

## How Has Rural Tax Reform Affected Farmers and Local Governance in China?

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### Abstract

*Using nationally representative data, the present paper examines the impact of China's ongoing rural tax reform on farmers. The difficulties in further local governance restructuring are also discussed. It is argued that the issues associated with rural taxation and local governance in China result from inherent tension between an increasingly liberalized economic system and a still centralized political system. Although rural tax reform has helped to reduce farmers' tax burdens in the short term, the establishment of an effective local governance regime requires coordinated reforms to downsize local bureaucracy by providing social security for laid-off cadres, to strengthen local accountability by granting higher local formal tax autonomy, and to promote meaningful participation by expanding local democracy.*

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**Key words:** farmers' tax burdens, local governance, rural tax reform, tax incidence

**JEL codes:** H57, H71, P32

### I. Introduction

In rural China in the 1990s, tax rates for the poorest group of farmers (annual income lower than RMB800) was as high as 30 percent of their already very low incomes, whereas tax rates for higher income groups (annual income higher than RMB4000) were only around 10 percent (Tao and Liu, 2005). At the same time, tax collection was very costly because the bulk of local cadres' work in many agriculture-based regions involved charging individual

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rural households fees. Anecdotal evidence suggests that in many less-developed regions, a vicious cycle emerged: local governments had to recruit more staff to ensure tax collection and to manage the resistance from farmers. Tax arrears ensued; higher tax revenues then had to be used to support an enlarging local bureaucracy. This in turn led to even greater tax collections and a larger local bureaucracy (Bernstein and Lu, 2000).

If the purpose of taxation is to raise resources in an administratively and politically feasible way to finance government spending and to promote equity and efficiency as far as possible (Burgess and Stern, 1993), China's rural direct taxation in the 1990s and the early 2000s failed both in terms of income equity and economic efficiency. As informal charges paid by farmers to local authorities grew rapidly in many agricultural regions in this period, the Chinese state seemed unable to devise, implement and enforce a fair, equitable and reasonably honest rural tax system. As a result, by the early 2000s, not only were the rural informal taxes undermining efficiency and equity in the countryside, but also farmers' growing frustration started to threaten social stability and even endanger the state's political legitimacy. Rural taxation became a major source of grievance and social instability and many of China's agriculture-based localities witnessed escalating levels of conflict and protest against local governments (Chen, 2003).

In response to farmers' growing frustration and protests, in 2002 the Chinese Central Government initiated a rural tax reform that involved gradually phasing out all state formal taxes and informal fee charges on farmers by 2006. Universal tax relief was viewed as a central measure in the official effort of the Chinese state to consolidate its political legitimacy and build a "harmonious society", a leading slogan of China's current administration. Along with rural tax reform, the government has begun streamlining local bureaucracy by downsizing local governments and cutting personnel expenditure, while at the same time re-orienting local government functions from fee charging towards the provision of public services.

The present paper aims to provide an early assessment of the government's rural tax reform initiatives and to analyze the remaining challenges ahead. The evolution of rural tax reform policies is outlined in Section II. Using a large dataset that covers 116 villages in 6 provinces across China in 2000 and 2004, the impacts of rural tax reform on the level, structure and incidence of farmers' tax burdens are explored in Section III. In Section IV the impacts of rural tax reform on China's local governance practices are analyzed and remaining challenges are pinpointed. Conclusions are drawn in Section V.

## II. Rural Tax Reform: Evolving Policies

To accommodate farmers in underdeveloped regions' bitter complaints regarding heavy tax burdens, a series of policy changes have been installed by the Central Government. These

reforms were first introduced on a local level pilot basis in 2000, and were then promulgated as a national initiative. In March 2000, the Central Committee of the Chinese Communist Party and the State Council issued the “Circular on Implementing Pilot Project of Rural Taxation Reform”. It was announced that rural tax reform would be carried out in Anhui province on a pilot basis in 2000, and that other provinces could select a few counties or cities as their own pilot localities. By the end of 2001, the coastal province of Jiangsu had also carried out pilot rural tax reforms. By 2002, 20 provinces in China had commenced rural tax reform on a pilot basis.

