Rural Informal Taxation in China: Historical Evolution and an Analytic Framework

Justin Yifu Lin and Mingxing Liu

Abstract

This paper examines the historical evolution of China’s rural taxation system from the pre-reform period to the late 1990s. We propose that under information asymmetry between the upper level and the lower level governments on policy implementation, local governments had to be granted some informal tax autonomy to fulfill the upper level policy mandates. This easily led to excessive local informal taxation on farmers. As market liberalization of the grain sector progressed, the low-cost tax instruments through the traditional approach of implicit taxation gradually eroded. Local governments in agricultural regions had to resort to informal fees collected directly from individual rural households while the more industrialized regions shifted to non-agricultural taxes that are less costly in terms of tax collection. Under such a circumstance, political tension between farmers and local governments in agriculture-based regions emerged and rural tax reform became necessary.

Key words: policy mandate rural informal taxation tax instrument

JEL codes: H57, H71, P32

I. Introduction

In many developing and transitional countries where agriculture is of central importance, whether taxation on agriculture is administratively feasible and at the same time promotes equity and efficiency as far as possible is an essential issue (Ahmad and Stern, 1991). However, the instruments through which agriculture can be taxed are usually quite limited, especially when a country experiences agricultural liberalization in economic transition. Often being able to control the pricing of food and vital agricultural inputs such as fertilizers, governments in many developing and socialist countries could tax agriculture implicitly via the so-called “price scissors” (Dixit, 1973, Lipton, 1977, Sah and Stiglitz, 1987). However, as these countries started liberalization in agricultural sectors, these implicit tax instruments gradually eroded and significant changes in agricultural taxation became inevitable (Burgess and Stern, 1993).

As a large developing country undergoing fast economic transition, China presents an excellent opportunity for study of agricultural taxation changes in economic liberalization and how the availability of tax instruments may differ for localities of different development level. As China de-collectivized and liberalized its agriculture in the 1980s, the country witnessed a significant decline of utilization of “price scissors” as a tax instrument to raise resources from agriculture. When China further marketized in the 1990s, the country’s more developed regions, mainly located in the eastern coast, saw a gradual shift away from taxation on farmers and rural land. However, it was also during this period that many agriculture-based localities in inland

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China saw rising rural tax burdens on farmers. The tax rates could be as high as 20-30 percent of the already very low incomes of farmers there and much of the tax burden on farmers came in the form of informal and arbitrary fee charge. This was followed by farmers’ growing frustration and complaints against local governments (Chen, 2003). Under some extreme circumstances, farmers opted to move to cities on a large scale leaving their land fallow, because they could not afford the heavy taxes (Berstein and Lu, 2000).

This paper examines the evolution of China’s rural tax system and the institutional mechanism of rising rural informal fees. The objective is to provide an analytical framework for investigating rural taxation issue during China’s economic transition, which, we hope, will help to gain a better understanding of China’s overall transition process. The rest of the paper is structured as follows. Part 2 describes the evolution of China’s rural tax system since the plan period. Part 3 provides an analytical framework for China’s rural taxation issue. Part 4 concludes.

II. The Evolution of China’s Rural Tax System

1. Pre-reform Period: Agricultural Taxation through Price Scissors

A formal state agricultural tax was present in the People’s Republic of China as early as the 1950s. The national average rate of this tax was set then at 15.5 percent of a state-defined tax base that was fixed for several decades. In the 1950s and 1960s the tax base was on average a third lower than the national grain output. Therefore, the actual agricultural tax rate was around 10 percent of grain output in China’s first and second “Five-year Plan” periods (1953-57 and 1958-62). As grain output grew in the 1960s and the 1970s, the effective rate declined to 6 and 5 percent respectively in the third and fourth “Five-year Plan periods” (1966-1970 and 1970-1974). Judged by these numbers, the formal agricultural tax was not very high during the command period and even declined from the 1950s to the 1970s.

