

# Discuss the Feasibility of Fiscal Decentralization in China

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**Abstract:** *In the form of a literature review, this essay will discuss the definition of fiscal decentralization, analyzes the formation and root causes of "Chinese fiscal decentralization" in conjunction with the practice of contemporary China's fiscal system reform, and describes the rationality and specificity of fiscal decentralization in China. Furthermore, this research illustrates that fiscal decentralization in China has a favorable influence on market reform and the economy of local governments in terms of infrastructure and education. At the same time, the article emphasizes that, while modern China practices decentralized financial system reform, that is, Chinese style financial decentralization, Financial Decentralization under the political centralization system has shaped the characteristics of simultaneous increase of local financial autonomy and central financial control.*

**Keywords:** *Fiscal decentralization; Chinese-style fiscal decentralization; Political centralization; Economic development*

## 1. Introduction

Fiscal decentralization theory is scattered in various schools of public economics. Fiscal federalism theory is an important branch of fiscal decentralization theory. It is used to study which activities should be carried out at the central government level and which activities should be carried out by local governments. To execute. The theory of fiscal federalism emerged in the 1950s and has now developed into the second generation. The second-generation fiscal federalism theory emphasizes the incentive effect of local taxes that promote local economic prosperity. Although different from the theories of the first and second generations of fiscal federalism, it is undeniable that the fiscal system reform after 1978 is compared with the centralized fiscal system that "unified revenue and expenditure" during the planned economy period. There are signs of decentralization. This paper mainly explains the phenomenon of fiscal decentralization in China and analyzes its role in stimulating the economy in Zhejiang Province, China.

## 2. Traditional Definition of Fiscal Decentralization

The tendency of fiscal decentralization is becoming more visible over the world, whether in industrialized or developing countries. Everyone has a different definition of fiscal decentralization. Stigler's theory just describes the reasons and necessity of local government, but Richard Abel Musgrave explicitly demonstrated a fiscal revenue sharing structure. Wallace E. Oates and Richard W. Tresch, both American academicians, have suggested their own views. Here is the most commonly accepted definition of fiscal decentralization. Fiscal decentralization is a financial system based on government functions or powers, reflecting the spirit of democracy, adopting a democratic way and legal guarantee, governments at all levels have a relatively independent range of fiscal revenue and expenditure, and dealing with the relationship between the central government and local governments and governments. According to Chinese practice, the tax system reform of "tax reduction and profit transfer" opened the forerunner of reform and opening up in the early periods of reform and opening up. The 1994 tax system reform managed to further enhance the fiscal decentralization system of the revenue sharing system. The central government's pixel density on Several Issues Concerning the Improvement of the Socialist Market Economic System stated that "adequate tax administration power should be handed to local governments under the concept of unified tax administration." China has likewise gone through a gradual trend of

fiscal decentralization. In this view, fiscal and tax decentralization is an inevitability of economic development law. Fiscal decentralization also contains the five desirable features enumerated below: (1) Fiscal function and relative independence of revenue and spending (2) Optimization and efficiency. (3) Democracy and fairness. (4) Legal and normative considerations. (5) Motivational compatibility.

### **3. The Formation and Origin of Chinese-Style Fiscal Decentralization**

Decentralization styles differ due to the plurality of state powers or functions, including fiscal decentralization, administrative decentralization, political decentralization, policy decentralization, economic decentralization, and market decentralization. These forms of political decentralization are obviously not synchronized in a political organic entity. They will be determined by a multitude of circumstances, particularly political ones, and will be interwoven in a variety of ways. Fiscal decentralization is unquestionably one of the most essential types of decentralization. It is not just common in established federal nations, but it is also common in developing nations. Fiscal decentralization theory is spread among numerous public economics schools. Fiscal federalism theory is a crucial part of fiscal decentralization theory. It is used to identify which activities should be performed by the central government and which by local governments.

In contrast to the centralized financial system of "unified revenue and expenditure" during the planned economy period, there are evidence of decentralization in the financial system reform after 1978. Three key financial system improvements occurred in the 1980s. In essence, these were financial lump sum systems utilized in different forms, in which the local government can retain the leftover money after negotiating and determining to send over a defined proportion or quantity of income to its superior authority. At the same time, the central government continuously delegated the financing responsibility of public goods or services to the local government. In order to correct the systematic deviation of financial decentralization caused by the financial contract system, the central government has carried out the reform of tax sharing system since January 1, 1994. Since then, China's fiscal revenue concentration and fiscal expenditure decentralization have both increased, and the fiscal revenue and expenditure gap of local governments has expanded, resulting in the inequality of fiscal revenue and expenditure of local governments, that is, while the central financial resources are gradually expanding, with the decentralization of fiscal expenditure tasks at all levels, the affairs of local governments are increasing day by day.