Rural tax reform before 2004 consisted of the following elements: (i) abolishment of existing township pooling funds, but an increase in the agriculture tax rate to 7 percent; and (ii) abolishment of the three village levies. Remuneration of village cadres, social relief and administration expenses, which used to be financed by village levies, are now financed by a so-called “agricultural tax supplement”, which can be no more than 20 percent of the baseline agricultural tax.<sup>2</sup> In general, the reform measures before 2004 can be characterized as a “fee-tax swap” so that all informal fees were to be replaced with agricultural taxes (and the agricultural tax supplement as township and village revenue). By disallowing local governments to levy any informal fee, the center hoped to halt the trend of rising rural informal fees imposed on farmers by local governments.

Since 2004, the Chinese Central Government has begun to readjust its agricultural tax policy to accelerate the pace of tax reduction. In 2004, pilot programs to fully exempt farmers from agricultural tax were run in the northeast provinces of Heilongjiang and Jilin. Another 11 agriculture-based provinces were asked by the center to cut their agricultural tax rates by 3 percent that year, and all other provinces by at least 1 percent per year. The center also stated that the relatively developed provinces could move faster in rural tax reform. In 2004, Premier Wen Jiabao promised that all agricultural tax would be phased out within 5 years. By the end of 2005, 28 of 31 provincial areas in China’s mainland had exempted farmers from agriculture tax. A further step was taken in 2005 when the center announced the phasing out all agricultural tax at the beginning of 2006.

As a coordinated policy, the Central Government has increased transfers to compensate for local revenue shortfalls. In 2002 and 2003, the center transferred RMB17.9bn and RMB30.5bn, respectively, to compensate local governments (mainly in inland agriculture-based regions) for revenue shortfalls. In 2004 and 2005, such transfers were further increased to RMB51.0bn and RMB66.4bn, respectively. Along with rural tax reform, the Chinese

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<sup>1</sup> In addition, the slaughter tax was also abolished and farmers’ compulsory labor was to be gradually abolished. There was also adjustment of the agricultural special product tax with tax rates for cash crops slightly higher than the baseline agricultural tax rate.

Government also began to streamline its local bureaucracy by downsizing local governments and cutting personnel expenditures. From the very beginning, local government restructuring and staff downsizing have been the core components of the rural tax reform. The central authority realizes that downsizing has become an essential source of the savings needed to offset revenues lost through bans on local government fees and levies. In many localities there have also been measures taken to consolidate villages, townships and school districts to create more efficient scales for service provision. For example, smaller townships have been merged into larger ones and the number of townships in China was reduced from 43 735 in 2000 to 38 028 by 2003.

### III. Impacts of Rural Tax Reform on Farmers

#### 1. Farmers' Tax Burden: Data Source and Definitions

Our data comes from a survey carried out by the Center for Chinese Agricultural Policy at the Chinese Academy of Sciences in 2005. The survey aimed to collect a nationally representative dataset that can be used to analyze the impacts of rural tax reform on farmers and local governance practices. One province was first randomly selected from each of China's major regions. These are Shaanxi (northwest), Sichuan (southwest), Hebei (north), Jilin (northeast), Jiangsu (east) and Fujian (southeast). Then 5 counties were identified in each province by ranking all counties within the province according to measure of income and selecting 1 county per quintile. Next, 2 townships within each county were randomly selected and 2 villages in each township were randomly selected. In each village, 16–18 rural households were selected to complete surveys. Detailed information about farmers' tax burdens as well as many other individual and village level social and economic indicators were collected. We were able to collect effective data from 1918 villagers from 58 townships (from 114 villages in 29 counties).

Farmers' are subject to a wide array of taxes and fees, including legally permitted taxes and fees as well as irregularly and illegally collected fees. Despite their complexity and significant regional variation, rural taxes, prior to their abolishment, were commonly divided into four categories: (i) state agricultural taxes; (ii) so-called "five township-pooling funds" for township governments to provide basic public goods, such as education, public security, law and order and civil service, and to carry out the state mandates of family planning and grain procurement, and the "three village levies" to village community organizations to provide for collective capital accumulation, collective welfare funds and cadres' salaries (these township and village levies were adjusted and levied as an "agricultural tax supplement" after the rural tax reform; (iii) rural compulsory labor; and (iv) miscellaneous

local fees, including illegal fundraising, fines and administrative fee charges without explicit government regulations or legislation (Bernstein and Lu, 2000 ; Tao and Liu, 2005). Here, administrative fees include vehicle plate fees, marriage certificates and user charges for residential land. In the present paper, we divide rural tax burdens more broadly into “taxation under central legislation” (iii) and “taxation beyond central legislation” (iv). The values of compulsory labor are obtained by multiplying farmers’ working days by the local daily wages.