However, farmers were taxed much more heavily than the state agricultural tax statistics suggest. By controlling the distribution of food and being the main or only supplier of such vital agricultural inputs as fertilizer, pesticides, water and electricity, during the plan period the Chinese government was able to tax agriculture implicitly through the price scissors, increasing the prices of agricultural inputs and depressing the prices of agricultural outputs. As Lin et al (2003) have argued the choice of a heavy-industry-oriented development strategy in China’s plan period compelled the state to extract resources from agriculture through price distortions in order to subsidize the priority sectors. To facilitate such taxation, production brigades and people’s communes were set up in rural areas and a highly controlled allocation system of major agricultural inputs and outputs was established. Compulsory procurement quotas were imposed on farmers and farmers were entitled only to residual grain after the state procurement. As a tax in kind, the state agricultural tax was also collected via the mandatory procurement system. Between 1953 and 1978, the implicit taxation through price distortions was as high as RMB 280 billion, 17 percent of total agricultural output in the same period. This greatly exceeds the formal state agricultural tax (CNY 89.8 billion) in the same period (Cui, 1988; Yan, 1988).

Besides the formal agricultural tax and the implicit tax collected via the price scissors, farmers faced further levies imposed by local communes and production brigades. Before farmers received their incomes from rural collectives, the brigades and communes deducted
their collective accumulation fund, welfare fund and cadre compensation. Only thereafter did team members receive their compensation part in grain and part in cash (Lin, 1992). Therefore, in the plan period the formal agricultural tax was automatically collected through a mandatory procurement system in which farmers were required to sell most of their agricultural output to the state. Because rural collectives were able to control income distribution among farmers through the work-point system, local levies by communes and production brigades were also collected before farmers were paid for state-procured grain (Lardy, 1983; Rozelle, 1996).

2. The 1980s and Early 1990s: Gradual Changes in Agricultural Tax Instruments

The agricultural reforms since the late 1970s not only raised agricultural productivity dramatically, but also gradually reshaped the way agriculture was taxed. In the late 1970s, reform in the agricultural sector was mainly characterized by de-collectivization. The Household Responsibility System (HRS) adopted since then furnished individual rural households with incentives by making them the residual claimants to farming returns once they fulfill the state grain quota and agricultural taxes and fees (Lin, 1992, Debra et al., 2004). In the early 1980s, the mandatory grain quota system was abolished and replaced by grain procurement contracts in which every rural household was required to sell a certain amount of its grain output at state-set procurement prices. With rare exceptions, the market prices exceed the state procurement prices and farmers thereafter could market their surplus produce (Lin 1992). This price margin enabled the state grain sector, as the agent of the state, to continue tax agriculture implicitly.

However, the introduction of the HRS deprived local governments and village community organizations of their power to distribute income within villages. To collect revenue for townships and village collective organizations, the government introduced two major categories of fees, i.e., the so-called “five township-pooling funds” to township governments to provide basic public goods such as education, public security, law and order, and civil service, and 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.

Beside the two major fee categories permitted by the state, townships and villages also collected revenue implicitly by adding a margin for household grain procurement above the state quota.1 Adding a margin over the state procurement quota would contribute to local revenue as local officials could exploit the price margin between the market price for grain and the state procurement price.2 In practice, farmers usually had no way to know if there was such a margin and/or how large it was. In many places, implicit taxes on such economic crops as cotton, rapeseed, jute, hemp, and tobacco; sideline products such as cocoons and pigs; and agricultural inputs such as fertilizers and pesticides were also collected by local governments through their control of the transaction channels and prices. Under the state grain procurement

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1 Though the state set the grain quota for each locality, it was up to township governments to allocate the quota to villages and the latter to individual households. Local officials, in the name of fulfilling grain procurement contracts, usually over-procured grain by adding a margin over the state quota. Then farmers sold their grain at below market prices to the state grain sector, the latter often worked with local cadres in tax and fee collection.

2 Furthermore, the higher the quota margin over the state grain quota, the higher the payment should, in principle, be made to farmers (even at the state procurement price), and the more easily local officials could deduct agricultural taxes and fees before paying the farmers.
system, local governments had every reason to assert the necessity of regulating the whole agricultural production structure in order to fulfill their state grain quotas. In practice, many local officials dictated farmers’ specific farming operations. They not only required a specified share of the total arable land be allocated to grain production, but also frequently mandated that farmers plant certain cash crops and sell to them at depressed prices.

