer. For example, peasants in Shanghai, Beijing, Zhejiang and Guangdong enjoy the highest per capita rural income in the country, yet the per capita size of

cultivated land under these households is only about 50 percent of the national average. On the other hand, the average per capita entitlement to cultivated land in provinces like Heilongjiang and Jilin is double or even quadruple the national average, yet rural income in these regions is just in line with the national average. And in more remote Gansu and Shaanxi, above-average land possession still cannot enable peasants there to achieve even 60 percent of the average per capita rural income.

Thus, the size of land possession is no longer the most important determinant of peasant income in rural China today. Consequently, the proposed extraction mode based on land size may result in a perverse scenario with the poor paying more in taxes. It could also reinforce the disincentive to participate in farming.

The most delicate issue concerning full implementation of the tax-for-fee reform is its negative impact on rural finance. In the first place, the immediate effect of the new arrangement is to restrict non-budgetary extractions. This implies more than a loss of fiscal autonomy, however, for many local administrations, it is a matter of survival. In 1999, the total revenues collected by all sub-national levels of administration reached about U.S. \$12 billion, of which one third came from non-budgetary sources. It is highly debatable whether the agricultural tax supplement sufficiently compensates for this loss. The central government is aware of the problem and Premier Zhu Rongji, who is the main force behind the experiment, has promised an extra annual financial subsidy of about U.S. \$2.5 billion for local administrations once the scheme is implemented nationwide. However, according to the Anhui experience, township finances suffered an average loss of about U.S. \$110,000 a year and village revenue showed a parallel decrease of 40 percent in general. If these are representative of the impact on local finance, the extra grant of U.S. \$2.5 billion is insufficient for a country with 50,000 towns and 740,000 villages (Jingji Ribao, 3/5/2001).

Financial pressures are particularly intense at the village level. For village administrations, the immediate effect of the proposed change is the total surrender of control over local revenue to township governments. In areas where tax-for-fee

reform is in place, village administrations have no control over the extent of extraction and collection and its share of the tax supplement must be deposited in the township finance office and managed accordingly. Worse still, the formula for redistributing the agricultural tax supplement and the prospective extra grant between township and village levels is unspecified in most cases. Township governments are tempted to take advantage of the situation given the financial constraints imposed by the new system. Thus, it is likely that the pressure will be passed down to the village level, and it will be a colossal task for village officials at the forefront of rural governance to maintain effective order with a further drain on their financial resources.

### **Fundamental Cause: Rural Finance Undermined by Centralization**

How effective are these prescriptions in alleviating rural tension? Certainly, as we have seen, the exposure of village officials to electoral politics helps to enhance accountability and should be useful in deterring fiscal malpractice and excessive extraction. Also, greater transparency and clarity in fiscal obligations may also reduce skepticism among peasants. Nevertheless, the fundamental diagnosis attributing rural unrest solely to the role played by rural administrators is misplaced. Why are local governments so hungry for revenues in the first place, even at the risk of triggering off violent responses and jeopardizing their own political careers? Corruption and incompetence among individual officials certainly exacerbates the problem, but the remedies mentioned above --which put all the blame on the local administration-- do not get to the root of the issue. The structural reason for rural discontent lies in the paucity of rural revenue, and the recentralization of fiscal management in China since the early 1990s has played a major role in this development.

The early years of China's reforms were characterized by economic decentralization. Provincial governments were motivated by the newly delegated power in economic decision-making and access to a substantial share of local economic success. Under the old fiscal contracting system, the average share of total revenue retained by governments at the provincial level and below between 1990-1993 reached 73 percent (China's Financial Yearbook, 2000: 421-2).



Dissatisfaction with the declining regulatory capacity of the central government and calls to strengthen macroeconomic control became audible within the Party beginning in the late 1980s. The drive for fiscal reform was eventually galvanized with the introduction of tax assignment reform in 1994.

In brief, the general arrangement of the new system is to divide all taxes into three categories: central tax, local tax and shared tax. Central and local taxes are collected separately by different agencies, the shared tax on the other hand first goes through central finance mechanisms and a portion is then returned to local governments. The reform has achieved the very important effect of strengthening the central government's fiscal regulatory ability. Revenues circulating within the budgetary channel are subject to extensive regulation and monitoring. Although local taxes and tax refunds are the entitlements of local governments, the allocation and use of this revenue requires formal budgetary approval from a higher level and the local finance bureau. Greater fiscal discipline is thus instilled and the central government is now in a better position to influence the allocation of revenue at local levels. Before the introduction of tax assignment reform in 1994, only 12 percent of local finances was transferred from the center; but in 1996, the percentage jumped to 32 percent (Guo, 1998). The center is obviously enjoying a firmer grip on provincial pocketbooks.

The tax-for-fee reform is a corollary change of the tax assignment scheme. For local officials, more revenue is channeled into a formal budgetary regulatory regime and will thus try to minimize a decline in fiscal autonomy by diverting resources to less regulated channels. How can they do this? In the countryside, officials can easily maintain control over additional funds by raising administrative charges and levies, while concurrently observing considerable laxity in terms of tax collection. Put into this perspective, the tax-for-fee reform is a logical move by the central government in this cat-and-mouse game. The tightening of control over non-budgetary extraction leaves little room for local administrations to pursue this diversion strategy.

Closing options for non-budgetary extraction will surely put further pressure on local finances. It is important to note that although local finances have enjoyed a growing share of revenue in the reform period, they also shoulder an escalating burden of financing new expenditures. Local government's share of total expenditures has grown

from 45.7 percent in 1980 to 68.5 percent in 1998. And as mentioned above, as one third of their revenue comes from non-budgetary sources, the deprivation of this form of revenue may herald a fiscal crisis.