## 2. Changes in Average Tax Burden

On the basis of the Center for Chinese Agricultural Policy data, Table 1 shows farmers’ tax burden per capita in 2000 and 2004 (i.e. before and after rural tax reform). One thing to note is that although the rural tax reform policy has stipulated that no informal fees are to be levied on farmers, in practice local governments have still charged farmers through various fund-raising activities as well as administrative fees. Therefore, we put these illegitimate fees together here under an item of taxation beyond central legislation in Table 1.

As shown in Table 1, the total farmer’s tax burdens per capita fell significantly with the introduction of the rural tax reform. For all the farmers in the 6 provinces we have surveyed, the per capita taxes and fees dropped by more than half from RMB145 in 2000 to RMB72 in 2004. However, the reduction was purely a result of changes in taxation under central legislation. Taxation under central legislation dropped by 71 percent from RMB103 per capita in 2000 to RMB30 per capita in 2004. For taxation beyond central legislation, per capita levies remained at a per capita level of RMB42 for years 2000 and 2004. For taxation under central legislation, the township pooling funds and village deductions were reduced

**Table 1. Per Capita Tax Burden before and after Rural Tax Reform**

	Per capita tax			Tax structure			Tax rate		
	2000	2004	Change	2000	2004	Change	2000	2004	Change
	(RMB/capita)		(%)	(%)		(%)	(%)		(%)
Total tax burden	145	72	-51	100	100		6.9	2.5	-64
Taxation under central legislation	103	30	-71	71	41	-30	4.9	1.0	-80
Agricultural tax and supplement	63	19	-70	61	63	2			
Township and village levies	32	5	-85	31	16	-15			
Compulsory labor	8	6	-25	8	21	13			
Taxation beyond central legislation	42	42	0	29	59	30	2.0	1.5	-25
Various fundraising	15	16	4	36	38	2			
Administrative fees	27	26	-3	64	62	-2			

**Source:** Center for Chinese Agricultural Policy 2005 survey.

**Note:** Tax rates are calculated by dividing farmers’ tax burdens per capita by farmers’ incomes per capita.

by 85 percent and agriculture tax and supplements also dropped by 70 percent. For taxation beyond central legislation, the 3 percent decrease in administrative fees was offset by a 4 percent increase in local fundraising.

Table 1 also shows that the rural tax reform has significantly changed the structure of tax burdens between taxation under central legislation and taxation beyond central legislation. Before the tax reform, taxation under central legislation comprised approximately 71 percent of total tax burden, but by 2004 the figure was only 41 percent. Farmers' overall tax burden as a share of their net incomes dropped from 6.9 to 2.5 percent from 2000 to 2004. Generally speaking, the rural tax reform has led to a significant reduction in overall rural tax burden. Thanks partly to tax reform and to other agriculture-support policies, farmers' annual incomes have grown rapidly by at least 4–6 percent in the past three or four years. Complaints about excessive informal fees have gradually declined in rural China from 2002 on.

Table 2 presents farmers' tax burden per capita by province for the 2 years of 2000 and 2004. As shown in the table, there is huge regional heterogeneity both before and after the rural tax reform. In 2000, Jilin province had a per capita tax burden of RMB214, whereas in