Therefore, as in the plan period, the continued (though declining) existence of state grain procurement greatly facilitated the imposition of the agricultural tax and various local informal fees. Before farmers obtained the state payment for procured grain sold to the state grain sector, township governments and village community organizations, with cooperation from the state grain sector, deducted all the taxes and fees. Farmers were then paid the residual. Because state grain quotas were still relatively large, only in rare case farmers were required to pay more taxes and fees than the value of their grain quotas (Bernstein and Lu, 2003). Given that every rural household was allocated some land under the HRS, in practice both the agricultural tax and most local fees were mainly levied on land allocation, while some other fees were levied on household members or laborers. Since the land is allocated largely according to family size and labor force, agricultural taxes and fees in rural China can be largely viewed as land-based tax burdens. With the introduction of HRS, China’s countryside witnessed a gradual transition in which rural taxation began to change from the dominant tax instrument of the price scissors to a combination of the pricing instrument and land-based agricultural taxation with the latter becoming increasingly important.

However, rural taxation was still not a prominent issue in the 1980s and the early 1990s as some share of agricultural taxes and fees was collected through the implicit instrument of the price scissors, and almost all agricultural taxes and local levies could be deducted beforehand under the remaining grain procurement arrangements. Neither was the issue of local illegal levies a very serious one in this period. Even when such levies existed, they were at least not very explicit since they were either deducted prior to the payment for grain procurement deliveries, or through the over-procurement from farmers and the control of major agricultural input distribution by local governments.

3. The 1990s: The Emergence of Excessive Informal Taxation in Rural Regions

After the introduction of the HRS in the early 1980s, China’s agricultural sector in the witnessed a faster market liberalization that began in the late 1980s and continued through the 1990s (Weersink and Rozelle, 1997). The issue of excessive rural taxation emerged in the 1990s when many rural areas (especially those in agriculture-based regions) experienced a surge of diverse, local illegal fundraising. These fees were imposed on farmers, without explicit government regulations or legislation, for anywhere between a few dozen and more than one hundred items, ranging from charges for road and school construction and other local improvement projects, to

3 Unlike the late industrializing countries of Africa or Latin America that are often plagued by bureaucracies lacking organizational capacity, the Chinese bureaucracy is an elaborate network that extends to all levels of society, down to the neighborhood. As the Maoist legacy, the Chinese bureaucracy exhibits a high degree of discipline by international standard (Oi, 1995). Therefore, there is no lack of administrative capacity to conduct cadastral surveys and administer the land-based tax. After the communist revolution, there have been no interest groups strong enough to resist the taxation on land (Bardhan, 2002).
purchase of insurance, to charges for marriage certificates or housing construction, to prohibitive prices for electricity and tap water, and so on. For example, in some regions marriage certificates cost CNY 600, a quarter of the average annual net income of local farmers. In many localities, villages were forced to purchase various newspapers or periodicals (State Planning Commission, 2000). In the 1990s in rural China, a large share of the village and township government expenditure came from such informal charges. These fees did not enter into formal budgets but constituted an important share of local extra-budgetary revenue for township governments and village collective organizations.

However, the emergence of excessive rural taxation and the surge of informal fee charges did not occur uniformly throughout China. It is a regional, though still relatively broad-based, phenomenon that mainly involved inland agriculture-based areas in the second half of the 1990s. Using a 6000 household panel data set from 1986 to 1999 collected by the Ministry of Agriculture, we calculate rural tax burdens as a share of farmers’ income for 10 provinces (both developed and under-developed) across China in 1986, 1993 and 1999. As shown in Table 1, on average, there was no significant increase in rural direct taxes as a share of rural net income in the period covered. In most provinces, total tax burdens on rural households (both formal taxes and informal fee charges) grew only by 1-4 percentage points as a share of rural net incomes from 1986 to 1999. In some more developed coastal provinces such as Guangdong and Zhejiang, there was even some decline of tax rates in the period.

