

CSF Notebook

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NEWS FROM THE CENTER FOR THE STUDY OF FEDERALISM

ACIR RELEASES CASEBOOK ON STATE CONSTITUTIONAL LAW

The U.S. Advisory Commission on Intergovernmental Relations has recently published State Constitutional Law: Cases and Materials, compiled by Robert F. Williams of the Rutgers University School of Law, Camden, New Jersey. This is the first major collection of court cases, law review articles, and other materials ever to be made available on a broad range of state constitutional law affecting the 50 states. State constitutional law is being "rediscovered" by a growing number of scholars and practitioners in the legal and political communities. This work fills a gap in the literature and highlights a new development in American federalism. Justice William J. Brennan, Jr. commented: "I'd been hoping for some time that a casebook would be published. With the growing interest in reliance by state courts on their own constitutions, it's been very badly needed."



MORE NEWS FROM THE CENTER FOR THE STUDY OF FEDERALISM

SELECTION PROCESS FOR 1989-90 EARTHART FELLOWSHIP

Thanks to the generous support of the Earhart Foundation, the Center for the Study of Federalism maintains a fellowship for an outstanding graduate student in political science at Temple University. The 1988-89 recipient, Joseph Marbach, will graduate this spring. Nominations and applications are now being accepted from candidates for the 1989-90 year. Interested individuals should contact Ellis Katz at the Center for the Study of Federalism.

ASPA PLANS FEDERALISM PANELS AT ANNUAL MEETING

More than a dozen panels on federalism-related issues are planned for the national conference of the American Society for Public Administration, to be held in Miami, April 8-12, 1989. Among the problems to be addressed are the intergovernmental aspects of infrastructure finance, resource management, international competitiveness, mandating, tax reform, and rural economic development. In addition, Terry Busson of Eastern Kentucky University will assume the position of chairman of the ASPA Section on Intergovernmental Administration, taking over from outgoing chairman David R. Beam of Illinois Institute of Technology.

APSA AND SPOOR DIALOGUES PRESENT SUMMER SEMINAR AT DARTMOUTH

The William H. Spoor Dialogues on Leadership Program at Dartmouth College and the APSA announce a summer teaching-research seminar on "leadership in the American federal system and in American state politics" to be held June 25-29, 1989. Sessions will be devoted to different research perspectives on leadership in American state and national politics and government, as well as on the interactions among these leaders and how these research developments can best be presented to students. The Spoors Dialogues Program will bear the costs of participants' dormitory rooms, board, and seminar materials and supplies. For additional information, contact: Professor Richard F. Winters, Dartmouth College, Nelson A. Rockefeller Center for the Social Sciences, Hanover, NH 03755

NATIONAL ASSOC. OF ATTORNEYS GENERAL STUDENT ARTICLE COMPETITION

The National Association of Attorneys General State Constitutional Law Clearinghouse invites law and graduate students to submit, by April 28, 1989, an article for consideration for Volume 2 of Emerging Issues in State Constitutional Law. The winner will be awarded a prize of \$1,000. An original and four copies of an article on any issue of importance to state constitutional law, in double-spaced typed manuscripts not exceeding 40 pages (with minimum 1" margins) and following a law review and Blue Book citation format, will be considered. Footnotes may be either at the end of the manuscript or at the bottom of the pages. Interested applicants should mail by March 3, 1989 a MORE

MORE NEWS FROM THE CENTER FOR THE STUDY OF FEDERALISM

postcard of intention to submit an article to: SJI Project, Article Competition, National Association of Attorneys General, 444 North Capitol Street, Suite 403, Washington, DC 20001.

FEDERALISM AND INTERGOVERNMENTAL RELATIONS SYLLABI COLLECTED

The request for syllabi for courses in federalism or intergovernmental relations contained in the last issue of the CSF Notebook resulted in the collection of a number of syllabi from a variety of courses. Ellis Katz has accumulated these syllabi and will maintain them as a resource for future reference. If you are interested in receiving a copy of a syllabus for a particular course, contact the Center for the Study of Federalism. Also, if you have not yet sent a copy of your syllabus, it is not too late to do so.

