

# **Asymmetry of Local Sharing Tax System in China**

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## **Summary**

After the application of tax sharing system in China, the financial revenue and expenditure between governments of all levels appear to be asymmetrical. It is represented by the fact that superior governments control the proportion of revenue in order to reinforce their capacities of macro-economic control; and increase their expenditure proportion through transfer payments in large scale so that the contradiction between centralization and decentralization could be coordinated. Obviously, the asymmetry of tax sharing system does coordinate the contradiction between centralization and decentralization, which improve largely the rapid economic growth in China. It is a result of a gradual convergence of the centralization theory and the decentralization theory. Chinese local sharing system presents also, in evidence, its asymmetry. This paper analyzes the problems of transfer payments and proposes the suggestions to ameliorate the tax sharing system.

**Key words:** tax sharing system, asymmetry

Since the economic reform in China, there exists a contradiction: the country's financial resources are reduced while local financial expenditure is augmented. Since the tax sharing system was carried out in 1994, the above cited contradiction was resolved by the asymmetrical financial revenue and expenditure, so that Chinese rapid economic growth was largely pushed forward. This paper is subjected to analyze this feature of the tax sharing system in both theoretical and practical ways, and propose the solutions correspondent to new problems induced.

## **I. The theoretical origins of the asymmetrical financial revenue and expenditure.**

So far, there exist two revenue and expenditure patterns in the global world, i.e. the symmetrical and the asymmetrical relationships between fiscal administrations of different levels.

### **1. Symmetrical revenue and expenditure**

The symmetrical revenue and expenditure mean that the proportions are almost kept equilibrated between financial revenue and expenditure of each administrative level in the total national revenue and expenditure. The central government launches in small scale transfer payments towards local financial administrations. The United-States are the best example of this pattern. (See Table 1) The American federal fiscal revenue weights 40% of the national total revenue, and a proportion of 33% in federal expenditure of the overall. Fiscal revenue and expenditure of the states occupy respectively 27% and 23% of the total. Those of local governments: 33% for revenue, 44% for the expenditure.

### **2. Asymmetrical revenue and expenditure**

On the contrary, the asymmetrical revenue and expenditure means the disproportions of local-leveled revenue and expenditure in the total, i.e. the fiscal budgetary plan is achieved by transfer payments from financial superior administrations to the inferiors. Japan represents this pattern. (See Table 1) In the years of 70, Japanese central fiscal administration controls 70% of the whole national revenue, while local governments occupy only 30%. But the expenditure of the former has a proportion of 30% in the whole national expenditure, while the latter dispense 70%. Local governments achieve their fiscal revenue and expenditure plan by transfer payments from their superiors.

### 3. Financial transfer payments

Financial transfer payments: the fiscal capitals, estates or services between governments of different levels are transferred from one government to another, without any cost. Scientific and standardized transfer payment system is not only an important part of a standard tax sharing fiscal system, but also one of the basic instruments to efficiently solve the unequal allocations of financial resources between governments, and realize the equality of regional public services and a coordinated development. In the aspects of symmetrical and asymmetrical revenue and expenditure, transfer payments have great differences. As U.S. carry out the symmetrical revenue and expenditure system, the proportion of transfer payments remains limited in the central expenditure budget: 17.8% in 1975, 18.4% in 1980, and 13.2% in 1983. On the contrary in an asymmetrical one, the subsidies that the Japanese central government gives to local governments occupy around 50% of the central fiscal expenditure budget.

In the international level, transfer payments can be divided into three categories: special transfer payment, transfer payment for different categories, and general transfer payment. The first one is usually used to subsidize concrete construction projects; the second one defines in general only the direction of the utilization of capitals to be granted, i.e. for education, environment protection, etc. As no concrete project is required, inferior governments have decision-making possibilities in this category. In order to keep the balance between different areas, the general transfer payment doesn't restrict the usage of granted capitals, so that poorer regions could have enough money to embody their governmental functions.