However, further investigation shows that rural taxation became an acute problem due to fast growth of rural income disparity after the 1990s and the uneven tax and fee distribution among different income groups. Still using the same data from the Ministry of Agriculture, we find that rural income inequality in the 10 provinces increased significantly from 1986 to 1999; over the same period the incidence of rural taxation among different income groups did not change correspondingly. If we include all formal tax and informal fees paid by rural households, the tax burden for the lowest-income group in 1986 (annual per capita income less than CNY 200) was 10.5 percent of net income, while that for the highest-income group (annual per capita income larger than CNY 4000) was 9.5 percent. However, in 1999, the tax burdens for the lowest-income group (with an annual per capita income less than CNY 400) climbed to as high as 25.6 percent of net income, while that of the highest-income group (with annual income larger than CNY 8000) was only 4.4 percent. Therefore, the increasingly regressive nature of rural taxes and the heavier burdens on poor farmers, rather than the increase of average rural tax rate, is at the heart of the rural taxation issue in China.
Table 1. Rural Direct Taxes as a Percentage of Rural Net Income by Provinces (%)

<table>
<thead>
<tr>
<th>Province</th>
<th>Year</th>
<th>Burdentotal/1</th>
<th>Feetotal/2</th>
<th>Fee1/3</th>
<th>Fee2/4</th>
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<tr>
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<td>2.6</td>
<td>2.4</td>
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</tr>
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<td>4.6</td>
<td>3.3</td>
<td>1.3</td>
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<tr>
<td></td>
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<td>2.3</td>
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<td>Sichuan</td>
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<td>3.1</td>
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Note: 1. Burdentotal is defined as all formal taxes paid by individual households plus all township and village informal levies as a percentage of household net income.
2. Feetotal is defined as township and village levies (including village and township levies permitted by the central government, plus various local charges not legitimated by national government policy as a percentage of household net income.
3. Fee1 is defined as the township and village levies permitted by the central government.
4. Fee2 is defined as those various charges not legitimated by national government policy but imposed by local (county or township) government and village community organizations as a percentage of household net income.

Source: RCRE (Research Center for Rural Economy, Ministry of Agriculture).
The reason that the poor farmers paid much higher shares of their incomes for taxes relates to the nature of the rural tax system in China’s economic transition. Taxes on the Chinese rural households are predominantly agricultural taxes levied on arable land. However, since the early 1990s, an increasing share of rural income has derived from non-agricultural sources, such as township and village enterprises and migrants remittances, which have not been subject to state tax administration. This is especially true for farmers in more developed regions. Since the poor usually comprise the group of people with the lowest proportion of income from non-agricultural sources, they are more vulnerable to rural direct taxes. Therefore, rural taxation became an increasingly serious issue essentially because with rising rural income inequality the rural tax system failed to respond accordingly and taxes fell dis-proportionally on the shoulders of the relatively poor farmers dependent on agriculture. As a result, though in effective tax rates the state formal tax, i.e. the agricultural tax was on average only around 2-3% of farmers’ income across the nation and 4-5 percent in less developed agricultural regions, informal fees in many less developed regions are much higher, usually reaching 20-30 percent for the poor farmers (Tao and Liu, 2005).

III. Institutional Mechanism of Rural Informal Taxation in China

Our discussion of China’s rural taxation so far begs answers for the following three questions. First, what was the fundamental source of rural taxation problem and why did rural informal fees emerge in China? Second, why did the issue become serious only in the late 1990s rather than in earlier period? Finally, why was the phenomenon confined to the more agriculture-based regions?

1. Upper Level Policy Mandates and Rural Informal Taxation

Our answer to the first question relates to the policy mandates imposed on local government at the county and/or township level and village community organizations in China. In China, local governments were not elected and their policy directives are issued and implementation monitored from above. Therefore, local governments have to fulfill many tasks mandated by higher-level governments. For example, at township level throughout the 1980s, these include government grain procurement, birth control and compulsory education. These policy burdens could create a justification for local governments to levy informal taxation from within community. Though the upper level government could theoretically provide fiscal transfers to cover the policy implementation costs, the financial and personnel costs of local policy implementation are not fully known to, thus could not be covered by, the upper level government. The latter, understanding that transfer alone would be insufficient to induce policy coordination, has to grant local governments certain autonomy in informal taxation (by e.g. turning a blind eye to illicit fee collections). However, once such autonomy is granted, unelected local governments could take advantage of and draw on the legitimacy of the higher-level government to overcharge farmers and even engage in rent-seeking. Therefore, in many rural areas, the bulk of local cadres’ work was to charge fees, and then to use the revenues to implement the policies required by upper-level governments. Given that many policies were quite unpopular among farmers, administrative costs usually turned out to be very high. High
personnel and administrative expenditures rendered rural governments in many less developed regions incapable of providing basic public services within budgets.