LIBERTY FUND CONFERENCE PAPERS AVAILABLE

In November, 1988, the Center for the Study of Federalism, with the support of the Liberty Fund, conducted a colloquium on the contemporary relevance of the debates between the Federalists and the Anti-Federalists. Copies of the papers presented at the conference are now available from the Center for the Study of Federalism. Daniel J. Elazar, "Contrasting Conceptions of Freedom and Responsibility in the Federalist and Anti-Federalist Writings"; Donald S. Lutz, "The Federalists in Intellectual History"; Vincent Ostrom, "Hamilton's Theorem, Coexisting Governments, and Jurisprudential Puzzles"; Stephen L. Schechter, "Antifederalism and the Idea of Liberty in Clintonian New York"; and Michael Zuckert, "Liberty and Responsibility in The Federalist". Contact Mark Schneider.

NEWS FROM THE INTERNATIONAL ASSOCIATION OF
CENTERS FOR FEDERAL STUDIES

CONFERENCE ON "AUTONOMISM AND FEDERALISM" SET FOR SPAIN

The Research Group on Pluralism, Federalism and Democracy of the Centro de Investigacion y Formacion Europea/Universidad Complutense, Madrid and the Center for the Study of Federalism, in cooperation with the Institut d'Estudis Autonòmics, Barcelona, have scheduled a conference in Madrid and Barcelona. The tentative dates for the conference are May 24-26, 1989. The conference will bring together scholars from North America and Europe to discuss emerging issues of federalism as applied to developments in Spain and the European Community. For additional information, contact Ellis Katz (Philadelphia) or Cesar Diaz-Carrera (Madrid).

NEW ACTING DIRECTOR AT QUEEN'S UNIVERSITY

Ronald L. Watts has been named acting director of the Institute of Intergovernmental Relations at Queen's University, Kingston, Alberta, Canada. Watts replaces Peter Leslie who accepted a position at the Federal Provincial Relations Office.

MAILING ADDRESSES FOR IACFS MEMBERS

As reported in the last issue of the CSF Notebook, the IACFS recently added four new members. Listed below are the mailing addresses and contact persons for each member organization.

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NEW BOOKS AND PUBLICATIONS

American Federalism and Public Policy: How the System Works, by Thomas Anton, Philadelphia, Temple University Press, 1989.

This is a study of the ways in which the federal, state, and local governments share responsibility for policies, producing a system that combines uniformity and diversity. While numerous empirical studies in recent years have detailed particular examples of reforms in federalism, there has been no widely accepted theory by which to evaluate the significance of those details. The author synthesizes the particulars to discover what is true in general about the state of American federalism, using a "benefits coalition" conceptual framework on which to organize the discussion.

Australian Federalism, edited by Brian Galligan, Longman Cheshire, Melbourne, 1988.

This book provides an overview of the federal system in Australia in the post-war years and includes sections on federal theory and institutions, the states and international affairs, and the states and economic policy. Its approach is interdisciplinary and it reviews scholarly commentaries on the system and explores alternative theories and perspectives.

Comparative State Policies, edited by Brian Galligan, Longman Cheshire, Melbourne, 1988.

This book emphasizes the considerable policy-making role of the Australian states and their substantial influence on national policy. It outlines similarities and differences between the states focussing on state policy structures, processes, and outcomes. It includes chapters on education policy, human services, the promotion of industry, minerals, and energy, and housing policy.

MORE NEW BOOKS AND PUBLICATIONS

Democracy in Latin America: Colombia and Venezuela, by Donald L. Herman, Westport, Conn.: London, Baker, 1988.

Although Venezuela is formally a federal system and Colombia has a long tradition of decentralization, there is no reference in this collection of articles to either federalism or decentralization. There are short paragraphs dealing with the question of regionalism but that is all. Granted, federalism in both Venezuela and Colombia has had to confront problems of regime instability but even so these omissions tell us about the character of the book. Although the authors avoid the issues of federalism and decentralization, some information and both subjects can be gleaned from the book by close reading.

