

# On Measuring the Scale and Effects of Fiscal Equalization Grants in China

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JEL Codes: H5, H7 and R1

## *Abstract*

Among China's current central-local fiscal grants system, general fiscal transfers is the only type of grants applied for fiscal equalization purpose. Its scale and effects have been the major determinants for evaluating equalization effectiveness of the overall central-provincial fiscal adjustment system. After analysing the development trend in the scale of China's general fiscal transfers and measuring the effectiveness of the overall central-provincial fiscal transfers by newly-designed indicators, this paper finds out that the relative small scale of general fiscal transfers is the main factor to explain current undesirable equalization effects of the overall central-provincial fiscal transfers. In order to effectively address regional fiscal disparities, it is recommended then that China's current fiscal transfer system should be improved with an attempt to further increase the relative scale of general fiscal transfers.

## **1. Introduction**

As an important component of intergovernmental fiscal transfer system in China, general fiscal transfers (hereafter GFT) is a kind of equalization grants, goal of which is oriented to fill the financial gap of fiscal indigent regions, equalize fiscal disparities among regions and realize balanced government abilities to deliver basic public services among regions.

After the 1994 tax-sharing reform, China gradually established and improved its fiscal transfer system between central and provincial governments by drawing relevant international experience and taking into account its actual national conditions. As the

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sole type of fiscal transfers used for equalization purpose, GFT<sup>2</sup> has played an irreplaceable role in equalizing regional fiscal disparities and boosting coordinated social and economic development. Hence, the scale of GFT becomes extraordinarily significant when evaluating effectiveness of the whole fiscal transfer system in China.

Due to the constraints of data availability<sup>3</sup>, most of the previous studies on China's GFT drew the conclusion that the effect of GFT is unsatisfactory either by normative judgements (Zhu Ling, 1997) or by a simple comparison between the scales GFT and other relevant indicators such as central government revenue (Chen and Xu, 2004). Apart from the above, other studies do try to judging the effectiveness by analysing the development trend of regional fiscal disparities such as the Gini coefficient of per capita regional fiscal expenditure (Liu and Jiao, 2002).

Ideally, as the main and direct goal of GFT is to equalize regional fiscal disparities, a better measurement of the equalization effectiveness of GFT should be one able to take account of both sides of fiscal equalization, that is, the revenue capacities of relevant governments before and after fiscal equalization. In view of this, the objective of this paper is to try to design some satisfactory indicators, based on the scale of GFT, to accurately measure the equalization effectiveness of GFT.

By doing this, this paper contributes to the existing methodology used to measure the effects of intergovernmental equalization grants. Also, detailed policy recommendations in the paper given after relevant analysis should also be helpful for China's future adjustments on its central-provincial fiscal transfer system.

Besides the introduction, the paper consists of five parts. The first part is a summary of theoretical cases for horizontal fiscal transfers. Then, an introduction and analysis is given on types and structure of current central-provincial fiscal transfers in Part 2. As the main body and thrust of the paper, Part 3 goes into a deep analysis on the growth trend of GFT scale and the equalization effectiveness of GFT. Based on the above discussion, relevant policy recommendations are proposed in Part 4 which are aimed to improve current transfer system and further increase the scale of GFT. At last, Part 5 is a brief conclusion of the paper.

## **2. Theoretical Underpins of Fiscal Equalization**

Theoretically, the equalization of regional fiscal disparities (Horizontal Fiscal Equalization) is necessary from both equity and efficiency perspectives.

For the aspect of fiscal equity, one generally accepted principle regarding horizontal equity is "equal treatment of equals", which was first proposed by James Buchanan in 1950. According to Buchanan, in a federation, those who have equal economic status and thus incurred equal tax burdens should also enjoy equal fiscal benefits (public

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<sup>2</sup> System subsidies under China's traditional financial contracts system before 1994 also featured the equalization characteristics of GFT. As a supplemental measure of the tax-sharing reform, GFT was introduced in 1995 and was originally named *traditional fiscal transfers*, funds of which came for a part of annual central revenue growth and were mainly used to ethnic minority regions. After the reform on income tax sharing in 2002, traditional fiscal transfers was renamed GFT.

