

Intergovernmental Fiscal Relation in China

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ABSTRACT— *Conventionally, the Chinese fiscal and revenue collection system has been highly centralized with almost no-taxation power for local governments as well as control over their budget. Local governments have been bound to remit most of the taxes to central government who in turn transferred it back to them in accordance with their needs and requirements. In the year 1980, Fiscal Contracting System (FCS) was introduced to decentralize the fiscal scheme by adopting some features of Western Market-Economy. It proved economical because by administering the local affairs at local level weigh down the fiscal burden at part of the central government. The evaluation of the inter-regional fiscal system reflects that the FCS has brought substantial fiscal autonomy for sub-national governments which enabled them to expand their contribution towards national economic growth through remitting fix share to national exchequer. The whole tax system was categorized into three levels: central, regional, and joint central/regional level taxes while the inheriting principle of dual supervision has made local governments accountable to the higher levels. But contradiction between theory and practice of Chinese governance pertaining to intergovernmental fiscal relations is particularly posturing immense challenges for establishment of a transparent and equitable fiscal system.*

Keywords: Fiscal Contracting System (FCS), Western Market-Economy, Intergovernmental Fiscal Relations, Public Policy & Governance, China.

1. INTRODUCTION

During last two decade's rapid globalization, scientific advancements and the revolution in information technology have changed the entire socio-political and economic fundamentals of the globe. It has turned the national cultures and life styles to a trans-national culture and entangled people across the world. But at the same time, its associated problems such as unemployment, poverty, inadequate health facilities, ethno-religious controversies and environmental dilapidation have also distended the gap between promises and performance of national governments. Consequently, the formal authority of central state has been eroded and relocated both upward to supra-national socio-economic and political institutions across the globe and downward to decentralized sub-national, regional or local governments. In simple words, the globalization has turned the concept of government to more composite order of Governance.

Factually, the concept of legitimate, efficient and receptive decentralized governance revolves around the principles of devolution of authority and direct interactions between governments and its citizens. Decentralized governance has several dimensions; politically it brings government closer to people and promotes the concepts of liberty, equality, welfare and national integration. It is economical because by managing the local affairs at local level reduce the expenses and burden at part of the central government. Socially, public participation in policy making process at grassroots level creates the sense of citizenship, ownership and allegiance among the citizens and thus helps the central government to resolve socio-cultural and ethnic differences within a diverse entity.

According to De Tocqueville and John Stuart Mill, local political institutions serve as the school or training institutions for local people and provide for better accountability and control than other administrative agencies within the society. The concept of local or sub-national government is as old as the history of humankind even it predates the emergence of nation-state and has been considered as one of the most effective tool capable of delivering various social services at grass root level by reducing the power of bureaucracy. The ancient Greek city states were synonymous to present day local or municipal governments. After the French Revolution (1789-1799), Napoleon introduced local

government system for highly centralized Napoleonic states based on the Napoleonic traditions of dual supervision and unbroken chain of command. The post Second World War era appeared with the idea that the economic development and distribution of public services should be harmonized across the countries and decentralized governments could be the most apt tool for achieving this objective.

During the decade of 1980, the charter of self-local government was introduced and later on it was adopted by the Council of Europe. It also recognized that only the principles of democracy and citizens' participation can protect and strengthen the idea of democratic Europe. Like most of the East Asian countries having the traditions of strong and centralized central governments, the Chinese constitution also recognizes the need of establishing sub-national governments at level of regions on the basis of the Franco-British model which revolves around the principle of strong central control with dual supervisions. Since 1979, the Chinese authorities have made tremendous efforts to reform Chinese local governance in the light of new challenges of globalization.

2. OBJECTIVE OF THE STUDY

This study intends to explore into the matter if the division of authority pertaining to financial resources at different levels of the government in China has rightly responded to the challenges of globalization or not?