Therefore, a plausible explanation of the rural informal taxation in China must be placed in the context of upper level policy mandates. If the policy mandates are heterogeneous across locality, heterogeneous rural tax burdens and local expenditure in fulfilling the mandates ensued. This is not only because heavier central mandates would entail heavier policy implementation costs in terms of financial and personnel resources, but also, under information asymmetry with regard to the exact policy enforcement costs, local governments could pad costs and intentionally increase the costs of implementing mandates by such means of cost manipulation.

The most telling example of such policy heterogeneity is the state grain procurement. Though the central government implemented the policy in almost all provinces across China, the quantities of government grain procurement (both in gross or per capita terms) vary significantly by locality.\(^4\) For example, using the Ministry of Agriculture data, we present the per capita grain procurement for the 10 provinces for 1987, 1995 and 1999. As shown in Figure 1, in 1987 the inland province of Jilin had a highest per capita state grain quota of about 350kg while the province of Henan had a lowest per capita state grain quota of about 70kg. Speaking generally, there was a clear declining trend in state grain quota per capita from 1987 to 1999 in almost all the provinces, though significant heterogeneity across provinces still existed even in 1999.\(^5\) Significant differentiation in policy mandates across localities help to account for heterogeneous tax burdens and local (township government and village organization) expenditure.\(^6\)

\(^4\) The quantity of grain procurement for every locality is determined by the center according to a set of rules that take account of factors such as natural conditions, local history, and even political concerns, such as local food self-sufficiency.

\(^5\) Another example of heterogeneity in policy enforcement cost is the state’s birth control policy. In less developed areas where income is lower, non-agricultural employment more limited and women and girls are less well educated, farmers usually strongly prefer to have more children than do farmers living in richer regions. Therefore, poorer regions face greater difficulties in fulfilling the birth control quota set by the center, which implies higher administrative costs and more financial and personnel resources.

\(^6\) Using the Ministry of Agriculture data, we empirically test the hypothesis and find that higher policy mandates (state grain quota per capita) indeed lead to higher formal and informal taxes (per capita), other things being controlled.
2. Agricultural Liberalization and Rural Tax Instruments

The answer to the second question, i.e., why did rural taxation become a serious issue only in the 1990s rather than earlier, relates to further marketization of major agricultural outputs and inputs. Starting from the early 1990s, changes to the procurement system, further lifting of restrictions on trading of commodities, moves to commercialize the state grain trading system, and calls for the expansion of market construction in rural and urban areas all led to a surge in market-oriented activity (Sicular, 1995, Rozelle 1996, Rozelle et al, 2000, Debray et al 2004). These liberalizations in agriculture in the 1990s reduced both the quantity of the state grain quota as well as the grain market-procurement pricing margin. This period also witnessed a fast liberalization of all major cash crops, sideline products and agricultural inputs. As explained earlier, in the 1980s, local governments collected implicit taxes on crops such as grain (through over-procurement), cotton, rapeseed, sideline products such as cocoons and pigs, and agricultural inputs such as fertilizers and pesticides, since they could control the transaction channels and prices. The gradual erosion of state grain procurement quotas, along with the gradual erosion of regulations on cash crops and declining controls on transaction channels for major agricultural outputs and inputs, reduced the implicit taxes local governments could exploit.

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7 For example, in the case of fertilizer, Ye and Rozelle (1994) show that after an early attempt at market liberalization in 1986 and 1987, perceived instability in the rural economy in 1988 led to sharp retrenchments. Only in the early 1990s did agricultural officials once again remove the controls on fertilizer marketing and begin to encourage private trade. Local governments had been able to earn some revenue from its control on distribution over major agricultural inputs.
resulting in rising explicit taxes levied on individual farm households.  

