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# Fiscal Decentralization in China

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Task Force on Decentralization

The fiscal system in China was highly centralized before the transition from a planned to a market system in the late 1970s. The financial relation between the central and provincial governments was labeled *tongshou tongzhi* (unified revenue collection and budget appropriation). No sub-national governments had a separate budget: the central government collected all revenues and prepared a consolidated budget for governments at all administrative levels. This financial arrangement was extended to state-owned enterprises (SOEs): they were required to remit all profits or financial surpluses to the state and the state would cover all their expenditures by fiscal appropriation. In effect, the financial management of the SOEs was a part of state finance.

The centralized fiscal system was consistent with the centralized production and resource allocation mode adopted in China during the pre-reform era, but was incompatible with the market-oriented reforms embarked upon in 1979. There are three major driving forces behind the changes in China's fiscal system. The first impetus to decentralize the fiscal system stems from purely economic reasons. As it has become clear that economic interests greatly influence the behavior of individuals as well as governmental bodies, the centralized fiscal system has to be changed in order to provide local governments with incentives to step up the effort of revenue collection and to promote economic growth during the reform process. The second is that the remarkable growth of non-state-owned enterprises-- township and village enterprises, joint ventures and private firms--has undermined the dominance of state enterprises. Loss-making state enterprises have been rising in number and have become a great drain on the fiscal system. The government has been forced to turn to alternative revenue sources. Third, the balance of political power has shifted towards local autonomy as a result of the economic reforms. It is natural for sub-national governments to demand a commensurate decision-making power in the fiscal arena as a consequence of their greater political autonomy.

Like other reforms in China's transition to a market economy, fiscal decentralization reform started as an experiment. In as early as 1977, Jiangsu province was chosen to try out an alternative fiscal arrangement with the central government. Under this arrangement, the province was contracted to remit a share of its total revenues each year to the central government. The share was determined according to historical records of local revenues and expenditures of the province.

In 1980, the central government enacted revenue-sharing arrangements under the name "dividing revenues and expenditures with each level of government responsible for balancing its own budget." Under this arrangement, revenues were classified by source and divided into central fixed revenues (including customs duties and revenues remitted by centrally owned state enterprises), local fixed revenues (including salt taxes, agricultural taxes, industrial and commercial income taxes, revenues remitted by locally owned state enterprises, and other taxes and levies of a local nature), and central-local shared revenues (including profits of large-scale enterprises under dual leadership by the central and local government, industrial and commercial taxes or turnover taxes).

There were some exceptions to the 1980 arrangement. Guangdong and Fujian were required to remit a lump sum to the central government each year and allowed to retain the rest of their revenues. The five minority autonomous regions (Xizan, Xinjiang, Ningxia, Inner Mongolia, and Guangxi) and the three poor and remote provinces with large numbers of minority people (Qinghai, Yunnan, and Guizhou) received subsidies which were to increase at an annual rate of 10 percent.

However, despite promises to keep the sharing schemes unchanged for five years, there were frequent changes made to the sharing rules especially during 1982-83. The 1980 arrangement was very short lived.

In 1985, a major change occurred with the reform of the tax system and the replacement of state enterprises' profit remittances with income taxes. Although revenues were still divided into three categories — central fixed, local fixed, and shared — the criteria for the divisions were changed. Whereas the previous divisions were based primarily on the ownership of state enterprises, the new divisions were related to tax categories.

To accommodate different local social and economic conditions, four types of revenue-sharing arrangements were introduced. Fourteen provinces, including 3 municipalities, were contracted to remit a specific share of their local fixed and shared revenues. Guangdong and Heilongjiang received the most favorable provisions requiring remittance of a lump sum of revenues to the central government. Five provinces received lump sum transfers from the central government, while the remaining seven provinces received central subsidies that were stipulated to increase at an annual rate of 10 percent in subsequent years.

The 1985 fiscal arrangement ensured that central and local fixed revenues accounted for a relatively small part of the total government budget, the main portion being specified as shared revenue. This meant that the central government now relied on local governments to increase total revenues and to provide resources to the central government. Because local governments could retain some of the shared revenues, it was in their interest to increase these revenues.

In 1988, the arrangements were changed again under new fiscal contracting schemes. Five types of sharing schemes were established, as opposed to four types during 1985-87. The sharing formula for each province is reported in table 1. This system was not changed until 1994 when China adopted a new tax system, in which taxes were divided into local taxes and national taxes. The local governments' and central government's public functions were also redefined accordingly in the new tax system.