Table 1 U.S. & Japan comparison in local proportions of revenue and expenditure in that of the nation in 80's

	United States		Japan		
	revenue/total	expenditure/total		revenue/total	expenditure/total
Federal government	40%	33%	central	70%	30%
State government	27%	23%	local	30%	70%
Local government	33%	44%			

#### **4. The convergence of the centralization theory and the decentralization theory.**

The asymmetrical revenue and expenditure is the convergent result of the centralization theory and the decentralization theory. For the former, the absolute sovereignty theory was the most representative. They considered centralization as an extremely necessary method to ensure a country's supreme sovereignty. Engels pointed out in *Centralization and Freedom* that "centralization is the nature and life basis of a country"<sup>1</sup>. Goodland Connaught thought also, that to insist centralization is aimed to reflect better the State wills. If a country is committed to an independent and uncontrolled local political community, State wills are to be changed, which leads to a disintegration of the whole county<sup>2</sup>.

Since then, the modern centralization theory had a great development, gradually approaching to the decentralization theory. To some points of view, centralization and decentralization should be different according to different modernization stages. At the early industrialization and economic crisis, centralization is at the major position to favor the application of planning and allocating monopolized resources, in order to go through the economic crisis by State power. During the other periods, decentralization of powers should be encouraged and activated. Afterwards, the financial aid theories supported that the central government can equalize the relationships between regions, and continue to keep the centralized influence and power. We can see the centralization theory on its developing way on emphasis of decentralization.

The decentralization theory was created the first in the "Local authority" theory of Tore in 1789. In his opinion, the local authority is not inherited from history, nor granted by the superiors, but belongs to public organizations themselves. Since then on, the decentralization theory was pushed forward in its development. For example, in

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<sup>1</sup>Engels: *Collection of Marx and Engels* (Beijing: People's Publishing House, 1980):396

<sup>2</sup>Goodland Connaught, *Politics and Administration* (Beijing: Huaxia Publishing House, 1987):28-29

federalism, autonomy belongs to the local government from its nature, so the legitimacy of the federal government's national-wide powers should be transferred from local authorities.

Another approach of the modern decentralization theory is Constitutionalism which emphasizes the importance of Centralism. The legalization of local authorities is originated from the guarantee of Constitution. The central government and local governments coexist with cooperation rather than opposition. The constitution should guarantee the separation of powers; strengthen the supervision and equalization of these powers for governments of each level. In the aspects of financial decentralism, local governments are considered to possess a certain powers on fiscal revenue rights and expenditure responsibilities, and they can make their own decisions on the scale and the structure of expenditure budget. The creation and development of the decentralization theory indicate that the modern decentralization theory doesn't exclude centralization, but seeks the cooperation and coordination between central and local governments.

As a conclusion, the above two theories concerning the relationship between governments have both experienced a long-term development, and have already appeared a convergent trend. The coexistence of centralization and decentralization has become the basic tendency of each country in the world, indicated by some scholars<sup>1</sup>. The founder of the science of economic policy, J. Tinbergen, not only confirmed the objectivity of the coexistence between centralism and decentralism, but also proposed a foundation to coordinate the centralism and decentralism policies<sup>2</sup>. The cooperation between the central government and local governments will always keep both contradiction and equilibrium accompanied. The asymmetrical financial

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<sup>1</sup>Xiaoyun YANG, etc., "Inspiration and mode of coordinating the relationship between the central and local governments in western countries", *Research on Politics* (February, 1999)

<sup>2</sup> J. Tinbergen, *Centralization and Decentralization of Economic Policies* (Netherlands: Amsterdam Publishing House, 1954)

revenue and expenditure is exactly the product of this trend, and the result of coordinating the contradiction between centralization and decentralization policies. On one hand the importance of the national financial centralization is insisted, that the central government controls the main part of financial revenue. On the other hand, the role of local governments is paid attention, so that the local financial expenditure has a relatively high proportion. Because the local finance can improve the national economy, an asymmetrical form of revenue and expenditure is thus established.