3. BACKGROUND

In China "local government" refers to all types of sub-national governments. The large population and area of China has always been in need of some kind of administrative divisions since ancient times. The prior most division in administrations was dynasty of QIN in China. That was based on two different levels:

- Jun Commanderies
- Xian Counties

The three tier structure was formed as a result of dynasty of Han. Thereafter, such system remained effective till dynasty of Song. The Sui as well as Tang dynasty had abolished Commanderies. The Sui Dynasty and Tang Dynasty abolished Commanderies by introducing circuits on top level. The Yuan Dynasty under Mongol by introducing a new tier to provinces brought the number of levels to four. This system lasted in China till the last imperial dynasty, the Qing Dynasty. During the early 20th century, attempts were made to extend political administration beyond the County level and hence, the Townships government below the level of Counties appeared. In 1949, the Constitution of People's Republic of China officially recognized Provinces, Counties, and Townships as the administrative divisions. Later on, to provide better administrative support, two more levels Prefecture and Village were included as sub-levels of Province and Township. As of December 31, 2005, China was divided into 33 Provincial-level regions (includes 23 Provinces, 5 Autonomous Regions and 3 Cities), 333 Prefectural-level regions, 2,862 County-level regions (includes County, Autonomous County, County-Level City, Banner, Autonomous Banner, Forest Districts, Industrial Districts, Agricultural Districts, Districts of the City under the Jurisdiction of Province, Sub-Districts of the Apex Municipalities, etc.), about 41,636 Township-level regions and more than 704,386 Village-level regions. (Figure 1 & 2)

Each level of government has its own People's Congress to perform supervisory functions within its specific jurisdiction. The Deputies to the People's Congresses of Provinces and Counties are elected for the term of five years by direct vote, while the Deputies to the People's congresses in Cities, Municipalities, Sub-District and Townships levels are elected by the People's Congresses of the higher level governments. Conventionally, the Chinese fiscal and revenue collection system has been highly centralized with almost no-taxation power for local governments as well as control over their budget. Local governments have been bound to remit most of the taxes to central government who in turn transferred it back to them in accordance with their needs and requirements. Therefore, the matters related to organization and distribution of local revenues and finances have been remained the permanent bone of contention between the Central and sub-national governments since a very long time.

4. CHINA'S FISCAL CONTRACTING SYSTEM (FCS)

In the year 1980, Chinese government initiated a reform strategy and a Fiscal Contracting System (FCS) was introduced to decentralize the fiscal system by adopting some features of Western Market-Economy. The issues related to the central grants to local governments and the remittance from the regions to the central exchequer were to be defined through mutual contracts between the central and local governments. The FCS brought considerable autonomy for regional governments with regards to organizing local revenue and enabled them to expand their contribution towards national economic growth through remitting fix share to national exchequer. On the whole, these reforms were successful and during the next decade of reforms, the overall GDP growth remained at the highest level of 9%. The major part of income received from the bodies at local levels was often termed as immediate reasons for the economic development within the period during that period. However, even with high growth rates, the actual performance of local governments

with regards to overall revenue collections and share of remittance to central government declined sharply in 1990 up to the level that had been too lower in comparison to the average level exhibited by the underdeveloped countries within the period. The performance of Chinese local government within an international context can be seen through the comparative table.

Table 1: Showing Performance of Chinese Local Government in International Context

Countries	Share of Subnational Governments (in percent of total)			
	Revenues		Expenditures	
	1990	1997	1990	1997
Argentina	38.2	41.1	46.3	43.9
Australia	20.0	22.7	50.9	47.9
China	33.8	48.8	67.4	72.6
Germany	28.9	28.8	40.2	37.8
India	33.0	36.1	51.1	53.3
Indonesia	2.9	2.9	13.1	14.8
Mexico	19.0	20.6	17.8	26.1
Russian Federation	...	40.6	...	37.6
South Africa	5.5	5.3	20.7	49.8
United States	33.8	32.9	42.0	46.4

The data mentioned in the table reflects the whole equation. It can easily be observed that though, the local remittance to central government has remained at highest level as compared to other countries, but unluckily the amount of local expenditure also stretched out. The increase in expenditure in turn increased the rate of central subsidies for local or provincial governments and exerted extra burden upon central exchequer.

The critics of Chinese decentralization strategy have held FCS responsible for the situation. They regarded the new system as the strategy to “eat from other’s kitchens”. Furthermore, they held responsible the bargaining power of sub-national governments for the decline in the local share to central exchequer because under new arrangement the flow of net shares of local revenue towards central exchequer was to be defined purely on the basis of overall fiscal capacity of local governments but these flexible bilateral contracts have encouraged the sub-national governments to make false and exaggerated presentations regarding the provincial expenditures. The manipulated fiscal accounts had not only facilitated local governments in lessening their share of transfer of revenue to central government but also affected the overall National Policy Making process in China. Consequently, by showing fragile economy, the wealthy and privileged provinces succeeded in putting aside most of the local revenue under the heads of safe pools and further accelerated already expanding horizontal imbalances across the provinces.