Although the system rules of the financial contract system and the tax sharing system differ significantly after reform and opening up, they all meet the requirements of the financial decentralization theory on the transfer of financial power and the division of financial responsibilities without exception. As a result, attributing the present Chinese financial system to a decentralized financial system seems feasible.

China's decentralized financial system reform, after reform and opening up, not only strengthened local financial autonomy, but also did not diminish central financial oversight. On the contrary, the decentralized reform of 1994 increased financial power concentration and made macroeconomic control easier for the central government. According to traditional reasoning, the downward transfer of financial authority and financial functions throughout the process of financial decentralization from the central government to the local government should minimize central financial control and promote local financial autonomy. However, there is another situation in modern China, which is that as fiscal decentralization occurs, there is a phenomena in which local fiscal autonomy and central fiscal autonomy expand in the same direction.

In general, when split by unitary and federal systems, unitary nations tend to concentrate financial resources more than federal countries; when separated by degree of development, developing countries are more likely to have a centralized financial structure than developed countries. In a unitary state, the central government has complete power, while local governments are subordinate to it. To ensure social stability in emerging nations, where the government encourages private investment and the central government gives financial subsidies, financial centralization must be implemented. China is both a unitary state and a growing nation. As a result, the features and necessity of financial concentration in unitary and emerging nations may be validated to some extent in China. Following the 1978 financial system reform, the decentralization of financial resources became apparent. However, the central government continues to wield veto power over tax laws and revenue-sharing percentage negotiations with local governments. As a result, even after the reform of the tax sharing system, China's financial system is merely formal decentralization, and measured by the share of fiscal income, it is still centralized,

but this does not exclude us from claiming that China has a fiscal decentralization phenomena.

Because the fiscal system reform implemented in China following reform and opening up, whether the fiscal contract system or the tax sharing system, has the nature of decentralization but differs from fiscal decentralization in the theoretical sense of Western fiscal federalism. The contemporary Chinese fiscal system can be referred to as "Chinese-style fiscal decentralization." The goal of financial concentration in developing countries is to achieve the goals of stability, growth, balance, economies of scale, control, and so on, and the achievement of these goals in contemporary China is dependent on political centralization, which naturally leads people to associate Chinese style financial decentralization with political centralization. We may argue that political centralization has become an important foundation for the establishment of Chinese-style fiscal decentralization, which is also a consensus that we must achieve.

Chines-style fiscal decentralization is the fiscal decentralization system under the political centralization system. Although local governments at all levels cannot plan revenue and spending independently as they can under the financial federal system, they may partially grasp financial autonomy through the tax sharing system and even increase the amount of non-tax revenue. Because of this financial system, in which local financial autonomy grows in lockstep with central financial control, fiscal decentralization with Chinese elements differs from fiscal decentralization in the theoretical sense of Western fiscal federalism.

#### **4. Decentralization Promotes Economic Development——Take Zhejiang Province for Example**

The central government develops the economy by delegating administrative power to local governments. The central government make the management system, tax rules and personal appointment and dismissal. From the perspective of system formulation, this is the embodiment of unitary centralization. The central government's aim is to strengthen national management capacity and prevent the negative efforts of weakening local power (Wang, 1995). However, due to China's large land area, large population, complex conditions in various regions and large gaps between the rich and the poor. Unitary system is not good for local economic development. This cannot stimulate economic development. Decentralization is mainly embodied in several aspects that allow local authorities to formulate regional development plans, allow local authorities to allocate resources on their own and allow local authorities to initiate investment of projects (Yu, J., & Gao, X., 2013). Therefore, China's fiscal decentralization is based on local autonomy under a politically centralized system. Local governments use the retained tax revenue to carry out economic development. In addition, the central government has introduced an official performance appraisal mechanism to increase the local stimulus effect on economic development. Local officials use the retained taxes in the region to allocate investment proportions and combine investment projects to promote regional development. Achieve the goal of overall tax increase in the next year and the goal of completing performance appraisal. Therefore, the local autonomy formed after the central government devolves local power can better increase taxation and develop the economy. This is conducive to the orderly growth of the national economy. Under the fiscal decentralization system, China's eastern region is a region where non-agricultural industries and non-state ownership are concentrated. Individual economies in the eastern region are relatively active. Let's take Zhejiang Province as an example to discuss how local governments use the retained tax revenue to invest in infrastructure and education in the process of autonomy to promote regional economic development.