Still using the Ministry of Agriculture data, we can see the gradual decline of the margin between grain market prices and the state procurement price. Figure 52 shows the price margin for all 10 provinces plus the provinces of Hunan and Zhejiang from 1987 to 1999. The Figure 2 shows that, although the late 1980s and the middle 1990s witnessed two temporary rises in such price margins due to inflation, the clear overall trend was one of declining price margins from the 1980s to the 1990s. Therefore, when China started to liberalize agricultural prices, the implicit taxation through pricing instrument gradually eroded.

**Figure 2. Market/Quota Price Margin for 10 Provinces, Hunan and Zhejiang**

Note: the provincial price margin is approximated by first calculating the average price of the grain sold in the free market to the average price of the state-procured grain for all the households in a village, and then taking the arithmetic average of all villages within a province. Adopting such an approach avoids the possible heterogeneity in grain varieties across villages within a province.

Source: RCRE (Research Center for Rural Economy, Ministry of Agriculture).

Besides the liberalization in agricultural sectors, marketization reforms in other sectors also contributed to the emergence of the issue of excessive rural taxation. In the course of the accelerated marketization that took place during the 1990s, the power of the central government to directly control the economy and local governments was greatly reduced. The center had previously been in firmer control of the macro-economy through its command of economic resources and regulations on investment and foreign trade. But from the mid-1990s, with the effects of broader liberalization and administrative decentralization, the center found itself incapable of establishing effective incentives and disincentives for local governments. The center’s response was to re-centralize fiscal revenues so that transfers could be used to help ensure policy implementation. Such revenue centralization imposed large pressures on county and township governments’ fiscal balance sheets and pushed them to find more resources on their own. Local governments then were forced to look for other ways to mobilize revenue. Taxing farmers through various fees was seen as a way out for many local governments in less developed regions. A further channel through which the general economic transition affected the rural taxation has been the economic restructuring of local SOEs and TVEs. That contributed to the expansion of local bureaucracy and perpetuated the rural tax problem. With a significant restructuring of local SOEs and TVEs from the middle 1990s, ex-leaders and the well-connected employees of the bankrupt SOEs and TVEs shifted to local government agencies and public service units both at county and township level. This was more serious in less-developed regions when local SOEs and TVEs experienced fierce competition from enterprises from more developed regions.
There is a further channel through which the liberalization of the agricultural sector affected rural taxation, namely the gradual decline of state grain quotas. The gradual erosion of state grain procurement quotas made it increasingly infeasible for the township and village officials to deduct taxes and fees before paying farmers for their state grain quota delivery. As a result, local officials now had to collect fees directly out of farmers’ pockets. Compared to previous direct tax deduction via the state grain procurement system, the work of collecting explicit taxes from individuals rural households proved to be much more costly in terms of local cadres’ administrative and personnel expenses. Such tax collection significantly raised the administrative workloads of local government officials responsible both for collecting taxes and for managing the conflict these collection efforts spawned, thus raising the direct costs of tax collection itself as well as indirect costs of managing complaints and petitions, hearing appeals, and so on. In response, higher local fees had to be collected to compensate the revenue shortfalls. Anecdotal evidence also suggests that in many less-developed regions, a vicious cycle emerged in which local governments had to recruit more staffs, both formal and informal to ensure tax collection; higher tax revenues then had to be used to support an expanding local bureaucracy. This in turn led to even higher informal taxes and larger local bureaucracy (Chen 2003, Yep, 2004).

Still based on the MOA data, there was decreasing availability of direct tax deduction via the grain procurement system. Figure 3 shows the share of taxes and fees that could not be deducted beforehand via the state grain procurement system for all the 10 provinces in RCRE data set and also for two provinces of Hunan and Zhejiang from 1987 to 1999. From the figure, there was a clear tendency for this share to rise, thereby illustrating the decreasing capacity to deduct taxes and fees beforehand via the grain quota system.

Figure 3. Indexes of Non-deductible Tax Shares Prior to Procurement Payment

![Graph showing the share of non-deductible tax payments from 1987 to 1999 for different categories of rural households and provinces.]

Note: Nondesha represents the share of rural households whose state agricultural tax was higher than (thus cannot be fully deducted from) their grain procurement payment for the 10 provinces. Nondeshb represents the share of rural households whose state agricultural tax and the “Five Township Pooling Funds” and “Three Village Deductions” was higher than the value of their grain procurement. Nondeshe represents the share of villages whose value of state agricultural tax was higher than the values of their grain procurement for the 10 provinces. Nondeshec represents the share...
of villages whose value of state agricultural tax, the “Five Township Pooling Funds” and “Three Village Deductions” were higher than the values of their grain procurement. 
Source: RCRE (Research Center for Rural Economy, Ministry of Agriculture).

