China Economic Review 23 (2012) 190–203

Contents lists available at SciVerse ScienceDirect

China Economic Review

Rural tax reform and the extractive capacity of local state in China[☆]

Mingxing LIU [a], Zhigang XU [b], Fubing SU [c], Ran TAO [d,*]

[a] China Institute for Educational Finance Research, Peking University, China
[b] Center for Chinese Agricultural Policy, Chinese Academy of Sciences, China
[c] School of Economics Renmin University of China, China
[d] Department of Political Science, Vassar College USA

ARTICLE INFO

Article history:
Received 16 January 2011
Received in revised form 10 October 2011
Accepted 17 October 2011
Available online 25 October 2011

JEL classification:
H22
H71
P52

Keywords:
Central–local relations
Local public finance
Farmers' burdens
Rural Tax reform
China

ABSTRACT

China's fiscal arrangement in the 1980s has preserved local governments' incentive but the 1994 fiscal reform recentralized revenues. Since then, farmers' tax burdens have risen steeply and become a major challenge to the state legitimacy. How to account for the huge regional variation? Why were some localities able to tax more heavily than others? Based on a national survey of village governance in China, we examine farmers' burdens empirically and identify political and social factors that explain the local governments' ability to tax farmers. This paper suggests that developments since the 1990s have shown that it overstates local discretionary power and does not pay enough attention to societal forces in understanding local public finance.

1. Introduction

Tax is the lifeblood of a modern state. Without sufficient revenues, the state cannot finance its basic functions and win popular support. Excessive taxation, however, dissipates regime legitimacy quickly and results in state failure (Cheibub, 1998; Levi, 1988). Oppressive taxation and peasants' uprisings have been common under the Chinese dynastic rule and many empires crumbled as a result of popular rebellions (Bernhardt, 1997). In the 1990s, excessive taxation reemerged in China's countryside. In addition to formal taxes, local governments charged exorbitant levies and fees on rural households. In some cases, farmers' financial burdens reached as high as 20–30% of their already low incomes (Chen, 2003). Many agricultural regions have developed a vicious cycle: to secure tax collection, local governments recruited more staff members; an enlarged local bureaucracy in turn required more revenues and collections (Chen, 2003; Yep, 2004). Excessive taxation and farmers' burdens have become a major source of grievance in China's vast rural areas. Farmers brought their complaints against their local governments to higher levels of the administration, including the central government, the court, and also the pubic media. In many incidences, frustration with these formal and bureaucratic channels pushed desperate farmers into direct confrontation with local authorities (Bernstein & Lu, 2000; O'Brien & Li, 2005). The central government, fearful of the damage to its legitimacy, responded with a series of tax reform policies starting in 2000. The first step, known

☆ The authors would like also to recognize the China National Science Foundation (project 70633002 and project 70703032), The Ford Foundation, the Fundamental Research Funds for the Central Universities and the Research Funds of Renmin University of China and the Vassar College for support of related fieldwork.
* Corresponding author at: China Center for Public Economics and Governance (CCPEG), School of Economics Renmin University of China, Room 1038 Minde Zhulou No 59, ZhongguanCun Street, Haidian District Beijing 100872, China. Tel.: +86 10 82500195; fax: +86 10 62511091.
E-mail address: rantao1972@ruc.edu.cn (R. TAO).

1043-951X/$ – see front matter © 2011 Published by Elsevier Inc.
doi:10.1016/j.chieco.2011.10.002

as the "tax-for-fee" reform, converted some legitimate local fees into one unified agricultural tax. The new tax rate was raised but local governments were prohibited from levying new fees. In 2004, the central government took a bolder move and started to phase out the century-old agricultural tax on farmers. In the long sweep of Chinese history, this was a rare, if not unprecedented, instance of rescinding any obligation of the farmers to the state. Ultimately, the central leadership aimed to restore its political legitimacy and to reign in local state's excessive extraction of farmers.

Like many policy changes in China, implementation can be a major challenge. Have farmers' burdens fallen as a result? Did tax reforms achieve their intended targets? To answer these questions, we examine local state's extractive capacity. Why is there a regional variation in extraction rate and how can some local governments extract more resources than others? In 2005, we conducted a national survey of rural governance with particular attention to the financial aspect of it. As a result, we have collected systemic data about farmers' monetary burdens. The empirical test confirms some key hypotheses we have developed. Rural tax reforms initiated by the central government have indeed alleviated farmers' overall financial burdens — on average, the burdens were cut by more than half — but the pattern becomes more complicated and also more fascinating when we break them down into two components. In accordance with the central directives, local state did scale down agricultural taxes (i.e. the first component) very significantly. The other component includes various informal extractions, such as irregular fundraisings and fines, which local governments were able to maintain as a source of revenue, despite efforts made by the central government to minimize them. Local governments' extractive capacity in this area, however, was checked by two factors: the ability of farmers to resist and the development of informal organizations in villages.