Several established theories of decentralization have already recognized that central government must have effective control over the collection, administration and redistribution of tax revenue for preserving equality and transparency in the process of inter-regional redistribution of revenue across the country. Realizing the gravity of the problem, in 1994 Chinese policy makers finally decided to strike the root cause of the problem. They introduced comprehensive tax reform intended to bring transparency and equality in the process of collection and redistribution of revenue. The main objectives of the reforms were as under:

- to simplify the tax system
- eliminate misrepresentation from the regional governments
- suitable change and interventions in the assignments pertaining to revenue at several levels of the government
- the switching of the main fiscal system by eradicating the temporary transfer to new transparent revenue based tasks and assignments

5. TAX SHARING AT NATIONAL AND LOCAL LEVELS

The major result of comprehensive tax reform was the simplification of Chinese tax system in line with market-oriented Western economies. The whole tax system was categorized into three levels: central, regional, and joint central/regional government. The State Bureau of Tax Administration was made responsible for levying taxes under Central and joint central/regional levels while the regional tax administration got the responsibilities to look after the regional or sub-national tax collection.

Table 2: Composition of Taxes' Sharing at National and Local Levels

Categories	Composition of Taxes
Taxes at National Level	<ol style="list-style-type: none"> 1. Tax on Consumption 2. Tax on Vessel Tonnage 3. Import, Export and Custom Charges 4. Tax on Purchase of Vehicle
Taxes at Local Level	<ol style="list-style-type: none"> 1. Tax on Real Estate particular in Urban Areas 2. Tax on Fixed Assets and House Property 3. Maintenance Tax for Citizenship or Township 4. Tax on Occupying Land 5. Tax on Tobacco 6. Tax on Investment 7. Tax on Deed 8. Tax on Land Appreciation
Sharing Taxes	<ol style="list-style-type: none"> 1. <i>Value Added Taxes (VAT)</i>: The federal Government as well the local body of the city secures the major percentage of the VAT collected at domestic levels i.e. 75: 25. VAT is levied on imports and charged by customs. 2. <i>Income Tax on Enterprise</i>: It includes all sources other than part that belong directly to the federal Government as ruled. The rest is divided in between centre and local bodies with the ration of 60:40. Incomes from Railways, Postal Services, Industrial and Commercial banks, State Owned Banks, Natural Oil and Gas Company are directly belonging to the federal government. 3. <i>Tax on individual's income</i>: The text levied on individual's income is distributed among federal and local government with the ration of 60: 40. 4. <i>Tax on business activity</i>: The income earned from state owned banks, railways and insurance companies on business activities are received by federal government and rest goes to local bodies. 5. <i>Duty on stamp</i>: The major portion of the tax that is being levied on security transactions goes to the federal government i.e. 97% and the remaining 3% of the tax collected goes to the local body. 6. <i>Tax on maintenance and construction Tax</i> 7. <i>Resource Tax</i>: The income received from the oil enterprises that are working off-shore goes to the federal government. (N/A for now) and the remaining goes to the local bodies.

While using the technique of re-allocation of taxes and introduction of new national tax service, the government succeeded in setting up two separate sources of revenue with different ratios. In the year 2002, the revenue collected by the federal government raised up to 18% of the total gross domestic product. The federal government also increased the budgeted revenue from 22% (1993) to 50 % (2002). The accumulation of revenues in the centre also increased the central transfers to sub-national governments from 1.5 % (1993) to 6 % (2001) being part of gross domestic product. The oversimplification of the tax system and distribution mechanism has changed the major assignments pertaining to finance and revenue into several levels of the government and eradicated to some extent, misrepresentation or false representations from the provinces. But still the fiscal imbalance in revenue sharing, inequality of revenue redistribution and uneven development across the regional government in China have been undermining the efforts toward shifting the fiscal relationships from temporary transfers to other assignments pertaining to revenue based on transparency.

6. CONCLUSION

The evaluation of the inter-regional fiscal system reflects the initial efforts to decentralize entire fiscal system for the sake of providing sub-national governments an effective assistance for delivery of public services at local level. But sooner it was realized that the provincial fiscal autonomy has undermined the entire process of decentralization in China. It was realized that for the successful and meaningful fiscal decentralization, the central government must have effective

control over the policy formulation, administration, collection, and allocation of tax revenue. In this regard, several attempts were made to reform the fiscal relations in accordance with the established principles of decentralization.