<sup>3</sup> In China, some crucial data regarding measuring the effects fiscal transfers are not published, such as each province's claimants in total transfers.

services). In reality, however, due to different demographic composition and natural endowments of different regions, those equals dwelling in different regions have enjoyed different levels of public services. That shows, according to Buchanan, horizontal fiscal inequity has appeared as a result of the different fiscal residua (the gap between tax burdens and fiscal benefits) facing those equals. Consequently, there is a need for the federal or central government to restore horizontal fiscal equity by way of launching horizontal fiscal equalization. From such an equity perspective, the basic aim of fiscal equalisation grants from the upper level governments is ‘to enable citizens of the low-income states’ ‘to be placed in positions of fiscal equality with their equals in other states’ (Buchanan, 1950, p.596).

As regards the efficiency perspective, it is argued that efficiency loss would be resulted in without relevant horizontal fiscal equalization measures in place. The efficiency case for fiscal equalization is closely related to the above-mentioned principle of horizontal fiscal equity. For the equals who live in different regions, if they want to enjoy a comparably same level of public service under the background of horizontal fiscal inequity, those dwelling in poor regions would pay their taxes according to higher rates than those living in rich regions. The existence of such a disparity would then provide an incentive for those from poor regions to move to rich regions in an attempt to either reduce their current tax burdens or enjoy a higher level of public service. Such a regional migration will result in efficiency loss in view of following reasons: firstly, migration itself is costly and would lead to waste of resources (Oates W. E, 1972, p.83); secondly, other things being equal, economic efficiency is viable and improved only when the migration is induced by regional disparities in either actual production factors such as labour and technology or those factors relevant to the effective utilization of economic resources. Under the above fiscally-induced regional migration settings, however, the migration is contradictive to efficiency improvement as it is only induced by different fiscal treatments among regions.

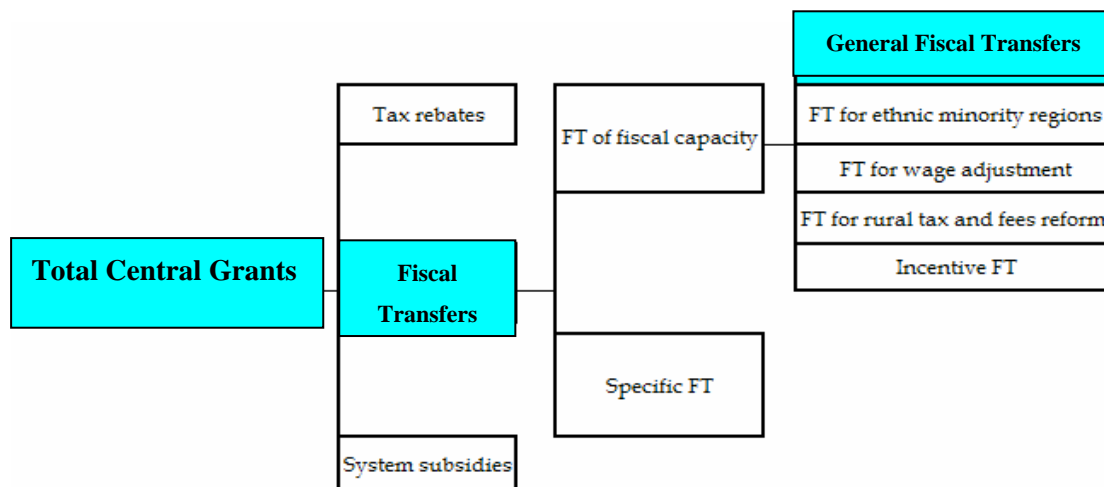
### **3. Types and Structure of Current Central-provincial Fiscal Transfers in China**

Normatively speaking, the starting point for analysing GFT should be to understand its position in the whole central-provincial fiscal transfer system. In China, the concept of fiscal transfers is relatively indistinct among the academic circle as the same term (*fiscal transfers, caizheng zhuan yi zhifu*) is often used to refer to three different relevant concepts which are not at the same level of the whole fiscal transfer system. They are, from top to bottom, total central grants, fiscal transfers and GFT. The mid-scaled one, fiscal transfers, covers specific fiscal transfers and transfers to enhance fiscal capacity, a part of which is GFT. While the total central grants, also called *central subsidies to local*, includes all of the free fiscal funds granted to provincial governments by the central. In addition to fiscal transfers, it also covers tax rebates and system subsidies<sup>4</sup>. The relationship among the three kinds of transfers is shown in Figure 1.