This paper contributes to the literature on fiscal federalism. Some political economists argue that China's rapid economic development can be explained by local governments' pro-growth policies. China is a unitary state but it adopted a quite unique fiscal system in the 1980s. The central government signed contracts with local governments and specified a fixed amount or a fixed ratio of revenue submissions. Beyond that, local governments could keep the surplus and had full discretion in spending. This financial incentive encouraged local officials to promote economic growth in their jurisdictions and maximize their budgetary incomes. These scholars believe that China has become a de facto fiscal federalism (Blanchard & Shleifer, 2000; Oi, 1992; Montinola, Qian, & Weingast, 1995; Jin, Qian, & Weingast, 2005). Instead of sorting and matching emphasized in the traditional fiscal federalism theory, this new analysis brings economic growth to the front and expands the scope of the theory.

Our discussion of farmers' burdens shows that local governments have acquired some autonomy and a delicate bargaining characterizes the central–local relations. But the fiscal federalism argument may have overstated local discretion in China. In the 1980s, the central government respected local discretion most of the time but things started to change in the 1990s. As a result of fiscal contracting, the central share in government revenues dropped. This resulted in the fiscal recentralization in 1994 which gave the central government a larger share in total revenues, including 75% of VAT. Enterprise income tax and personal income tax were initially assigned to local governments. When they grew unexpectedly fast in the following years, the central government forced local governments to give up half of them in 2002. In the meantime, the central government unloaded a lot of spending responsibilities onto local governments. To finance these unfunded mandates, local governments had to exact levies from farmers in the countryside. The rise of farmers' burdens demonstrates the lack of discretionary power (both revenues and expenditures) on the part of local governments. As will be elaborated toward the end of the paper, our research does not support the other extreme of an omnipotent center either. To ensure efficient provision of local public goods, the central government has left certain bargaining room in a highly centralized state.

The fiscal federalism argument has also understudied a major source of constraint local governments must face in revenue collections. Rules regulating central–local fiscal relations undoubtedly affect local governments' ability of revenue maximization. After the reform, the Chinese society has regained some vitality and started to constrain the hands of the state. In studying rural taxation, we found that local governments' extractive capacity depended on the extent to which local society collaborated with local authorities. In localities where the mass and cadres have developed high tensions, local officials had trouble mobilizing revenues. On the other hand, in places where self-governing organizations have developed a capacity for public service provision, local governments were relieved of certain financial burdens. These findings provide a more nuanced picture of state–society relationship in China and enrich the single-dimensioned (i.e. intergovernmental) focus in fiscal federalism (Hansen, 2008; Tsai, 2007).

The rest of the paper proceeds as follows. The next section analyzes the governance structure in rural taxation and explains the rise of farmers' burdens, especially after the fiscal recentralization in 1994. Section 3 develops three institutional hypotheses to explain local governments' extractive capacity. The data from our national survey and empirically tests are discussed next. The conclusion addresses some implications of this study for rural financial challenges and the overall rural governance.

2. Fiscal recentralization and the rise of farmers' burdens

Rural taxation has played a crucial role in the construction of the new China (Lin, 1992). The state relied on three taxation tools to extract resources from farmers. The agricultural tax was a tax in kind and the rate was about 10% of grain output in China's first five-year-plan period (1953–1957) but dropped to 5% in the 1960s and 1970s (Yan et al., 1988). The second taxation tool of "price scissors" was implicit but quite powerful. Farmers were mandated to sell their grain products to the state at below-the-market prices. According to one estimate, this implicit taxation amounted to as high as 280 billion Yuan between 1953 and 1978, i.e. about 17% of the total agricultural outputs. This figure was in fact much higher than the extraction from formal agricultural tax (89.8 billion Yuan) (Cui, 2002). These two sources of taxation were mostly controlled by the central state. Communes and production brigades relied largely on the final tool and levied a collective accumulation fund, a welfare fund, and a cadres' compensation fund. Heavy taxation in the rural areas was made feasible through the coercive grain procurement system. All rural collectives must sell their grains to the state at low prices. As a tax in kind, the agricultural tax was automatically deducted before the collectives could receive their payments, and