**Table 2. Rural Tax Burden by Province 2000 and 2004**

Province	Tax per capita					
	Total tax burden		Taxation under central legislation		Taxation beyond central legislation	
	Level	Share of income	Level	Share of income	Level	Share of income
	RMB	%	RMB	%	RMB	%
Province	2000					
Jiangsu	191	6.4	147	4.9	44	1.5
Sichuan	138	7.3	96	5.1	42	2.2
Shaanxi	74	8.7	56	6.5	18	2.1
Jilin	214	12.1	157	8.8	57	3.2
Hebei	161	9.8	121	7.4	40	2.5
Fujian	78	2.4	32	1.0	45	1.4
Province	2004					
Jiangsu	147	3.3	88	2.0	59	1.3
Sichuan	64	2.7	31	1.3	33	1.4
Shaanxi	24	2.3	9	0.9	15	1.4
Jilin	47	1.7	1	0.1	46	1.6
Hebei	94	4.1	46	2.0	48	2.1
Fujian	49	1.5	1	0.0	48	1.5

**Source:** Center for Chinese Agricultural Policy 2005 survey.

both Fujian and Shaanxi the burden was less than RMB80. By 2004, Jiangsu had the highest per capita tax burden of RMB147, whereas Shaanxi had the lowest burden of RMB24. Although all provinces witnessed a reduction in rural taxation, the changes were spatially very uneven. There was a drop of approximately 80 percent in per capita total tax burden for Jilin, but only a 20 percent drop for Jiangsu.

There was also significant regional heterogeneity in the reduction of taxation under central legislation. This is more or less consistent with the specific provincial policy in rural tax reform. In 2000, per capita taxation under central legislation was approximately RMB 150 in both Jiangsu and Jilin, whereas Fujian had the lowest such taxation under central legislation (RMB32) among all provinces. In 2004, this figure dropped to less than RMB10 for Fujian, Jilin and Shaanxi, whereas in Jiangsu it remained at a relatively high level of RMB88. The fast drop in taxation under central legislation in Jilin was a result of its specific reform policy that fully exempted farmers from agricultural tax as early as 2004, whereas the relatively developed province of Fujian had a low tax even back in 2000 and in 2004 it took a further step to remove all taxation under central legislation.

Although the regional heterogeneity in the reduction of taxation under central legislation was consistent with specific provincial reform policies, differences in the changes of taxation beyond central legislation among provinces were also very significant and the pattern could not be accounted for by specific provincial rural tax policies. From Table 2, we can see that whereas Sichuan, Jilin and Shaanxi witnessed a drop of 20 percent from 2000 to 2004, the per capita taxation beyond central legislation in Jiangsu and Hebei witnessed a 20 percent growth in the same period. One possibility is that after the rural tax reform, local governments tended to charge farmers less illegal fees if in the past farmers' tax arrears had been very serious because of strong resistance from farmers. On the basis of the Center for Chinese Agriculture survey, we divide our 116 sample villages in 6 provinces into five groups. The villages are ranked by the share of households in a village who did not pay the full amount of taxes and fees in 2000 as shown in Table 3. The average tax arrears share of all villages in a group was compared with the (absolute) changes in taxation both under and beyond central legislation of the same group of villages. As indicated in Table 3, there is a significant negative relationship between the tax arrears share in 2000 and the change in taxation beyond central legislation between 2000 and 2004, whereas no such relationship exists between the tax arrears share and the change in taxation under central legislation between 2000 and 2004. Therefore, the effectiveness of rural tax reform in reducing farmers' tax burdens was not only related to the upper-level tax reform policy, but was also influenced by the strength of farmers' resistance to illegal fee charges imposed by local governments.

**Table 3. Tax Arrears and Farmers' Tax Burdens**

Village group	Number of sample villages	Average share of tax arrears of villages (%)	Changes in taxation beyond central legislation (RMB)	Changes in taxation under central legislation (RMB)
Group 1	24	0.04	0.85	-53.90
Group 2	23	2.31	7.48	-73.36
Group 3	23	6.98	3.70	-71.70
Group 4	23	15.97	-0.20	-108.57
Group 5	20	35.22	-15.37	-65.49

**Source:** Center for Chinese Agricultural Policy 2005 survey

**Note:** The village tax arrears share is defined as the share of households in a village who did not pay full taxes and fees in 2000. Data from three outlier villages are omitted.