## **II. Asymmetry of tax sharing system in China**

### **1. The asymmetry between the central and the local revenue and expenditure.**

At the beginning of Chinese economic reform, local fiscal revenue and expenditure have both a proportion of 70% in the national whole revenue and expenditure. Local financial resources were rapidly increased, which largely improved the local economic development. But vicious competitions had been triggered, and the gap of different regions had been enlarged. Since the central government obtained far less revenue than local ones, it had less capacities of controlling financial resources. Before 1994, the severe inflation broke out for 4 times, with the inflation rate at 9.3%, 18.8%, 14.7%, 24.1%.

In order to reinforce the central government's capacity on macro-economic control, China carried out the tax sharing system between central government and the provinces since 1994. The central government's revenue was increased to 50% of the total national fiscal revenue, which strengthened largely the macro-control of the central government. The fiscal revenue and expenditure appeared to be obviously asymmetrical. (See Table 2) In 1980 and 1993, the central revenues occupied only 24.5% and 33.8% in the overall, while local revenue had the proportions of 75.5% and 66.2% respectively. Since 1994, the central revenue was kept above 50% of the whole fiscal revenue in most years; the highest one was 55%, while local fiscal revenue's

proportion was decreased below 50%. But the local expenditure had always around 70% in the overall expenditure; the highest one reached 75% in 2006.

Table 2 Central and local fiscal revenue and expenditure's proportion to the national ones %

Year	80	93	94	95	96	97	98	99	00	01	02	03	04	05	06
Central Revenue	24.5	33.8	55.7	52.2	49.4	48.9	49.5	51.1	52.2	52.4	55.0	54.6	54.9	52.3	52.8
Local Revenue	75.5	66.2	44.3	47.8	50.6	51.1	51.5	48.9	47.8	47.6	45.0	45.4	45.1	47.7	47.2
Central Expenditure	after transfer	30.3	29.2	27.1	27.4	28.9	31.5	34.7	30.5	30.7	30.1	27.7	25.9	24.7	
Local Expenditure	after transfer	69.7	70.8	72.9	72.6	71.1	68.5	65.3	69.5	69.3	69.9	72.3	74.1	75.3	

Source: *Chinese Statistical Yearbook 2007*

## 2. The necessity of the central government to control the main fiscal revenue

The reasons of which the central government should control most of the fiscal revenues are: firstly, compared to other countries in the world, Chinese central fiscal revenue's proportion is not only lower than that in developed countries but even lower than that of developing countries. In 1994, it contributed only 11.8% of GDP, not only lower than that of U.S. 34.4%, of France 46.5%, but also lower than that of Indonesia 17%<sup>1</sup>. Secondly, in China it occurred several times the vicious competitions between different regions. In order to avoid the irrational production and the deterioration of local industrial structures in such regions, the central government needs to guide and coordinate the industries between regions by financial resources. Thirdly, China is lacking of well equipped infrastructures coherent with the industrialization stage. The central government must centralize the financial resources to achieve the large-scale public constructions, i.e. transport networks as railways, highways and airports; the networks of electricity, cables and telecommunications in urban and rural areas; the environment protection as flood and sand control projects, which are far away from their achievements. Fourthly, the procedure of the economic reform in China is so complicated that emergencies and accidents could happen all the time. As the central

<sup>1</sup>IMF, *Government Finance Statistics Yearbook 1990*

government controls the most part of the fiscal revenue, these economic emergencies could be adjusted and controlled in time.

### **3. The necessity of local governments' fiscal expenditure to occupy the most part of the national expenditure in China**

However, with the economic development in China, local governments' expenditure has an increasing tendency. The main reasons are:

1) Urbanization constructions and national infrastructures need a very large expense from local governments.

The Chinese urbanization was as low as only 17.92%<sup>1</sup> in 1978. With the efforts during 30 years, it reached 44.9% in 2007<sup>2</sup>. But it is far away from the standard proportion of 70% in industrialized countries. Therefore the development of big-scaled industrial zones, transportation infrastructure, electricity and water supply system, etc. is mainly depending on fiscal expenses of local governments. If financial resources are not sufficient at local level, they will have a direct affect on local urbanization procedure.