In theory, the Central Government in China can still exercise tight control over the finances of the provinces because (1) Chinese economy is largely consisted upon state-owned enterprises, which account for about 75 percent of the state revenues therefore central authorities have very key role in determining the investment programs and formulating wage and subsidies policies. (2) The inheriting principle of dual supervision has made the sub-national governments accountable to the higher levels. (3) In Chinese local governance, the National People Congresses of province have the right to elect the administrative officers for local governments who though, serve within the institutional framework of regional governments but being the member of Chinese Communist Party serves as agents of Central government and is accountable only to the central government. (4) The principle of dual supervision has also minimized the bargaining powers of wealthy provincial governments and discouraged the practice of “eating from other’s kitchens”.

However, the review of the literature about Chinese fiscal decentralization has revealed that in practice, the overlapping of responsibilities of central and regional government has minimized the effectiveness of central controls. The introduction of FCS at various levels has also increased the capacity of regional governments with regards to providing services and the volume of their shares in the national economic development has also been expanding. It can be concluded that the contradiction between theory and practice of Chinese governance, especially with regard to intergovernmental fiscal relations have still been posturing enormous challenges for the establishment of transparent, just and accountable fiscal system.

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Figure 1: Map of the provinces showing linkage among various tiers of Chinese Governance

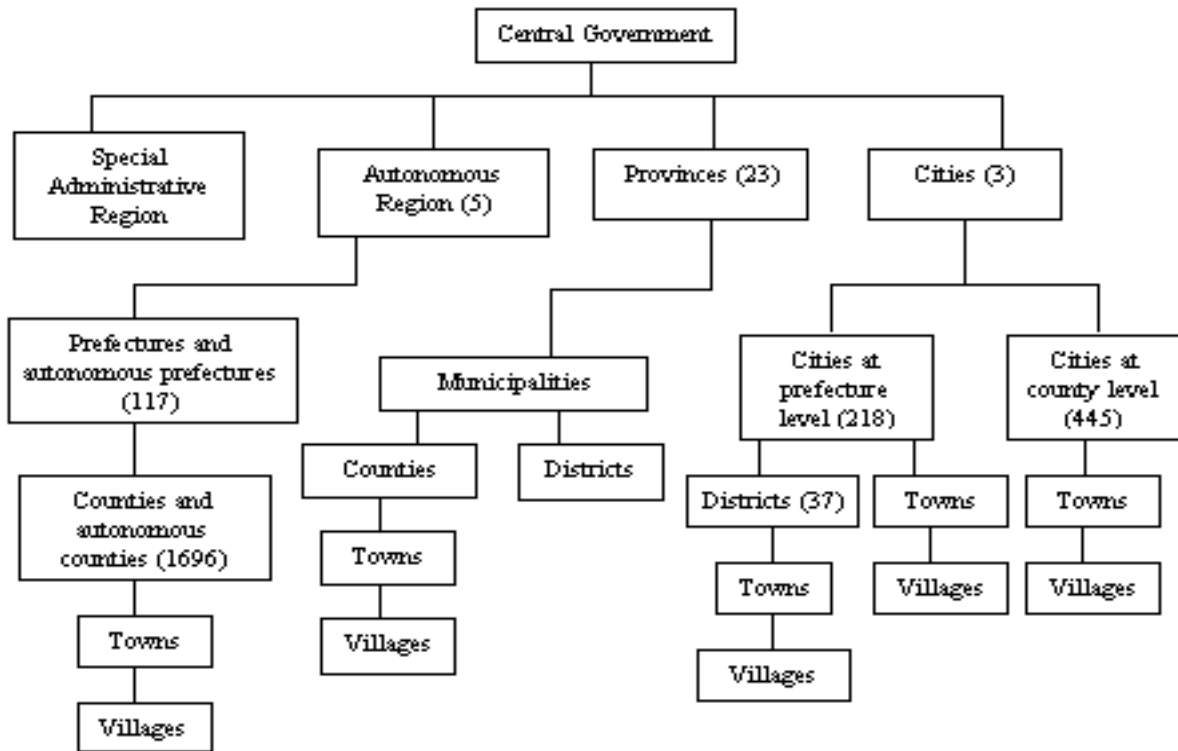


Figure 2: Chart showing linkage among various tiers of Chinese Governance