##### **4.1. Local Governments Invest in Infrastructure to Develop Economy**

According to the model and data calculation results studied by Brehm, it is shown that: "Infrastructure is fully confirmed for the case of revenue decentralization; infrastructure investments have a positive impact on efficiency and this effect is stronger when the level of decentralization is high" (Brehm, 2013, P. 100). In terms of promoting economic growth, with the greater degree of local decentralization, the more active local officials are in the allocation efficiency of infrastructure investment, and the more obvious the impact on tax revenue. Therefore, decentralization has increased the autonomy of local infrastructure investment and played a positive role in local economic development.

The development characteristics of Zhejiang province are different from those of Guangdong province or Fujian province. Guangdong province and Fujian province use special economic zones to bring policy convenience. Zhejiang province is also different from the state's capital investment in Shanghai. Zhejiang province is mainly the development model of individual economy. Liu points out

that governments in China make extensive use of infrastructure investment, such as property development and land conversion as an important policy tool to attract new investors and generate additional income (Liu, C., 2011). Officials are more familiar with the region, they have a better understanding of people's preferences. In order to improve investment conditions in the region, Zhejiang provincial officials were keen to promote urban development through infrastructure construction in the early stages of economic development. Officials say building urban roads will improve the city's image and attract private investment. Local development of industrial parks with different themes can meet the new investment needs of private enterprises. The improvement of city image and city function is conducive to attracting private enterprises to set up factories and offices locally, driving local employment rate and increasing local tax revenue. This has a positive impact on the performance evaluation of cadres (Choi, E. K., 2009). Although fiscal decentralization does not play a direct role in economic development, with the decentralization of power and the setting of official performance evaluation, local officials focus on providing citizens with a better quality of life, and take advantage of infrastructure investment to stimulate local economic development.

#### ***4.2. Local Governments Invest in Education to Develop Economy***

After the decentralization of power from the central government to the local government, the allocation and adjustment of investment in education by the regional government will also affect the regional economic development. The central government requires local governments to increase the enrollment rate of primary schools, but increasing investment in primary education is likely to lead to a decline in the proportion of investment in secondary education (Lin, J., & Zhang, Y., 2006). After decentralization, local governments can increase the investment in secondary education through self-financing. The universal access of citizens to secondary education can solve the bottleneck of basic education and provide talent guarantee for vocational high schools and colleges. The local government provides more professional labor force for the society by increasing the budget investment of vocational high schools or colleges, such as improving school conditions, improving the treatment of teachers and creating employment practice opportunities. The improvement of conditions is attractive to talents. It is beneficial to cultivate talents for the society. Increasing professional labor force is in line with the characteristics of individual economic development in Zhejiang Province. Although the economic effect of education investment is not as obvious as that of infrastructure investment, it can help economic development in the long run. Talents choose their desired enterprises and cities in the form of foot voting. The government issues educational policies to cultivate talents. Talents promote the development of enterprises. Enterprises raise government taxes. The government, enterprises and talents form a triangle interaction model to meet each other's needs in a virtuous cycle and realize regional economic development. Therefore, decentralization can increase regional autonomy and allow local officials to formulate investment allocation strategies that are in line with regional development, thereby promoting economic development.

### **5. Conclusion**

The changes of China's fiscal system and tax reform prove that Chinese-style fiscal decentralization is a decentralization system of local administration under centralized power. The central government's main purpose in doing this is to encourage local economic development, which is not only beneficial to the central government, but also to local governments. Local governments have a real grasp of the realities of the area and understand people's preferences. Local government autonomy can make investment portfolio flexibly and make economy develop effectively. Based on the investment in infrastructure and education in Zhejiang province, which is rich in individual economy, this paper demonstrates fiscal decentralization is feasible in China and demonstrates the promotion effect of decentralization on economic development. In addition, in the process of decentralization, we found that some local officials engaged in short-term economic development to achieve rapid promotion, that is, they borrowed a large number of funds from banks or financial institutions to invest in infrastructure, resulting in a large number of hidden liabilities of the government. The local government is under great pressure to repay the loans, which is not conducive to the long-term development of the region. Therefore, for the fiscal decentralization system, how to control the excessive use of power by local officials is what we need to study and discuss in the next step.

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