3. Uneven Industrialization and Regional Heterogeneity in Rural Taxation

Now we turn to the third question, i.e., why was the issue of much greater concern in agriculture-based regions? This is because the higher level of industrialization, and thus the larger non-agricultural tax base, in coastal regions contributed to their lower taxation on agriculture. It is more cost-effective, on average, to collect a unit of tax from an industrial firm than it is from individual households, especially when implicit taxation via pricing instruments becomes less readily available with the deepening of marketization.9

Using supplementary county level data that matches the Ministry of Agriculture data, Figure 4 presents the industrialization level by province for the 1995, 1997 and 1999.10 One can observe that the industrialization level varies considerably across provinces. Over the years, the industrialization level has increased. In 1999, the share of industrial output was as high as 90 percent in Zhejiang and Guangdong, but only 50-60 percent in Jilin and Gansu. In sum, when marketization reform rendered implicit taxation through pricing less likely, the erosion of the grain procurement system made it less handy to deduct taxes and fees prior to grain quota payment, the cost of collecting taxes directly from individual rural households rose. If that cost exceeds the revenues generated, it is more cost-effective for the local government to forego such taxes and make up the lost revenue from industrial firms. However, in regions with slower or little industrialization, local governments have no other option but to directly levy fees on individual farmers.11

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9 As Zhang (2005) has argued, regions with faster industrialization prefer to levy taxes on industrial firms. Moreover, the industrial base creates a high opportunity cost for labor. When there are abundant high-paying jobs available, the job of collecting taxes from individual households may be unappealing.


11 Though local governments in more industrialized regions have access to more revenue from growing manufacturing and service sectors, farmers in these regions have not been exempted from local government predation. Compared to their counterparts in less developed regions who were taxed more explicitly, farmers in more developed regions were mostly exploited through appropriation of their land. With faster industrialization and urbanization contributing to rising land values, rural land requisitioning has increased significantly in suburban areas and in places that lie in the way of main transportation projects such as roads, highways and railroads. Under a problematic land requisition system, local governments in developed regions have established a large number of industrial parks and urban new development zones by expropriating arable land from farmers without reasonable compensation. Revenue-hungry city governments have every incentive to tax farmers implicitly through aggressive land requisition since such land revenues fall into the locally controlled extra-budgets. As extra-budget revenues, such incomes in principle are to be used to finance urban infrastructure development. However, lack of transparency often makes it difficult to monitor and rent-seeking involving collusion between land developers and local governments has been pervasive and has significantly undermined farmers’ interests.
Figure 4. Industrialization Level by Provinces

Note: The provincial industrialization is approximated by first summing the industrial output of all counties within a province in which the Ministry of Agriculture has fixed-point villages for its survey, and then divided by the sum of industrial and agricultural output of these counties.
Source: RCRE (Research Center for Rural Economy, Ministry of Agriculture).

IV. Conclusions

After a brief description of the historic evolution of China’s rural tax system from the plan period to the late 1990s, in this paper we propose an analytical framework for exploring China’s rural informal taxation. It is argued that rural informal taxation was correlated to upper level policy mandates such as grain quota and birth control that were imposed on local governments. Under information asymmetry between the upper level and the lower level on policy implementation, local governments have to be granted certain informal tax autonomy to fulfill upper policy mandates. This leads to local informal taxation and very likely results in excessive informal taxes through illegal fundraising. As market liberalization of grain sector progressed, the traditional low-cost taxation operationalized through the “prior deduction before grain procurement payment” and “implicit local taxation via price scissors” gradually eroded. Under such a circumstance, local governments in agricultural regions had to resort to informal fees collected directly from individual rural households while the more industrialized regions shifted to non-agricultural taxes that are less costly in terms of tax collection.