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<sup>4</sup> Tax rebates in China cover rebates of VAT and consumption tax revenue, income tax rebates and rebates of

**Figure 1: Structure of China's Current Central-provincial fiscal transfer system**



Note: FT refers to fiscal transfers.

As regards various components of the total central grants, the equalization effectiveness of fiscal transfer funds is mainly played by *fiscal transfers of fiscal capacity*. Currently, fiscal transfers of fiscal capacity from the central to provincial governments includes GFT, *fiscal transfers to ethnic minority regions*, *fiscal transfers of incentive purpose*, *fiscal transfers of wage adjustment* and *fiscal transfers of rural tax and fees reform*. The latter two types of fiscal transfers were both introduced under the background of implementation of specific macro-regulation and control policies initiated by the central government, which would lead to revenue reduction or expenditure increase for local public finances. Due to this reason, funds for these two types of fiscal transfers are used in stipulated purposes and could not increase local governments' disposable revenue, which is not directly advantageous to the realization of fiscal equalization. Only the GFT and fiscal transfers to ethnic minority regions directly increase local governments' disposable revenue and contain strong equalization purpose.

#### 4. The Growth Trend and Equalization Effects of GFT

The scale of GFT has maintained a rapid growth trend since 1995. However, analysis from whatever the angle of the relative scale of GFT and the changes in fiscal disparities among regions in recent years show that it is necessary for China to further strengthen its GFT between central and provincial governments.

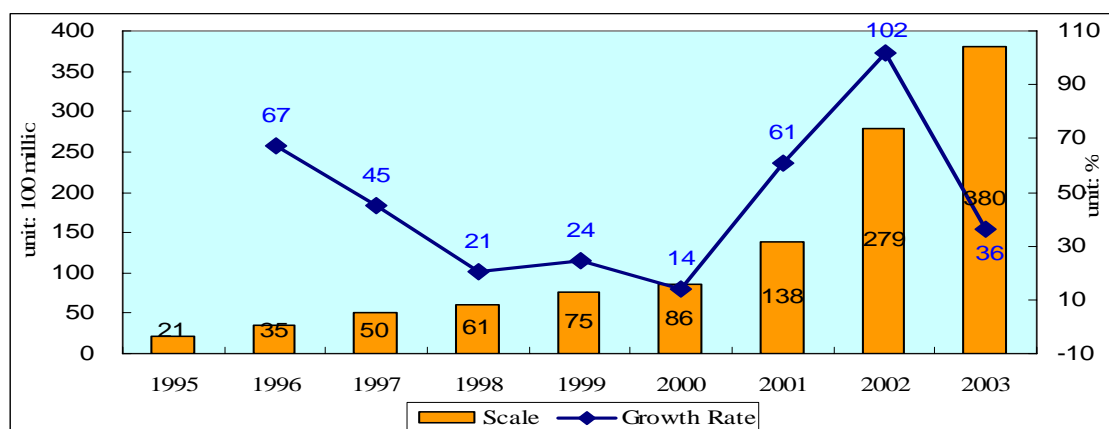
From 1995 to 2003, GFT in China grew from 2.1 billion to 38 billion, increasing 18.4 folds or an annual growth rate of 144.9% (Figure 2). An analysis on the growth trend shows that, the growth rate of GFT generally exhibited a declining trend before 2000 while after that it increased greatly, especially in 2002 as the reform on income tax-sharing was implemented and it is stipulated that central government's revenue

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export tax refund; while system subsidies include the original system subsidies under the fiscal contract regime, quota subsidies of fiscal settlements and etc.

increase as a result of the reform would be totally used for GFT to provincial governments.