Promoting Democracy: Opportunities and Issues, edited by F.M. Goldman and William A. Douglas, London, Baker, Democracy for the World, a project for the Robert Maynard Hutchins Center for the Study of Democratic Institutions, 1988.

This book is addressed to a very serious question, namely, the role of the United States in promoting democratic governments around the world. Its authors are serious students of the subject and the sponsoring center is well known for its efforts. This book covers the role of political parties, labor, business, cooperatives, diplomats, and philanthropies. It examines a long list of NEW democratic issues. Nowhere does it consider the possibility of utilizing the great American principle of federal democracy or federalism as part of the promotion of democracy. Nor does it show any awareness of the character of federal democracy, the fundamental American theory of democratic government as distinct from any other kind. This would be surprising if it were not typical. With a few exceptions, in Americans' efforts to promote democracy around the world since World War II, they have totally neglected federal democracy or federalism. This work is a case study of how this is so.

Campaigns, Congress and Courts: The Making of Federal Campaign Finance Law, by Robert E. Mutch, Praeger, 1988.

This is a case study devoted to a federal activity in the course of which it perforce deals with contributions to state and local campaigns. As such, it has a partial, one might say peripheral, interest to students of federalism.

Recent Publications from the U.S.

Advisory Commission on Intergovernmental Relations

The following publications have recently been released by the U.S. Advisory Commission on Intergovernmental Relations (ACIR). They are available from the ACIR office, 1111 20th Street, NW, Washington, DC 20575.

A Catalog of Federal Grant-in-Aid Programs to State and Local Governments: Grants in FY 1987, 1987 (M-153) \$10.

Assisting the Homeless: State and Local Responses in an Era of Limited Resources. Papers from a Policy Conference, 1988 (M-161) \$10.

MORE PUBLICATIONS FROM ACIR

Changing Public Attitudes on Governments and Taxes, 1988 (S-17) \$10.

Constitutional Reform of Federalism: Statements by State and Local Government Association Representatives, 1988 (M-164) \$5.

Devolution of Federal Aid Highway Programs: Cases in State-Local Relations and Issues in State Law, 1988 (M-160) \$5.

Federalism and the Constitution: A Symposium on Garcia, 1987 (M-152) \$10.

Federal Preemption of State Banking Authority: Good or Bad for the Nation's Dual Banking System? A Roundtable Discussion, 1988 (M-162) \$5.

Fiscal Capacity of the States, 1989 \$5.

Interjurisdictional Competition in the Federal System: A Roundtable Discussion, 1988 (M-157) \$5.

RECENT PUBLICATIONS FROM ACIR (cont.)

Is Constitutional Reform Necessary to Reinvigorate Federalism? A Roundtable Discussion, 1987 (M-154) \$5.

Local Revenue Diversification: Local Income Taxes, 1988 (SR-10) \$5.

Metropolitan Organization: The St. Louis Case, 1988 (M-158) \$10.

Perspectives on Federalism, 1976-1988, 1989, \$10.

Significant Features of Fiscal Federalism, 1989 Edition, Vol. I, 1989 (M-163) \$15.

State Constitutional Law: Cases and Materials, 1988 (M-159) \$25.

State-Local Highway Consultation and Cooperation: The Perspective of State Legislators, 1988 (SR-9) \$5.

State Regulation of Banks in an Era of Deregulation, 1988 (A-110) 10.

The Organization of Local Public Economies, 1987 (A-109) \$5.

ARKANA FOR THE POLITICS ADDICT

Arkansas Politics & Government: Do the People Rule? by Diane D. Blair. University of Nebraska Press. 362 pages. \$25.95 hardbound, \$15.95 paperback.

By Alan Ehrenhalt

State politics is an addiction. It is not one, admittedly, that strikes many people in this country, not even most of those who profess an interest in political affairs. Millions of people who followed every twist and turn of this year's presidential campaign could not care less what is going on in Sacramento or Albany, let alone Bismarck or Carson City.