### 3. Impacts of Rural Tax Reform on the Tax Incidence

As shown in Tao and Liu (2005), prior to rural tax reform, poorer farmers were paying the lion's share of rural taxes and fees, whereas richer farmers earned most of their income from off-farm sources and, therefore, were less subject to agricultural taxation. Therefore, rural taxation in China before the rural tax reform was highly regressive. A natural question to follow is how the rural tax reform has helped to alleviate the regressive nature of rural taxation. Because we do not have the income data for individual households but only have data for village average incomes, we have to compromise by comparing the tax incidence among provinces and villages with different income levels between 2000 and 2004.

Let us first look at rural tax as a share of rural income by province. As Table 2 shows, except in the relatively developed province of Fujian, which already had a very low tax rate in 2000, the other 5 provinces had a tax rate ranging from 6.4 to 12.1 percent in 2000 and those provinces with lower incomes tended to have higher tax rates. However, by 2004, the tax rates for all 6 provinces declined and the differences in provincial average tax rates became much smaller, indicating a much less regressive tax regime across provinces.

We can further analyze this issue of tax incidence at the more disaggregate village level. Based on the same data collected by the Center for Chinese Agricultural Policy, Table 4 presents the average tax burdens for villages of different (average) income levels. For both years 2000 and 2004, all villages surveyed are divided into four income groups, each of which has approximately the same number of villages. As shown in Table 4, in 2000, villages within the lowest-income group (per capita average net income of RMB764) had an average tax rate of 17.3 percent, whereas those in the three higher-income groups had



**Table 4. Rural Tax Rate by Income Group, 2000 and 2004**

Income group	Per capita average income (RMB)	Tax rate as a share of farmers' income (%)							
		Total	Taxation under central legislation				Taxation beyond central legislation		
			Subtotal	Agricultural tax	Township and village deduction	Compulsory labor	Subtotal	Local Fundraising	Administrative fees
2000									
I	764	17.3	13.5	7.6	4.8	1.1	3.9	1.1	2.8
II	1583	10.6	7.8	4.5	2.5	0.7	2.7	1.4	1.3
III	2343	6.0	4.3	2.9	1.1	0.4	1.6	0.6	1.0
IV	3808	3.7	2.0	1.3	0.6	0.1	1.3	0.4	1.1
2004									
I	1228	3.5	1.5	0.9	0.2	0.4	2.1	0.4	1.7
II	2206	3.2	1.2	0.7	0.2	0.4	1.9	1.1	0.8
III	3334	2.5	1.1	0.7	0.2	0.2	1.3	0.5	0.9
IV	5369	1.9	0.6	0.4	0.1	0.1	1.0	0.4	0.8

Source: Center for Chinese Agricultural Policy 2005 survey.

average rates of 10.6, 6.0 and 3.7 percent, respectively. The corresponding numbers for 2004 are 3.5, 3.2, 2.5 and 1.9 percent, respectively. Apparently, the tax also became less regressive across villages with the introduction of rural tax reform.

#### IV. Impacts of Rural tax Reform on Local Governance

In light of some of the serious problems that have prevailed in rural taxation and the social tension that has thus ensued as a result of farmers' resistance, one can easily understand why the center has chosen to implement rural tax reform. Nevertheless, rural tax reform has significantly reshaped the environment under which local governments in China operate. Serious challenges have emerged with regard to China's local governance as a result of rural tax reform.

##### 1. Difficulties in Local Government Downsizing

The first challenge is to downsize local governments after rural tax reform to cut government expenditure. Although many townships in rural China have been merged both before and after the rural tax reform, downsizing local bureaucracy has so far been unsuccessful. On the basis of a survey in 10 provinces across China, a recent study by Zhao (2005) finds that out of the 20 townships surveyed, 12 townships were newly merged townships either before or after the rural tax reform. However, township government downsizing has been extremely difficult because it involves breaking numerous "iron rice bowls". Apparently, township heads have an interest in maintaining a system that allows them to offer

employment and associated benefits to those who are well-connected and politically supportive. On account of this, even once townships have merged, most of the cadres from the previous townships have kept their posts.