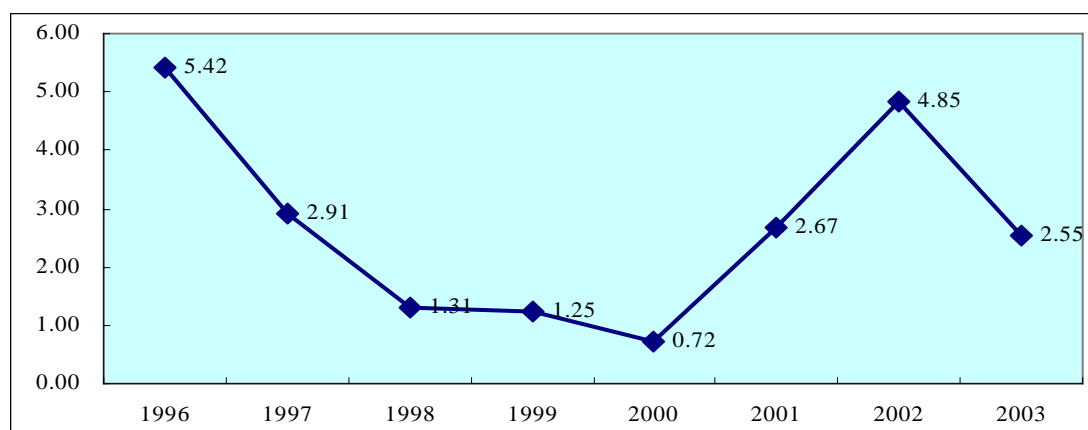
**Figure 2: Scale and Growth Trend of GFT 1995-2003**



Source: *Statistical Data of Local Public Finances*, various issues.

With regard to the growth elasticity of GFT, from 1995 to 2003, the annual elasticity coefficient<sup>5</sup> was all above 1 except that of 2000 (Figure 3), which means the growth rate of GFT generally exceeds that of central fiscal revenue during this period. The elasticity coefficient even hit 5.42 and 4.85 in 1996 and 2002, respectively. The reason is that for 1996, GFT was just introduced in 1995 and the base amount was rather low (2.1 billion yuan); while for 2002, the high coefficient was mainly attributed to the fast growth of GFT as a result of the income tax-sharing reform implemented then.

**Figure 3: Elasticity Coefficient of GFT in China 1996-2003**



Source: *China's Yearbook of Finance*, various issues; *Statistical Data of Local Public Finances*, various issues.

Although GFT in China has experienced fast growth in recent years, a comparative analysis shows that the scale of current China's GFT is still at a low level. Table 1

<sup>5</sup> The elasticity coefficient refers to the ratio of the growth rate of GFT to that of central fiscal revenue in the same year.

reflects ratios of GFT to total central grants and local fiscal expenditure from 1995 to 2003. Obviously, the ratio of GFT to total central grants exhibited a growing trend year by year, which shows that the equalization purpose of central government's overall fiscal transfers to local governments has been strengthened gradually. In the meantime, the ratio of GFT to local fiscal expenditure has also been growing, tending to prove the fact that the dependence of local public finances on central government's fiscal transfers is increasing. However, the above-mentioned two ratios are still at a lower level, compared with those of the typical market economies. For example, the central fiscal transfers in Britain consist of equalization grants, special grants and formula-based grants. The equalization grants are allocated through annual budget procedure, the amount of which stood at 44 billion pounds and accounted for 85.3% of total central fiscal transfers in the year of 2003-2004; while the special grants and formula-based grants are allocated through special procedures and the aggregate amount of these two types hit 7.6 billion pounds and accounted for 14.7% of the total central fiscal transfers in the same year. Meanwhile, local fiscal expenditure in Britain amounted to 115.8 billion pounds and the ratio of equalization grants to local fiscal expenditure was 38%<sup>6</sup>. However, the two ratios in China in 2003 only stood at 4.6% and 2.2%, respectively.

**Table 1: Changes in the Relative Scale of GFT**

Unit: 100 million yuan

Year	GFT	Total Central Grants	Local Fiscal Expenditure	Ratios of GFT (%)	
				Total Central Grants	Local Fiscal Expenditure
1995	20.7	2534.1	4828.3	0.8	0.4
1996	34.6	2722.5	5786.3	1.3	0.6
1997	50.2	2856.7	6701.1	1.8	0.7
1998	60.5	3321.5	7672.6	1.8	0.8
1999	75.3	4086.6	9035.3	1.8	0.8
2000	85.9	4665.3	10366.7	1.8	0.8
2001	138.2	6002.0	13134.6	2.3	1.1
2002	279.1	7351.8	15281.5	3.8	1.8
2003	380.3	8240.0	17229.9	4.6	2.2

Source: China's Yearbook of Finance 2004; Statistical Data of Local Public Finances, various issues.