State politics addicts are people with an intense curiosity about differences. They learned a long time ago that the Deep South is different from the Rockies. What they want to know is what makes Alabama different from Mississippi, or Wyoming from Montana. They are waiting for someone to tell them, as Diane D. Blair tries to in her new book on Arkansas, why that state produces politicians so different from the ones elected elsewhere in the Deep South.

Maybe, by the standards of most of us, state politics addicts are a little strange. But if that is the case, they have also been lucky. People who ask themselves endless questions about state politics have been able to feast on some of the most impressive works written

about this country in the past 50 years.

In the closing days of World War II, John Gunther traveled the nation for six months running and then returned home to write *Inside U.S.A.*, a thousand pages of riveting prose that still belongs on anyone's list of the most perceptive books about America in the 20th century. A few years later, V.O. Key Jr. published *Southern Politics*, a massive achievement in state-by-state analysis that may be the most admired book in modern political science. In the 1970s, Neal Peirce retraced Gunther's steps and issued nine large volumes, none as graceful as Gunther's but each comprehensive and scrupulously fair.

The first three decades of the post-World War II era marked what may be the modern low point in the reputation of states as political entities; a whole succession of writers portrayed state legislatures and politicians as ignorant, corrupt and trivial. Frank Trippett, writing in 1967, launched his book, *The States: United They Fell*, by proclaiming that "in almost every important way, the American states are in some dubious

Diane D. Blair

condition."

Gunther, Key and Peirce were driven to a large extent by intellectual curiosity; Trippett, a veteran state-house news reporter, was writing out of exasperation. What matters to the state politics addict is that all of them are interesting. States, like people, can be at least as much fun when they misbehave.

Today, states and their legislatures do not often misbehave the way they did during Trippett's time in the press galleries. But they are no less interesting for that. Somehow, in the 1980s, state politics and government have managed to acquire a respectable degree of competence and professionalism without entirely discarding the diverse collection of quirks and individual differences

that make the subject fascinating in the first place. Mississippi and Alabama are still different, even if they are no longer different in their old-fashioned in-

famous way. It would be nice to have John Gunther around to trace the changes and do for state politics in the 1980s what he did in the 1940s.

We don't have John Gunther. But it is good to be able to say, in his absence that Professor Daniel J. Elazar and the Center for the Study of Federalism at Temple University have undertaken a massive and valuable project: a series of individual books tracing the political history and culture of each one of the 50 states. And it is equally good to be able to say that Diane Blair, associate professor of political science at the University of Arkansas, has set a splendid example with a book on her home state that manages to be both scrupulous in documenting its eccentricities and provocative in its search for explanations.

We learn from Blair that, in 1837, in the very first legislative session, the speaker of the House made a name for himself by murdering one of the members on the House floor after they had disagreed over the use of wolf scalps as a form of taxation. We also learn that the state highway commission is still required by law to have five members, each from a different congressional district — a mathematical impossibility since there are now only four districts in the state. Arkansas solves this problem the way most states would: by ignoring the law.

Blair's book is full of larger questions as well, and she does her best to answer them. Why has Ar-

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PUBLIUS FORTHCOMING ISSUE

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The Declaration of Independence as Part of an American National Compact
by Donald S. Lutz

Federalism and the Strong-State/Weak-State Conundrum: Canadian Economic Policymaking in Comparative Perspective
by William M. Chandler and Herman Bakvis

The Role of Semi-Direct Democracy in Shaping Swiss Federalism: The Behavior of Cantons Regarding Revision of the Constitution, 1866-1981
by Andre Eschtet-Schwarz

Heavy Traffic: Trucking Deregulation, Federalism, and Canadian-U.S. Trade
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The Size Efficiency of Rural Governments: The Case of Low-Volume Rural Roads
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Transborder Cooperation, Regional Initiatives, and Sovereignty Conflicts in Western Europe: The Case of the Upper Rhine Valley
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kansas been so slow to do something about its inadequate educational system? Because the two dominant political blocs in the state were wealthy planters, who did not use the public schools, and hillbillies, in whose set of values schools played little role. Why has Arkansas, in the past 25 years, produced such a large supply of raw political talent? Because, according to Blair, politics was the best route to prominence for bright young people in an underdeveloped society.