Government downsizing has been more difficult in less-developed regions where there are fewer job opportunities outside of the government sector. In our fieldwork in Gansu, a poor northwestern province where the private sector is weak and the best paid jobs are found in the government sector, we found that it is extremely difficult to institute any genuine staff layoffs from any government department. In fact, after the upper-level authorities mandated that teachers' and officials' salaries be paid in full and on time, there has been significant growth in both teaching and administrative staff in local public schools. In contrast, in examining Jiangsu, a province where the private sector is booming, one of the authors discovered that local cadres had actually chosen to leave their government jobs for the private sector after the rural tax reform. Local governments in Jiangsu have also taken measures to encourage the laid-off cadres to seek jobs elsewhere. For instance, they sent some cadres to colleges for further training, and at the same time provided them with salaries for 3 years. Severance money was also paid for some cadres in exchange for voluntary early retirement from their work units.

The difficulties in downsizing local governments are also related to the large number of local government personnel and the general lack of a social security system at the county and township level. In 1994, the number of fiscal dependents at the township and county level in China was 22.5 million, but by 2000 it grew to 29.6 million, with a salary expenditure rise of at least RMB100bn. At present, the township and county level account for approximately 70 percent of all fiscal dependents nationwide. There are 12.85 million fiscal dependents at the township level alone (Zhao, 2005), but they only control 40 percent of the fiscal revenue of the nation. This implies that most of the county and township expenditure must be allocated for paying salaries (World Bank, 2002). However, China's social security system has so far barely touched the rural townships, particularly not in the less-developed regions where employment opportunities outside the public sector are limited. Even with the huge revenue shortfall as a result of rural tax reform, local governments in these regions are still very cautious in terms of personnel downsizing because downsizing might result in social instability. In many cases, local governments have opted to keep all employees but cut their salaries.

No matter how difficult it is to downsize government, continuing to keep the existing large number of cadres on the payroll is just financially infeasible. Ongoing rural tax reform means that local governments cannot levy fees on farmers and at the same time they can only receive very limited funds from the upper level. Therefore, a full restructuring of local government at the township and even the county level has to be carried out and laying off

millions of existing fiscal dependents will be inevitable. Although some of the younger and more educated staff might find jobs outside the public sector, a significant number of these redundant staff will face difficulties in re-employment. Therefore, a better functioning social security system that provides unemployment insurance, medical insurance and pensions is desperately needed.

## **2. Inadequacy and Ineffective Use of Upper-level Transfers**

Serious concerns also exist in policy circles with regard to the adequacy and effective use of the upper-level transfers allocated to compensate local revenue shortfalls as a result of rural tax reform. Rural tax reform has largely eliminated the ability of township governments to generate self-raised funds from agriculture. However, upper-level transfers have been insufficient. According to Zhang (2005), rural tax reform has led to a reduction of approximately RMB150–160bn in agricultural taxes and fees in 2005 alone. However, the central transfer was only RMB66.4bn in this year. Local budgetary situations in many regions have deteriorated significantly. For example, based on the Center for Chinese Agricultural Policy dataset, we found that Jilin province had an average township surplus of RMB67 000 in 2000, but this turned to be a deficit of RMB81 000 by 2004. In Hebei province, the average township deficit grew from RMB1.13m in 2000 to RMB1.52m in 2004. As far as the township debt is concerned, the net township debt rose in all the surveyed provinces except in Sichuan. In Jiangsu province, the average township net debt grew from RMB4.56m in 2000 to RMB14.36m in 2004. Under some extreme circumstances, insufficient transfers and huge local deficits and debt have pushed townships to collapse into county administrative shells. With inadequate locally generated revenue and transfers, many townships have become much less effective in providing basic services to local populations.

Even if local bureaucracy downsizing succeeds and higher transfers from above are realized, there is still an issue of effective use of the upper-level transfers. Although higher transfers might help to alleviate the serious financial shortfall in China's countryside, they have not helped to raise local government incentives to provide public goods and services that cater to real local needs. Put it in another way, even if central transfers can be in place, under a centralized political system with little local government accountability, there still exists no institutional mechanism to ensure that these transfers are used effectively to provide for real local needs. The upper-level government would have difficulty adequately tracking where, how, or by how much public money is spent, what services the public sector delivers, or how many people the local governments employ. Under circumstances in which government downsizing is very difficult to implement, enhancing transfers might only result in more political competition for the transfers that are used to fill the shortfall in personnel expenditure.

