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**Economic Reform Since 1978: Fiscal Decentralization**

Fiscal decentralization has been described, in both the Chinese official accounts and much of the Western-based literature, as the critical institutional reform that set the scene for the Chinese economic reform. The landmark development was the 1980 fiscal reform that allowed provincial governments a “residual claim” to the bulk of newly generated local revenues, and which the central government started with the aim of “tightening up, not letting go (revenues)” (Shirk 1993, p. 164). Fiscal revenues had become so dispersed in the aftermath of the Cultural Revolution (1966–1969) that by the late 1970s the central government had a hard time maintaining fiscal revenue at current levels. The idea of a multiyear fiscal contract thus appealed to the Ministry of Finance for the protection it rendered to central coffers. Local governments played an important part too, as several provinces experimented with new fiscal-sharing schemes during 1976 and 1977 in order to retain more local revenue. The 1980 fiscal reform was thus the product of the interaction of central and provincial considerations in a nonzero-sum game (Li 1998, p. 34).

**EXTENT: HOW DECENTRALIZED WAS THE CHINESE FISCAL SYSTEM AFTER 1980?**

The post-1980 fiscal system was generally described as highly decentralized largely due to its diversified nature. Whilst there were a number of general features and patterns across provinces, how revenues and expenditures were shared between each province and the central government, and how much was allotted to each side, were decided in confidential “bilateral” bargaining and “fiscal contracts” concluded between the central government and each and every province individually. Whilst tax laws prescribed a variety of taxes, these central-provincial negotiations included an estimation of total fiscal revenue and expenditure in the province, and, in case of a surplus, designation of a ratio of distribution of the surplus between central and provincial coffers. Alternatively, if a deficit was envisaged, negotiation would focus on the amount of central subsidy to finance the deficit (Wong et al. 1995, chap. 3).

The exact degree of decentralization is, however, difficult to ascertain given the complexity of fiscal flows across government levels and the lack of transparency as to how spending decisions are made. A customary method to define fiscal decentralization is through some measurement of the share of local revenue and/or expenditures. However, the actual central-local distribution of revenues is often unavailable, and revenue figures mostly employed in the economics literature refer largely to revenues collected by central or local governments (see Wong et al. 1995, pp. 92–93, for contracted and earmarked transfers, by province, 1985–1990). Because local governments were charged with the job of revenue collection for the central government until 1994 (when a separate national tax administration bureaucracy was for the first time established to collect central taxes), revenues (collected revenue) had always been, by definition, highly decentralized. Indeed, from this perspective revenues became less decentralized after the 1980 reform: subnational revenue share was 83 percent in 1979 and 60 percent in 1992 (for consistency, all revenue and expenditure figures in the entry are drawn from Chinese official sources). This conclusion is, however, misleading, because local revenue so defined also includes upward remittances to the central government.

Local expenditure statistics include spending financed by locally retained revenue (locally collected revenue minus remittances to the central government) and incoming central transfers; these are thus arguably a better indicator of the resources at local disposal, and of fiscal decentralization, than local revenue (collected) figures. Between 1979 and 1992, the share of local expenditure rose to 59 percent from 49 percent, suggesting increased dispersal of fiscal resources after the 1980 fiscal reform.

In 1994 the fiscal system had further major surgery. Province-specific contracts were scrapped and a rule-based tax-assignment system uniform to all provinces was put in place, with a new national tax administration to collect central revenue. Instead of sharing total revenue, the new system designated each tax category to either the central or provincial coffers, or to both, with each sharing a preset percentage of the tax, uniform across all provinces. For instance, tax/revenue items designated exclusively to central coffers include customs duties, value-added taxes on imports, excise tax, consumption tax, enterprise income tax, and profit remittances of central enterprises and banks; local revenue items include business tax, stamp tax, real estate taxes, vehicle-utilization taxes, inheritance and gift taxes, agricultural and animal-husbandry tax, slaughter tax, personal income tax, enterprise income tax and profit remittances of local enterprises, state land-sales revenues, capital-gains tax on land, contract tax, and so forth. Value-added tax and securities-trading tax are shared taxes, with the central government getting 75 percent of value-added tax revenues and 50 percent of the securities-trading tax. Personal income tax and enterprise income tax also became shared taxes from 2002 according to a transitional arrangement.

More revenue was consequently centralized: The share of central revenue surged to 55 percent in 1994 from 33 percent a year earlier. In the meantime, the decentralization of expenditure continued. By 2007, subnational spending accounted for three-quarters of total government expenditure. The widening gap between local revenue and spending filled by central transfer payments, which in 2007 financed nearly half of local spending. A question thus arises: To what extent do the transfers enhance central influence over local spending decisions? More research on the transfers system, central-local negotiations, and decision making on local expenditures is needed.

**SIGNIFICANCE: WAS FISCAL DECENTRALIZATION CONDUCIVE TO ECONOMIC GROWTH?**

The literature gives a mixed answer by focusing on different aspects of the question. The “fiscal federalism” literature argues that fiscal decentralization contributed to economic growth through territorial competition. Local officials were motivated to develop the local tax base since they were allowed a residual claim to the collected revenues. Akin to the property rights arguments, the fiscal federalism discourse asserts that subnational governments had operated with hardened budget constraints after the 1980 fiscal reform, and as a result became self-made business entrepreneurs and market reformers (Jin Hehui et al. 2005).

Others disagreed, stressing the lack of evidence of “hardened budgets” (e.g., the proliferation of soft bank loans), the rent-seeking and predatory behavior of many local governments, and continuous economic growth after the recentralizing tax-assignment reform in 1994. In other words, the fiscal federalism arguments cannot stand because their grounds are empirically invalid, incomplete, and irrelevant. More diverse explanations—for instance, the competition between central factions and the central-local linkage mechanisms synchronizing central and local incentives—are more plausible (Sinha 2005; Cai and Treisman 2006).

These two positions are *not* mutually exclusive on closer examination, however. The argument for the motivational effects of the post-1980 fiscal reforms does not preclude predatory government behaviors under some circumstances. Economic growth as an end result is contingent upon a wide range of factors, of which the behavior of local governments is only one. But where local governments are largely predatory, the local economy seldom prospers. The role of fiscal decentralization, and local government actions, in local and national economic development is a complex one. Problems in understanding arise when nuances are dismissed in the interest of a simplified picture. A credible short answer to the question posed above is: yes, but local governments do not act alone, and “conducive to” should not be conflated with “cause.”

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