It can be further argued that China’s continued political centralization and lack of local government accountability necessarily entails upper level policy mandates imposed on local governments. Under continued political centralization with no election mechanism to reveal voters’ preferences and to monitor local governments from below, the policy targets of local governments have to be set from above and the performance of local governments is evaluated.
on the basis of how well or poorly those policy targets are achieved.\textsuperscript{12} To ensure that policy targets are met, the center not only controls political appointments, but also has strong incentives to control formal fiscal revenues and spend them in the form of transfers. However, because the upper-level policy mandates need to be implemented locally and there is significant information asymmetry about policy implementation costs, transfers from above alone would be insufficient since local governments may always claim higher costs than the upper level transfers. Under such circumstances, local governments also have to be granted certain autonomy in local informal taxation. However, once such autonomy was granted, excessive rural taxation and abusive land requisition soon became socially, or even politically, destabilizing.

In this sense, the issue of rural taxation that emerged in the latter half of 1990s in China effectively reflected a tension between the country’s increasingly decentralizing and liberalized economic system and the still centralized political system. Even though China has made significant progress in economic liberalization in the 1980s and 1990s, the country has maintained a centralized political system with the Communist Party as the single ruling party and local officials appointed from above. In such a context, the existence of policy mandates and the emergence of rural informal taxation became inevitable.

Facing increasing complaints and social unrest from disgruntled farmers, the center, unwilling to yield political control, had to respond with further fiscal and administrative centralization to contain local transgressions. Indeed, China in recent years has seen a trend toward further centralization of fiscal powers.\textsuperscript{13} The rural tax reform initiated in the early 2000s can also be viewed as a move toward higher fiscal and administrative centralization. To address the bitter complaints from farmers about excessive tax burdens, the government under the leadership of President Hu Jintao and Premier Wen Jiabao started removing all local informal fee charges and formal agricultural taxes on farmers when they took office in 2003. The fee and tax have been completely abolished at the beginning of 2006. This reform implies that local governments are now having little tax autonomy and are increasingly dependent on upper level

\textsuperscript{12} At each level of government, there are performance indicators set by upper level government that are used to evaluate lower level government officials. These indicators usually include a number of economic targets such as the annual growth of local GDP, the revenue collected and the contributions to higher levels of the state apparatus, the amount of foreign investment attracted, as well as various ‘social’ targets such as those for birth control, maintaining public security, raising school enrollments and so on (Edin, 2003). Successfully reaching or exceeding the targets set by higher-level governments is decisive for local officials seeking political promotion (Li and Zhou, 2005). Throughout the 1980s and 1990s, reaching the state grain procurement quota and implementing the birth control policy were invariably two essential policy targets to be fulfilled at the township and village levels in most agriculture-based regions.

\textsuperscript{13} Besides the rural tax reform that deprives local governments of their power to tax informally, the center has begun to claim a higher share of the personal and enterprise income taxes that used to belong exclusively to localities. Centralizing administrative measures have also been introduced in the rural land requisition system. Responding to protests by farmers about the inadequacy of land compensation, the center issued many policy documents to local governments requiring them to constrain their abusive land requisition and raise compensation to farmers. The center also plans to centralize land requisition power to the provincial and central level by establishing a vertically controlled land management system with tighter land supply quotas and stronger supervision Starting from 2005, numerous development zones have had to be removed and national inspection teams have been sent out. A newly-promulgated Party document has declared that China intends to establish and implement the most rigorous arable land protection system in the world to ensure farmers’ rights and national food security (State Council, 2004).
Given the enlarging urban-rural divide and serious lack of public services in rural China, the Chinese government’s new policy of exempting farmers from any direct taxation is certainly laudable. However, whether such a move will be effective in the long run is still not clear. If the various upper level policy mandates are endogenous to the current governance system and thus will not be removed, local governments may still have incentive to find other ways to tax farmers. For example, recent years China has witnessed, in the process of fast urban expansion, waves of abusive land requisition without fair compensation to the dispossessed farmers. Moreover, the impacts of dispatching more transfers to compensate local revenue shortfalls are also dubious since under the current regime where there is a general lack of local government accountability to the people, higher transfers from the center might simply lead to fund diversion to maintain the local bureaucracy and further reduce the local cadres’ accountability for local needs. Apparently there is no easy solution to these issues and better outcomes may warrant more fundamental governance reforms than mere removal of rural informal taxes.

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