The relatively small scale has withheld general fiscal transfers' role in equalizing regional fiscal disparities. Equalization effectiveness of the total transfers can be indicated by two measurements. The first one is *absolute indicator* which is calculated by the gap between Gini coefficients of per capita revenue and expenditure. The second one is defined as *relative indicator*. Being the ratio of the absolute indicator to the Gini coefficient of per capita fiscal revenue, this indicator is intended to explain how much of the original revenue disparities would be equalized by fiscal transfers. For both of the indicators, the bigger their figures, the more effective of fiscal transfers.

<sup>6</sup> Website of HM Treasury: <http://www.hm-treasury.gov.uk/>

According to Table 2, from 1994 to 2003, the absolute indicator for China increased from 0.038 to 0.108, which shows growing effectiveness of the total transfers in equalizing provincial fiscal disparities. However, such growing equalization effectiveness does not automatically lead to a desirably balanced pattern of provincial fiscal performance as the Gini coefficient of per capita provincial expenditure is still on an increase from 0.320 in 1994 to 0.340 in 2003. Also, although the relative indicator during this period has exhibited a growing trend from 10.6% in 1994 to 24.1% in 2003, it is still at a low level which is proved by the fact that only roughly one quarter of the original regional revenue disparities has been equalized as a result of fiscal transfers.

**Table 2: Indicators for the Effectiveness of China's Central-provincial Fiscal Transfers**

Year	Revenue Per Capita	Expenditure Per Capita	Effectiveness Of Transfers	
			Absolute Indicator	Relative Indicator
	A	B	C=A-B	D=(C/A)%
1994	0.358	0.320	0.038	10.6
1995	0.386	0.331	0.055	14.2
1996	0.389	0.326	0.062	15.9
1997	0.399	0.336	0.062	15.5
1998	0.401	0.332	0.069	17.2
1999	0.411	0.332	0.079	19.2
2000	0.413	0.318	0.095	23.0
2001	0.439	0.330	0.110	25.1
2002	0.446	0.336	0.110	24.7
2003	0.449	0.340	0.108	24.1

Source: calculated based on data from China's Yearbook of Finance and China Statistical Yearbook, various issues.

The growing regional fiscal disparities can be defined more clearly by using Theil entropy which is able to decompose the total inequality into two parts: within-region inequality and between-region inequality. From 1994 to 2003, the between-region<sup>7</sup> Theil index of per capita provincial revenue grew from 0.0814 to 0.1723 along with an increased contributing share from 42.9% to 60.6% (Table 3). After fiscal transfers, Theil index of the expenditure side is generally smaller than the revenue one but the between-region Theil index of the expenditure side is still on a rise, the contributing share of which to the total provincial expenditure disparities increased from 28.5% in 1994 to 34.9% in 2003.

**Table 3: Theil Index of Provincial per Capita Revenue and Expenditure**

<sup>7</sup> Regions here are defined according to the generally-accepted division of eastern, central and western regions.

Year	Revenue Per Capita			Expenditure Per Capita		
	National Total	Between-region		National Total	Between-region	
		Index	Contribution %		Index	Contribution %
1994	0.1895	0.0814	42.9	0.1238	0.0352	28.5
1995	0.1983	0.0894	45.1	0.1358	0.0433	31.9
1996	0.1976	0.0907	45.9	0.1334	0.0439	32.9
1997	0.2047	0.0953	46.6	0.1433	0.0475	33.1
1998	0.2083	0.1016	48.8	0.1405	0.0496	35.3
1999	0.2229	0.1161	52.1	0.1404	0.0465	33.1
2000	0.2322	0.1344	57.9	0.1296	0.0440	33.9
2001	0.2692	0.1659	61.6	0.1269	0.0405	31.9
2002	0.2793	0.1662	59.5	0.1278	0.0398	31.2
2003	0.2846	0.1723	60.6	0.1394	0.0487	34.9

Source: calculated based on data from China's Yearbook of Finance and China Statistical Yearbook, various issues.