To address the issue of local government incentives to use money more effectively, local financial and fiscal authority needs to be linked more closely to local service provision responsibilities and functions so that local officials have higher incentives to effectively provide the locally needed public goods and services. This would mean that the center, depriving local government of powers in arbitrarily collecting informal fees, need to grant local governments some formal tax autonomy. This could be done, for example, by introducing property tax as a purely local tax.

### **3. Lack of Local Government Accountability**

A more fundamental challenge is how to reconstruct the accountability of local governments in the post-tax reform period. Unfortunately, the rural tax reform and other local governance reforms, by further centralizing political, administrative and fiscal powers to the county level, run the danger of additionally lowering township governments' accountability to their constituencies and, therefore, weakening their incentives to serve local needs. This is evident from China's local governance reform experiments since the early 2000s. One approach that has gained currency in the past two or three years is to abolish the township as a level of local government altogether and to set up county-designated administrative branches at the township level so as to provide essential public services. In the inland province of Hubei, pilot reform along this line has been implemented in quite a few prefectures with strong support from the provincial government. However, given that many townships have a constituency of over 100 000 people after recent township restructuring, it is difficult to imagine how such a large population can be effectively served through the limited number of county administrative branches and how policy coordination among different county level agencies can be achieved at the township level. Since the officials in these branches are appointed by the county line bureaus and their salaries are dispatched from above, they might have even lower incentives to serve the local populations than before.

An alternative, perhaps more effective approach for promoting local government accountability is to expand local democracy to the township level. In another inland province of Sichuan, this approach was adopted largely as a result of local leaders endeavoring to promote their careers by taking the lead in initiating electoral reforms. Rather than abolishing township governments, this approach aims to empower township governments by expanding grass-roots democracy from the village level further to the township level.

## **V. Conclusion**

Given the social tension and political conflicts arising from the excessive informal taxation

in the 1990s in rural China, the rural tax reform initiated by the Chinese Central Government has certainly been necessary and timely. As shown in the present paper, rural tax reform has effectively reduced farmers' tax burdens, although there is still significant regional heterogeneity in policy implementation. While in some provinces taxation both under and beyond central legislation has largely disappeared, in other provinces local governments still charge farmers various fees that are prohibited according to the central regulations.

Rural tax reform has also alleviated the degree of rural tax repressiveness. By significantly reducing taxes and fees, farmers in poorer villages and provinces are now paying much lower shares of their incomes as taxes and fees. The more-even tax incidences between poor and rich farmers in China's countryside will help to alleviate the enlarging intra-rural income disparity we have witnessed.

However, as discussed in the present paper, the center's attempt to improve rural livelihood by exempting farmers from state agricultural taxes and various local informal fees might prove unsuccessful if coordinated reforms in local governance are not in place. After rural tax reform, local governments in many localities need to be significantly downsized. Even though the Central Government fully understands this need and requires that local governments take effective action in this respect, effective downsizing can only be achieved when there is a well-functioning social security system at the local level to provide incomes for the laid-off cadres from local government restructuring.

More importantly, higher transfers from the center in the post-rural-tax-reform period might fail to reach the farmers in need if there is still a lack of local government accountability. Under the current local governance regime, it is still very difficult for upper-level governments to adequately track how public money is spent and what the real local needs are. Under such circumstances, enhancing transfers might well result in more political competition for transfers and local bureaucracy expansion that might not help farmers. Therefore, better local governance outcomes in China warrant more fundamental reforms in the country's political system that induces wider local participation.

The success of China's transition in the past two and a half decades has been praised because an experimental approach of "Crossing the River by Groping for Stones" has been adopted. The Chinese Government also experimented with tax reform policy first in some localities before the reform was extended nationwide. However, mere tax exemption can not fully address the issue of providing local cadres with incentives to really serve local people. Some fundamental institutional changes, such as expanding local democracy and granting higher local formal tax autonomy, are necessary. This is because China has reached a stage in its transition where the traditional experimental approach in reform, although still necessary, is sufficient. Further institutional changes to achieve better governance outcomes in China need to be carried out in a holistic rather than a piecemeal manner (Tao and Xu, 2006). To

address the challenges ahead, the Chinese leadership needs stronger political will and wiser economic reasoning to push forward more fundamental and better coordinated reforms.

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