In a broad sense, fiscal decentralization as outlined in the above is much the same in China as elsewhere in the world: the central government relinquishes its fiscal controls to sub-national governments. According to the proponents of fiscal decentralization, such a shift of fiscal power and responsibility to lower levels of government may increase economic efficiency because governments at lower levels have informational advantage over the central government concerning resource allocation. In other words, sub-national governments are in better positions to provide the kind of public goods and services that closely meet the local need. Furthermore, when local government officials are responsible for the provision of public services, they are under closer scrutiny by their constituencies and have a greater incentive, as a result, to exercise their fiscal responsibilities in the best interest of the general public. In addition, local governments in China control the majority of the country's enterprises. Fiscal decentralization may harden the budget constraints of local enterprises and consequently may improve the local enterprises' efficiency and lead to a higher and more sustainable economic growth. Fiscal decentralization may also bring about dynamic gains to the economy as well. It is conceivable therefore that a change from a centralized to a decentralized fiscal system can increase the long-term rate of economic growth.

However, some economists have challenged the significance of the efficiency gain that fiscal decentralization can bring about. First, the alleged informational advantage of the local government may not be in fact significant. The central government can assign its representatives to local offices, who can have sufficient knowledge about the local preferences and can therefore play a role in the resource allocation process under a centralized fiscal system. Second, the central government can involve officials at the sub-national level in the decision process as well. Third, there is the question whether local officials are necessarily better informed given that they are not elected in democratic elections as in the case of most developing countries; and even though they are indeed better informed, there is still the question whether they have greater incentive to act upon the information. Moreover, as local governments in China directly own most local enterprises, they may set up trade barriers to protect local enterprises, causing fragmentation of markets, rent seeking and other efficiency losses.

The Chinese economy has grown at a record-setting rate of about 10 percent annually since the transition to a market system in the late 1970s. Many factors are shown to have played important roles in the growth process. These include, among others, agricultural reforms that made the household the unit of production, enterprise reforms that introduced material incentives to enterprise management, various price reforms, importation of technology, opening up the market to international trade and foreign investment, and a flourishing non-state sector. Fiscal decentralization is an important aspect of this multi-faceted reform. Therefore, it is theoretically interesting and empirically relevant to have a careful study of how the fiscal arrangements have affected China's economic performance before and after the reform. The availability of sub-national panel data in China also make it possible to test various competing hypotheses about the effects of fiscal decentralization on various aspects of economic development by Chinese data.

Table 1: Central-province Fiscal Arrangements and Marginal Retention Rate

| | 1985-1987 | | 1988-1993 | |
|---|---|---|---|---|
| Province | Sharing Scheme | FD | Sharing Scheme | FD |
| Beijing | A | 49.55 | b | 100.00 |
| Tianjin | a | 39.45 | a | 46.55 |
| Shanghai | a | 23.54 | c | 100.00 |
| Hebei | a | 69.00 | b | 100.00 |
| Shanxi | a | 97.50 | a | 87.55 |
| Liaoning | a | 51.08 | b | 100.00 |
| Heilongjiang | c | 100.00 | c | 100.00 |
| Jiangsu | a | 40.00 | b | 100.00 |
| Zhejiang | a | 55.00 | b | 100.00 |
| Anhui | a | 80.10 | a | 77.50 |
| Shandong | a | 59.00 | c | 100.00 |
| Henan | a | 80.00 | b | 100.00 |
| Hunan | a | 88.00 | d | 100.00 |
| Hubei | a | 100.00 | a | 100.00 |
| Sichuan | a | 100.00 | a | 100.00 |
| Shaanxi | e | 100.00 | e | 100.00 |
| Jilin | e | 100.00 | e | 100.00 |
| Jiangxi | e | 100.00 | e | 100.00 |
| Gansu | e | 100.00 | e | 100.00 |
| Inner Mongolia | f | 100.00 | e | 100.00 |
| Xinjiang | f | 100.00 | e | 100.00 |
| Guangxi | f | 100.00 | e | 100.00 |
| Ningxia | f | 100.00 | e | 100.00 |
| Yunan | f | 100.00 | e | 100.00 |
| Guizhou | f | 100.00 | e | 100.00 |
| Qinghai | f | 100.00 | e | 100.00 |
| Guangdong | c | 100.00 | e | 100.00 |
| Fujian | e | 100.00 | e | 100.00 |

Sharing Schemes:
Remitting a share of the local revenues;
Remitting a share of local revenue in the base year and the total remittance increases at a pre-determined rate in the subsequent years;
Remitting a fixed amount of the revenues to the central government;
Remitting a fixed amount in the base year and the total remittance increases at a pre-determined rate in subsequent years;
Receiving a fixed amount of subsidy from the central government;
Receiving a fixed amount of subsidy in the base year and the total subsidy increases at a pre-determined rate in subsequent years.