To summarize, China's central-provincial fiscal transfers have only partially achieved its goal to equalize regional fiscal disparities which is still growing though the inequality in per capita expenditure is less obvious, as a result of the transfers, than that of per capita revenue.

This unsatisfactory equalization effectiveness of current fiscal transfers stems from not the scale of the total central grants but that of the general fiscal transfers relative to the total, or its share in the total central grants. To prove this, correlations between equalization effectiveness of the transfers and the relative scales of total central grants and general fiscal transfers are calculated below. The results show that the relative correlation between the relative scale of total central grants, measured by the ratio of total central grants to aggregate provincial fiscal expenditure, and the equalization effectiveness of fiscal transfers, is insignificant. However, the relative scale of general fiscal transfers is significantly correlated with the equalization effectiveness of fiscal transfers which is indicated by the gap between Gini coefficients of per capita revenue and expenditure.

As a result, it is safe to argue that in an attempt to improve the equalization effects of its central-provincial fiscal transfers, China should further increase the funds for general fiscal transfers and aggrandize the relative scale of it.

**Correlations Between Equalization Effects (EET) and  
Relative Scale of Total Fiscal Transfers (RSt)**

		EET	RSt
EET	Pearson Correlation	1	.305
	Sig. (2-tailed)		.425
	N	9	9
RSt	Pearson Correlation	.305	1
	Sig. (2-tailed)	.425	
	N	9	9

**Correlations Between Equalization Effects (EET) and  
Relative Scale of General Fiscal Transfers (RSg)**

		EET	RSg
EET	Pearson Correlation	1	.809**
	Sig. (2-tailed)		.008
	N	9	9
RSg	Pearson Correlation	.809**	1
	Sig. (2-tailed)	.008	
	N	9	9

\*\*. Correlation is significant at the 0.01 level

## 5. Policy Recommendations for Increasing the Scale of GFT

The growing disparity of public services among regions would not only hamper realization of China’s strategic development goals, but also endanger normal operation of government functions at grassroots level in fiscally difficult regions. Hence, as well as adopting various measures to accelerate the development of less-developed regions, the top priority now is to put effort to increase the scale of GFT and gradually set up a new mechanism for the stable growth of funds for GFT so that fiscal support to central and west regions could be further strengthened and the growing fiscal disparity among regions would be effectively addressed. Relevant recommendations in this regard are as follows:

### **1) To consolidate and incorporate different types of fiscal transfers and increase the scale of GFT in the short-run.**

Firstly, to put in order and decrease the number of current items of specific fiscal transfers, and strictly control introduction of new specific transfers items in accordance with the division of intergovernmental expenditure responsibilities. As regards the responsibilities of local governments, the central government should not arrange specific fiscal transfers. Meanwhile, the obsolete and overlapping items should be abolished as well as the scale of specific fiscal transfers strictly controlled. Besides, the annual newly-increased funds for large-scaled fiscal transfers shall be allocated with the emphasis on GFT with an attempt to gradually increase the percentage of GFT in the large-scaled central fiscal transfers.

Secondly, with regard to the types of fiscal transfers introduced as a result of the implementation of specific macro-regulation and control policies, such as fiscal transfers of wage adjustment and that of rural tax and fees reform, as those transfers have already become vested revenues of local governments, it would not be realistic to abolish them along with the withdrawal of relevant macro-regulation and control policies. An alternative way is to gradually incorporate funds for those types of fiscal transfers into GFT and allocate them through equalization formulas.