Then as China launches huge constructions in national infrastructure, these projects should be also connected with local infrastructures, for example the extension of a town-leveled highway, etc. If the local government doesn't invest sufficiently in this part, the national infrastructure will remain idle which causes the waste of financial resources.

2) The adjustment of the industrial structure depends on local governments

The local government is positioned at the best place to know the local features and resources advantages. In aspects of mineral production, local products, geography, climate, and labor specialties, etc., they could adjust the industrial structure and make

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<sup>1</sup>China Statistics Yearbook 2007

<sup>2</sup>National Bureau of Statistics of China, *The statistics gazette on national economy and social development in 2007* (28<sup>th</sup> February, 2008)

use of their advantages according to their resource features. In the other side, the central government can coordinate the main industry and department at the national level, in order to control the industrial disproportion and coordinate the industrial relations between regions. Nevertheless, local public needs, the supply-demand situation and resource advantages of each region cannot be deeply acquired at the central level. Thus, optimization and adjustment of the Chinese industrial structure should be finally dependent on local governments.

3) The heavy employment pressure needs to be solved by local economic development.

The unemployment rate in China remains always high, which is not only a waste of human resources, but also a constraint key to limit the revenue, consumption capacity and economic growth. During the economic development, the local government has the best knowledge on the employment situation and the demand of the local public, like the bankruptcy or propriety transfer of a company, layoffs of corporate enterprises, laid-off workers and migrant workers on wage, etc. At the same time, according to the local resources and geographical advantages, the local government is able to enlarge the scale of an industry or a company and public services in a targeted manner, so as to propose ways and means appropriate to the local public needs. Laid-off workers could be re-employed, the inflow and outflow of the labor could be well organized, so that the employment problem in the region could be solved.

As a metropolitan, Shanghai has evident differences in employment compared to the other cities or provinces. After having studied the local features, the employment issue is solved out through informal employment organizations or associations by developing the industries adapted to a metropolitan as urban industry, community services, etc. This kind of organizations have been developed to a number of 10 thousands, among which 300 have been developed to formal small companies that

absorbed already thousands of unemployed people and introduced these informal employment into a standardized management channels. They created the first example for a metropolitan to manage the informal employment, which attracted the high attention of ILO (International Labor Organization) with their appraisals.

Therefore, the increase of Chinese local governments' fiscal expenditure meets the objective requirements of the modern economic development, in accordance with the current development of the global economy. After World War II, it prevailed in each country an augmentation of their fiscal expenditure. Developed countries and developing countries were both on their way to increase their fiscal expenditures. The apparition of the urbanization procedure in each country was the main reason, which reflected the objective requirements of local economic developments and of local habitants for living with a higher quality. As these public expenses demanded huge costs, the local expenditures were largely raised. So the specialists thought that the requirements of the local governments towards the central governments for decentralization in administrative rights and benefits should be "irreproachable and difficult to prohibit"<sup>1</sup>.

#### **4. The transfer payment from the central government to local ones.**

Therefore, there appeared the fierce conflicts between governments of each level on their fiscal revenue and expenditure. The central revenue needs to be kept in a high proportion, in order to retain enough capacities and initiatives in its macro-economic control; while local economies play a gradually important role as a main driving force to the national economy. To resolve this contradiction, after the application of tax sharing system in China, thus occurred an obvious asymmetry. The central government obtained half of the financial revenue. With its transfer payments towards local governments in large scale, the proportion of local expenditure was increased towards