In fact, many rural administrations have been running deficits since the early 1990s. While the income-expenditure ratio at the central level achieved a dramatic improvement from 0.87 in 1991 to 1.63 in 1995, the county and township levels suffered drops from 0.73 to 0.45 and 1.40 to 0.97 respectively during the same period (He, 1997). In another recent survey of county account books in seven provinces, the percentage of county finance in the red stands at the alarming level of 63 percent (Task Force on the Study of County Finance, 1997)! Fiscal pressure is generally passed to the next lower level --the township government-- and many are saddled by debt. According to the Ministry of Civil Affairs in 2001, the average amount owed by township governments is in the region of US\$500,000 --a significant amount for a budget of around U.S. \$1 to 2 million (Mingpao, 6/20/2001).

The impact of tightening fiscal discipline varies among different localities. For rural areas with well-developed industries, local governments are buffered by lucrative local factories. While tax-for-fee reform has ruled out the possibility of imposing many levies and charges, profits from these enterprises --another major source of non-budgetary income is still legitimate. In other words, localities with a solid base of rural enterprises are relatively less affected by the change, while those governments without this luxury suffer more. Unfortunately, the latter are usually governing a poorer area, and hence have a smaller tax base in the first place.

The problem is made worse by the absence mechanism for fiscal redistribution. The downward transfer of revenue from above is mostly confined to tax rebates. That is, under the tax-assignment system, local levels are entitled to a certain percentage of shared tax and this tax rebate forms 73 percent of downward transfers. And the lack of progressive redistribution is notable: a rebate is calculated on the basis of contribution (i.e. poorer regions with smaller remittances in turn receive a smaller transfer). Of the remaining 27 percent, another 18 percent is delivered as policy grants for specific projects or goals and a mere 1 percent is given on the basis of need (Guo, op. cit).

In short, the central government's effort since the 1990s to regain a firm grip on revenue management has successfully provided the center with greater leverage in macroeconomic management and instilled greater fiscal discipline. The tax-for-fee system is the latest development along these lines. However, success comes at the price of exacerbating the dire financial situation of the local levels and hence weakening the overall capability to maintain effective governance. Worse still, with a heavy reliance on non-budgetary income and an absence of progressive redistribution in China's fiscal system, fiscal centralization has caused more harm than good to poor regions which are the most tempted to compensate for lost income by intensifying non-budgetary extraction from the local community, making them more prone to social tensions.

### **What's next?**

The prospect of maintaining rural stability is thus linked to further reforms. The building of market institutions certainly requires an effective central government as it is unrealistic to expect local governments with parochial concerns to provide public goods indispensable for the development of market economy; put into this perspective, the fiscal centralization process witnessed above is justified. However, the preceding analysis also shows the importance of parallel reforms in the transfer payment system. Unequal development across China makes a standard formula of revenue sharing impossible. International experience of how to achieve progressive redistribution among regions can certainly help China to improve its fiscal arrangement.

The goal of commanding greater leverage can also be achieved beyond the focus of center-local relationship. A more effective assessment of the tax base and a more efficient tax collection procedure are essential. The four decades of hidden taxes and administrative pricing inherent in a planned economy made China and its population strangers to conventional taxation practices common in market economies. The rapid opening of China's economy and dramatic diversification of ownership structures necessitates much catching up for China's taxation and accounting professionals. Here, professionals in the United States and international community can make a substantial contribution. And parallel experiences in building and reforming tax administrations in other post-communist countries are particularly useful for China.

The maintenance of rural stability also entails a change of governing philosophy. All the strategies mentioned above are government interventions based on imposing new rules or prohibiting certain behavior. However, tension can best be alleviated by enabling peasants to solve their own dilemmas. In order to create an environment for them to do so central authorities must lift restrictions on rural mobility. Introduced in the 1950s, the residential permit system, which is intended to prevent peasants from entering urban areas, remains the largest obstacle thwarting peasants' efforts to solve their own problems. The systematic discrimination inherent in the residential permit system imposes a high premium (as illegal residents) on underemployed peasants for finding a solution for their economic hardship. Not only does it impose a *de facto* bar on peasant income increases, but it also deprives local governments of potential sources of revenue. Lifting this obsolete and unfair restriction is necessary to make the option to enter the urban economy more accessible for peasants.

Critics may argue that relinquishing this control will lead to a massive influx of peasants into urban areas. For city governments where facilities were designed on the premise of a static population, the price is too high to ignore. However, Chinese peasants have been moving since the advent of economic reforms. Chinese experts estimate there are 80 to 100 million peasants on the move at present. The so-called "blind flow" of peasants is simply a part of the marketization process in post-Mao China. Thus, the retrospective lifting of residential permit restrictions can help to alleviate feelings of urban-rural inequality, thus moderating rural discontent.

The prospective effect of raising income through remittances can contribute not only in terms of reducing rural agitation, but the resultant rise in rural consumption power can also provide an extra impetus for the domestic market. The abolition of the residential permit system entails parallel changes in other policy dimensions. China's urban welfare provision, structured very much on the basis of life-long employment and financed mainly by enterprises or the government, would certainly need major reform to accommodate many ensuing socio-economic changes. Financing a new welfare system and arranging for a new, mobile work force deserve more study and analysis. Here again, the United States and the broader international community are instructive with their past experiences and current dilemmas with welfare and fiscal reform.

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