Thirdly, to abolish tax rebates in a timely manner. Current central tax rebates include tax rebates of VAT and consumption tax, income tax rebates and rebates of export tax refund. Introduction of all these types of tax rebates were to return local fiscal revenue reduction as a result of relevant reforms on central and local tax-sharing system to local governments according to the principle of maintaining local vested interests. This kind of special arrangements is exclusively aimed at boosting the smooth implementation of the reforms and hence features strong transitional characteristics. Under such a kind of tax rebate system, the more developed a region is, the more rebates it will receive as it suffers more revenue reduction due to relevant reforms. Obviously, China's current tax rebate system would not be beneficial to ease regional fiscal disparities but become an institutional arrangement to widen such disparities. Therefore, it is necessary to abolish current tax rebates and incorporate these funds into GFT. However, in view of the rigidity of local vested interests, the process of abolishment and incorporation should follow a principle of *progressive, incrementalism* and *prudence*. *Progressive* means to abolish different types of tax rebates from small-scaled one to large-scaled one. That is, to abolish rebates of export tax refund first, then income tax rebates and tax rebates of VAT and consumption tax at last. *Incrementalism* means to reduce the rebate scale according to a declining ratio year by year during a certain period, say three to five years, in order to mitigate possible revenue shock induced by the abolishment. *Prudence* means that the central government should enunciate that the central revenue increase as a result of the abolishment would be totally used for GFT in a view to win local governments' support, maintain the image of central government and guarantee smooth implementation of the reform.

## **2) To use annual fiscal revenue exceeding the budgeted figure to increase the scale of GFT**

Whatever due to the enhanced revenue administration ability of taxation bureaus or the conservative principle applied for budget formulation process, fiscal revenue exceeding the budgeted figure has appeared every year since the 1994 tax-sharing reform. Also, the scale of this kind of "unexpected" revenue is not small and account for an average 7% of China's annual total fiscal revenue. In 2004, it even hit 278.6 billion yuan, 10.6% of the total fiscal revenue (Table 4).

**Table 4: Fiscal Revenue Exceeding the Budgeted Figure in China 1994-2004**

Unit: 100 million yuan

Year	Fiscal Revenue	Actually Increased Revenue	Budgeted Revenue	Budgeted Increased Revenue	Revenue Exceeding Budgeted Figure	Ratio of Revenue Exceeding Budgeted Figure to Fiscal Revenue	Ratio of Revenue Exceeding Budgeted Figure to Actually Increased Revenue
1994	5218.10	869.15	4759.95	411.00	458.15	8.8%	52.7%
1995	6242.20	1024.10	5692.4	474.30	549.80	8.8%	53.7%
1996	7407.99	1165.79	6872.18	629.98	535.81	7.2%	46.0%
1997	8651.14	1243.15	8397.94	989.95	253.20	2.9%	20.4%
1998	9875.95	1224.81	9683.68	1032.54	192.27	1.9%	15.7%
1999	11444.08	1568.13	10809.00	933.05	635.08	5.5%	40.5%
2000	13395.23	1951.15	12338.00	893.92	1057.23	7.9%	54.2%
2001	16386.04	2990.81	14760.20	1364.97	1625.84	9.9%	54.4%
2002	18903.64	2517.60	18015.00	1628.96	888.64	4.7%	35.3%
2003	21715.25	2811.61	20501.00	1597.36	1214.25	5.6%	43.2%
2004	26355.88	4640.63	23570.00	1854.75	2785.88	10.6%	60.0%
Total	145595.50	22006.93	135399.35	11810.78	10196.15	7.0%	46.3%

Source: *China's Yearbook of Finance*, various issues; annual central and local budget reports.

According to relevant stipulations from China's *Budget Law*, fiscal revenue exceeding the budgeted figure should be mainly used to reduce fiscal deficits and add to expenditure. However, this kind of revenue in China in recent years has been exclusively used to add to expenditure, mainly those items suffering insufficient budgeted amount<sup>8</sup>. In 2004, the central government allocated 32.1 billion yuan of the revenue exceeding the budgeted figure to finance its large-scaled fiscal transfers to local governments, which only accounted 12.6% of the total amount of this kind of revenue in the same year. If we exclude other types of the large-scaled fiscal transfers, the exceeded revenue used for GFT in 2004 would be even smaller.

As a result, in view of the relatively stable amount of revenue exceeding the budgeted figure and the low scale of GFT in China, it is recommended that the central government may stipulates that a certain proportion, say 50%, of the annual central revenue exceeding the budgeted figure would be used to GFT in order to fully realize the utilization effects of those funds and further strengthen the efforts to equalize regional disparities in delivering public services.