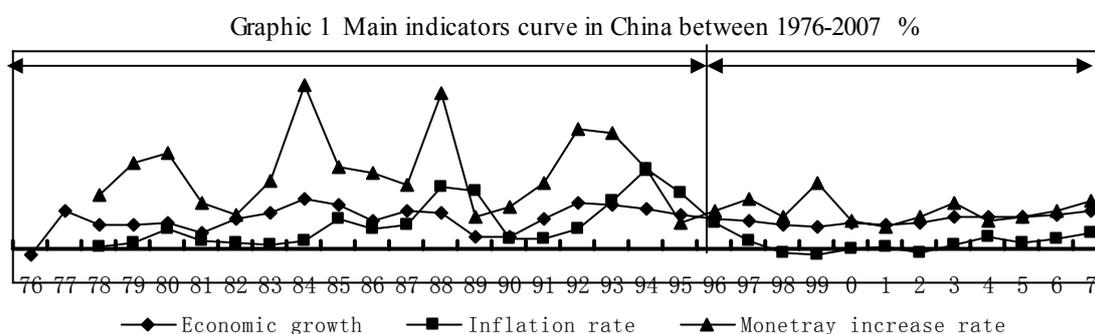
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<sup>1</sup>Xinqiao PING, *Comparison of Financial Foundations and System* (SUP Bookstore/Shanghai Sanlian, April,1995): 371-375

70%. The supports from the central are reinforced to its inferiors, which improve the high economic growth in China.

There are 3 categories of transfer payments in China. 1) Tax revenue returns: when a local government expenses more than its local tax revenue plus its sharing tax revenue, the central government returns the difference (its expenditure minus its revenue from taxes). The amount of return is defined by the growth rate of national fiscal revenue (1:0.5). According to the degree of poverty, this rate could be increased. 2) Special-purpose funding: the central government grants the funds in alternative to local social services and economic construction projects, for example in education and medical domains. 3) Special appropriation: when big natural catastrophes and other major accidents occurred in a region.

The practices have proved that the asymmetry of tax sharing system meets the requirements of Chinese economic development on the current stage. Thanks to the financial decentralization, local economies play a driving-force role in the national economy, and the macro-economy is kept stable by national centralized powers. Since 1994, the economic growths in China appeared to be stable on its increasing way. (See Graphic 1)



Source: referenced to Chinese Statistics Yearbooks

### III. The asymmetry of local tax sharing system in Shanghai

Before 2000, it was a symmetrical fiscal revenue and expenditure in Shanghai municipality and districts. But in the municipal level, the fiscal revenue and expenditure kept always few proportion of the total, for example in 2004 and 2005 around 35%; while at district levels, the two figures remained around 65% (See Table 3). After the achievement of the tax sharing system reform in 2006, the asymmetrical features appeared to be more and more obvious. The municipal revenue was raised by 50%; but at district levels, the expenditure was raised upon 65%. The asymmetry of fiscal revenue and expenditure in Shanghai is also coordinated between superior and inferior relationships by transfer payments.

Table 3 Revenue and expenditure proportions in municipality and districts between 2000-2007 %

Year	2000	2004	2005	2006	2007
Municipal revenue	43.3	36.7	38.6	48.9	51.5
District-leveled revenue	56.7	63.3	61.4	51.1	48.5
Municipal expenditure	46.8	35.5	35.5	32.7	35.0
District-leveled expenditure	53.2	64.5	64.5	67.3	65.0

Source: Shanghai Statistics Yearbook

#### 1. The contents of transfer payments of local tax sharing system in Shanghai.

Transfer payments in Shanghai can be classified by special transfer payment and general transfer payment. The former includes tax revenue returns and so on in order to equalize the revenue level as same as that before the fiscal reform. General transfer payment includes three categories:

- 1) Replenishment of differences in public projects: subsidize the area which cannot reach the standard criteria defined in the expenditure of public projects. For example, we define the minimum guarantee criteria in Shanghai for science popularization, culture, library, national-wide fitness, family planning and compulsory education. If a district or a town cannot reach these standards due to

the lack of money, the differences can be granted by its superior leveled administration.

- 2) Special projects: the allocation by projects including caring facilities for senior farmers, grain field construction, rural cooperative medical services, and relocation due to public construction projects, etc.
- 3) Financial aid: according to different situations of financial resources in each district, the municipality gives a lump-sum grant for poverty-stricken towns where financial resources per habitant remain low.