Blair tries valiantly to answer what may be the

state's most intriguing electoral riddle: why moderate-to-liberal Democrats have won so many recent statewide elections. During the 1970s and 1980s, while Democratic candidates in neighboring states have carefully kept their distance from the leaders and policies of the national party, Dale Bumpers, David Pryor and Bill Clinton have won a string of elections for governor and U.S. senator in Arkansas without avoiding or apologizing for the national party.

The book offers a variety of novel theories to explain this. One is that Arkansas

is so backward that it has been slower than neighboring states to embrace Republicanism. Another is that the state is small enough for skillful and personable politicians to win on the basis of sheer friendliness. A third stresses the influence of the *Arkansas Gazette*, the influential liberal newspaper that is read statewide. All those ideas are provocative; none is quite satisfying.

This book will never be a big seller. Neither, it is safe to say, will any of the other 49 volumes that will comprise this series when it is completed (Alabama and

Nebraska have already appeared) sometime early in the 21st century. James Michener notwithstanding, it is unreasonable to expect large numbers of people to read a book full of details about a state they do not live in.

But there will be some, enough for all the authors in this series to embark on their work with the knowledge that an audience exists beyond the borders of the place they are writing about. In the case of Diane Blair's book, that audience will find the material not only informative but readable and fun. □

LOCAL GOVERNMENT FINANCE IN CHINA

(The following article, an excerpt from a paper prepared by Professor Roy Bahl, for the World Bank, appeared in REVENUES: Research & Policy Notes Concerning Public Finance in Developing Countries, Vol. 4, No. 1. REVENUES is a publication of the Metropolitan Studies Program of the Maxwell School at Syracuse University. It is reprinted here with permission.)

Local government finance in China is very complex but it also presents an interesting contrast to the approach taken in most market economies. Because China is such a large country, it is perhaps not surprising that the fiscal system is quite decentralized. Central, provincial and local governments share a common set of taxes with policy decisions made by the central government but with tax assessment and collection left to the local governments. The structure of shared taxes gives local governments substantial inducements to adjust their taxing and spending behavior but is also gives them access to Productive tax bases.

Local Government Structure

Even though China's governmental system is unitary rather than federal, there are three distinct levels of government. It is misleading and a mistake to view the provincial government and the local governments (municipalities, counties, public utility companies) as "the local government sector." In fact, the structure and workings of China's fiscal system vary from province to province, at the discretion of the provincial government.

Within the city or municipal area, there is considerable decentralization in the responsibility for delivering government services. One way to think about the division of fiscal responsibility and financing is to picture the municipal government as having three sectors--the general municipal government services sector; the public service companies; and municipally-owned business enterprises.

Municipal expenditures consist of expenditures for general municipal services and various forms of transfers to public utility, public service and business enterprises. Revenues consist of shares of the sales and profits taxes on all municipally-owned enterprises, and on collectives and private businesses; shares of the sales tax on Provincial and Central enterprises; the urban maintenance and construction tax (a sales tax surcharge); and a number of other taxes and fees of lesser revenue importance.

Local Government Finances

Local governments in China have little independence in matters of structuring their tax system and are constrained by higher level mandates in deciding on the level and composition of expenditures. All tax rates and bases are set centrally, hence provincial and local taxes in China are central government taxes whose revenues are allocated wholly or partially to provinces, municipalities and counties. This does not mean that subnational governments have no impact on spending or revenues. In fact, provincial governments have the responsibility to design and implement the system of Provincial-Local sharing, and local governments are responsible for tax administration. Moreover, both levels influence the operations of their enterprises.

LOCAL GOVERNMENT FINANCE IN CHINA (cont.)