### 3) To gradually establish a reliable mechanism for the funds source of GFT

When designing intergovernmental fiscal transfers, mature market economies normally follow an important principle of foreseeability. That is, fiscal transfers of the upper level governments must have stable funds sources so that the scale of fiscal

<sup>8</sup> "Fiscal Revenue Exceeding the Budgeted Figure Amounts to 300 Billion Yuan: China's Macroeconomic Regulation Is Facing Challenges", *21<sup>st</sup> Economic Report*, Nov 6, 2004.

transfers enjoyed by the lower level governments would be foreseeable and hence their budget formulation could be enhanced<sup>9</sup>

In this regard, a common practice adopted by some typical market economies is to designate revenues from certain taxes as the funds source for central fiscal transfers of equalization to local governments. Japan's equalization grants (*local allocation tax*) are financed through four sources: 32% of revenue from personal and company income taxes, 25% of revenue from tobacco tax and 24% of that from consumption tax<sup>10</sup>. In Germany, VAT sharing is not only an important tax-sharing arrangement but also a kind of fiscal transfers of equalization purpose. The sharing ratio of VAT between the federal government and landers was fixed as 63:37 in 1993 and 1994, 56:44 in 1995 and 50.5:49.5 in 1996 and 1997. For the aggregate VAT revenue shared by the landers, 75% of it are allocated to landers according to per capita national average and population of each lander, while the left 25% are allocated to landers whose taxation capacity (per capita tax revenue) are lower than that of the national average<sup>11</sup>.

However, there is only one clearly-defined funds source for China's GFT, which is the increased revenue of the central government as a result of the income tax-sharing reform implemented in 2002. Not only the scale of this part of revenue is rather small<sup>12</sup>, but also its stability is not satisfying due to impacts on current income tax-sharing structure between the central and local governments caused by the drafted reforms on enterprise income tax. As a result, in an attempt to introduce a sustainable and reliable mechanism of the funds source for GFT in the long-run, it would be wise to further reform current income tax-sharing system and incorporate the part of revenue shared by local governments (40% of income tax revenue) into GFT. Indeed, such a reform would cause impacts on local revenue structure and it must be planned with a broader view to other adjustments on central and local tax-sharing system as well as the improvements on local tax system.

#### **4) To establish and improve relevant supplemental measures**

To increase the scale of GFT is the fundamental condition for boosting China's equalization process. Meanwhile, it is also needed to actively establish and improve relevant supplemental measures in order to guarantee the utmost effectiveness of fiscal transfer funds. A supervision and evaluation system on GFT funds should be introduced. Different from that of the specific fiscal transfers, local governments have full autonomy in utilizing GFT funds and it is difficult to track the utilization effects of the funds. In view of this, it is recommended to launch an overall supervision and assessment on performance of local governments enjoying GFT in order to guarantee

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<sup>9</sup> Kou Tiejun, *Research on Central and Local Fiscal Relations*, Dalian, Northeast Finance and Economic Press, 1996, p.86.

<sup>10</sup> Ma Jun, *Research on Intergovernmental Fiscal Transfers: International Experience and Its reference for China*, Beijing, China Financial and Economic Press, Jan 1998, p.36.

<sup>11</sup> Ma Jun, *Research on Intergovernmental Fiscal Transfers: International Experience and Its reference for China*, Beijing, China Financial and Economic Press, Jan 1998, p.80.

<sup>12</sup> Before the income tax-sharing reform, the central and local governments in China shared enterprise income taxes according to the jurisdiction of each enterprise. While after that, the central and local governments share all of the personal and enterprise income taxes according to a fixed ratio (now it is 60:40). Under such an arrangement, local governments not only enjoy 40% of the revenue from income taxes but also receive relevant income tax rebates. Therefore, the increased revenue of central government as a result of the reform is limited.

GFT funds are allocated to fields of basic public services such as compulsory education.

## **6. Conclusion**

Having considered the development trend in the scale of China's GFT and its equalization effectiveness, the first conclusion of the paper is that despite the rapid growth in GFT scale in recent years, the equalization effectiveness of China's GFT is still poor as it is not able to reverse the growing trend in regional fiscal disparities.

The second conclusion is that for China's future reform and adjustment on its central-provincial fiscal relations, a priority should be given to further equalize the relatively sharp regional disparities. When doing so, it is indispensable that a powerful GFT system shall be in place through relevant improvements on the overall central-provincial fiscal transfer system.

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