## **2. The effects of transfer payments**

- 1) Transfer payments replenish efficiently the capital gap.

One of the objectives of transfer payment is to make up the lack of financial resources between governments and ensure their harmonized developments in regional economy and social public services. According to the statistics of a poverty-stricken district in Shanghai, the transfer payments like tax revenue returns occupied 28.39% of the total revenue of this district in 2004, 24.57% in 2005. We can see from these proportions that the capital transferred by its superior government have reached nearly  $\frac{1}{4}$  of its total revenue.

- 2) Improve the quality of public expenditure

As local governments don't have the same capacity in revenue and expenditure, it causes thus the differences on service capacity on public projects. The general transfer payment is subjected to keep equivalence on public services between different regions.

By the general payment transfer, Nanhui Town in Shanghai raised its science popularization funds from 0 to 3 RMB per habitant, 1 RMB/person to 8 RMB in national-wide fitness, 11 RMB/person to 30 RMB in fire prevention and security.

Through the transfer payment, the input of public projects for the poorer district reached or approached to the municipal average standard. The differences between the districts were reduced and the level of public services was achieved to be equilibrated.

### **3. Defaults and ameliorations of current transfer payments**

With the Chinese economic development, the labor flows into the cities are increased. In several districts of Shanghai augmented 100 thousand people coming from other areas out of Shanghai. Every year large amounts of expenses are put into social security, education, medical insurance, green maintenance etc. The range of public services is fiercely enlarged, and then the defaults of the payment transfer seem to be gradually merged.

- 1) The proportions of the general transfer payment are too low in public expenditure use.

In the financial transfer system, the mostly used category is tax revenue returns in special transfer payment, in order to mainly maintain the fiscal quality of governments of districts and towns. However, the proportion of the general payment transfer, which plays the role of equalization, remains too low. For example in the district Nanhui the revenue of general transfer was only 5.18% of their total revenue in 2004, 4.33% in 2005. The low general transfer is not able to equalize the public services level for each region.

The application of tax sharing system in cities and provinces provides the conditions to ameliorate transfer payments. The latter needs a certain scale to guarantee their application, since sufficient money is needed to resolve the unbalance between regions, in order to relieve the increasing trends of regional financial differences. The author of this paper suggests that the municipality or provincial government reserves a part of their revenue from the sharing tax to establish a fund for the transfer payment, to guarantee a fix and increasing financial source.

2) The projects and contents of transfer payments are not enough regulated.

As the public services' functions are strengthened, the governments of each level demands more and more financial resources. Therefore the projects needed to be paid by transfer are increasing, and then these projects themselves become more and more complicated. However some projects don't have a unified and transparent calculation standard, lacking of the systematical restriction and data statistics evidences.

So the supervision of transfer payments has to be reinforced, the legal system should be completed and ameliorated by defining the correspondent "Transfer Payment Management Regulations". The regulations will define their objectives, principles, forms, capital usages. By these legal means, transfer payments will be included in the budgetary planning so that the local governments of each administrative level could be able to manage them. Then, the capital use should be examined, managed and supervised, in order to prevent the concerned funds from misappropriation. Audit inspection is compulsory in utilization of each fund. Those who violate the regulations should be severely punished; who violate the law should be brought to justice. A supervision system should be thus established by NPC (National People's Congress), the auditing departments, and the financial supervision departments of each administrative level as well as the whole society. Thirdly, a democratic supervision as the budget participation can be introduced into the system. So far it prevails in European countries the budget participation, which organizes the citizens to participate in the discussion and supervision on the public expenditure's standards of budgets. This method can provide the references to define the rational transfer payment standards and help to supervise the execution of the budgets. In some aspects, the defaults in transfer payments could be replenished in this way.

In conclusion, the main default of the asymmetrical financial revenue and expenditure: unable to avoid the errors caused by subjectivity or randomness during the

administrative management. It is supposed to be a transitive form adapted to the current economic development and financial situation in China. Along with the economic development and the amelioration of Chinese tax sharing system, a symmetrical tax sharing system will be eventually achieved.

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