Provincial governments can alter the tax sharing arrangement for each municipality within the province, give grants to local governments in any way they choose, and are responsible for approving the budgets and financial plans of municipal and county governments. Moreover, because they set the tax sharing rates, they may indirectly affect municipal tax collections. Municipal governments control tax collection and assessment with what appears to be a minimum of direct central or provincial supervision. This responsibility puts a very powerful policy instrument in the hands of local government, and there is evidence that they use it.

Subnational fiscal autonomy in China includes a direct impact on the growth of the tax base. For example, production quotas of municipally-owned enterprises can be increased and new firms can be formed. Subnational governments can also take fiscal actions to affect the efficiency and/or profitability of operations of their state-owned enterprises (SOEs). They may do this directly with tax rate relief measures or they can institute measures to increase the cost basis of an enterprise's income position, e.g., by allowing full deductibility of loan repayments. The more important recent practice is "contracting" whereby the local government may negotiate an annual tax payment from an enterprise and subject any excess to a lower marginal rate.

This dimension of local fiscal autonomy highlights a fundamental difference between the role of local governments in China and in market economies. In most western countries local governments have substantial control over the tax rate but virtually no control over the growth in the tax base. Local governments in China are in somewhat the reverse position. They have little say in nominal tax rate determination but can have a substantial direct effect on the growth of local enterprises.

Autonomy on the expenditure side of the budget is in several respects limited. For example, in Zhejiang Province the provincial government and all local governments combined may spend no more than 55 percent of the total amount of taxes collected in the Province. The local budget must be approved at the provincial level, the prices of many inputs (including labor) are fixed centrally, and public employment levels are determined outside the control of the local government.

Taxation and Tax Sharing

China's revenue sharing system is primarily a division of sales and profit taxes among the central, provincial, and local governments. Whereas in most countries the taxes are collected by the central government and then allocated to the subnational governments, in China they are collected by the local governments and "shared up" to the higher levels.

Taxes in China can be divided into several categories according to the disposition of their yield: those of the central government (e.g., customs duties, sales and profit tax collections from centrally-owned enterprises) or the provincial government (taxes collected from provincial enterprises); those shared among central, provincial and municipal governments (notably profit and sales taxes), and those that are assigned exclusively to the municipal government (the urban maintenance and construction tax). The sales and profits taxes together usually account for 80 percent or more of municipal government revenues.

LOCAL GOVERNMENT FINANCE IN CHINA (cont.)

The profits tax is levied on the gross profits of SOEs, collectives, and private businesses according to three different rate schedules. A top rate of 55 percent is applied to large and medium sized SOEs. There is also an excess profits tax, known as the "adjustment tax." A third "tax" on profits is an earmarked contribution for the central government energy and transportation projects. These three taxes lead to a tax burden that is often 70 percent or more of gross profits.

China's uniform national sales tax, administered by municipal and county governments, is the most productive tax in the system. It has three components. The product tax, which yields about one-third of all national revenues, is a gross receipts tax on domestically produced and imported commodities. The operations tax is essentially a sales tax on services and on retailers. It is charged on a gross receipts basis for most activities. The third component is the value added tax, but it is levied only in certain sectors of the economy.

Each provincial government decides on the rate of tax sharing between the province and the local government. The central government mandates that the energy and transportation fund contribution accrues to the center and that municipal governments may not share in the taxes collected from enterprises owned by higher level governments. A case study of the sharing formulae in Zhejiang Province showed that the sharing formulae for all locally collected taxes led to the municipal governments retaining about one-third of all taxes collected. The provincial government can, and often does, vary the sharing rate among local governments within the province to achieve equalization and other objectives.

There is one major "local tax," the urban maintenance and construction tax. The rate and base are centrally determined at 7 percent of total sales tax liability for municipalities (5 percent for towns and 2 percent everywhere else). The tax accrues entirely to the collecting local government and is earmarked for urban maintenance and construction.

Though the public utilities do attempt to recoup a portion of costs through user charges, rates are well below efficient levels. Moreover, water, sewerage and gas (LPG) charges, bus fares and housing rents are all linked inextricably to wage policy. Cost recovery is a much bigger matter than simply raising the level of the user charge.

Local governments in China cannot run a deficit and cannot borrow. There is no regular grant program to support capital projects or current expenditures; there is no mechanism or formal program for lending to local governments; and there are no guidelines for local governments to develop beneficiary financing schemes. However, the municipally-owned enterprises can borrow and in some cases the municipal government has pledged its general revenues to secure the loans. And on an "experimental" basis, there is now some innovative use of credit financing and self-financing schemes.

Intergovernmental Fiscal Relations

There are three important dimensions to the system of intergovernmental fiscal relations in China. The first is central-provincial government relations. The second is the system of provincial-municipal tax sharing which was outlined above. The third is the system of horizontal fiscal relations within the province, the method by which the provincial government allocates fiscal

LOCAL GOVERNMENT FINANCE IN CHINA (cont.)

resources among its counties and municipalities.

The central government determines that a specified share of all taxes collected in each province is to be passed to the central government. In theory the share is fixed for a period of years and is generally meant to reflect the difference between fiscal capacity and expenditure needs. The variation across provinces is wide: from Shanghai's retention rate of about one-fourth of tax collections to several provinces which are allowed to retain all collections and receive an additional payment from the center.

An important dimension of intergovernmental relations is the degree to which the provincial government redistributes taxable capacity, e.g., from rich to poor counties or from urban to rural areas. The most powerful fiscal tool which the province can use is that it may vary the tax sharing ratios for each local government, apparently without central government approval, and on an ad hoc basis. In Zhejiang Province the rate actually varies from higher income areas turning it nearly all over, to lower income areas keeping it all.

Issues, Problems and Options

While the fiscal system in China has some very great strengths as regards local government financing, it is also beset by some serious problems. Moreover, the system is likely to change in order to accommodate the general economic reform that is underway. Among the most important problems facing the local governments are: (1) revenue adequacy and growth; (2) nonneutralities in the tax structure and tax sharing system; and (3) tax administration weakness.

As is the case with local governments in most countries, Chinese municipalities are strapped for revenue. A combination of a backlog in infrastructure needs and increasing urbanization has put great pressure on local budgets. Moreover, the overall elasticity of the profit and sales taxes may be relatively low--a structural problem that is possibly exacerbated by weakness in the tax administration system. Among the options presently under discussion in China are autonomous local taxes and, in particular, the institution of a local government property tax.

The Chinese system of taxation and tax sharing includes a number of penalties and incentives that might draw out undesirable actions from enterprises and from local governments. These distortions include:

- o A low tax sharing ratio may reduce the incentives of the local government to efficiently collect taxes;
- o The absence of borrowing and self-financing mechanisms creates a bias against infrastructure investments because the full cost is shifted onto the general public and to current beneficiaries;
- o The very high rate of taxation of profits provides a disincentive for local managers to maximize profitability;
- o The high tax rates give an incentive for evasion and avoidance to the firm and perhaps to the local government who owns the enterprise.

Based on available evidence and *a priori* reasoning, one might infer that tax administration is a problem which the Government of China is now facing and must continue to reckon with. The system is very complicated and therefore not easily administered. There are three different sales taxes levied on different types of sales at more than 60 different rates. The profits tax has three LOCAL

GOVERNMENT FINANCE IN CHINA (cont.)

different rate schedules, includes six different taxes on profits and the use of profits, and provides special treatment for incentive firms. The adjustment tax must be computed separately for every firm.

Record keeping could also be a problem. One side of the problem is the inadequacies in the books of accounts kept by the firms liable for tax. It is virtually certain that small firms do not keep books of account that would allow assessment of modern sales and income taxes. The other side of the record keeping problem is that the master file kept by local governments tends to be in a manual form and is very difficult to monitor. Finally, there are questions about whether the local government administrative staffs are of adequate size and well enough trained.

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