

Why Fiscal Capacity Equalisation is not Feasible for China

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Introduction

- China's provincial governments rely heavily on annual fiscal transfers from central government.
- Distribution of these transfers does not systematically favour the poor provinces
- Many observers advocate augmentation of fiscal capacity equalisation (FCE).
- Feasibility of FCE for China is questioned and an alternative approach is suggested

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Fiscal Decentralisation in China - 1

- Five levels of government in China
 - 1 central government;
 - 31 Provinces, Autonomous Regions and provincial level municipalities;
 - 331 Prefectures;
 - 2109 Counties; and
 - 44741 Townships

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Fiscal Decentralisation in China - 2

- Public spending is highly decentralised and local governments are responsible for 70% of total budgetary spending.
- Revenue from 'Local' taxes can finance only around 52% of local spending. The remaining budgetary spending is financed by central fiscal transfers.

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Distribution of Fiscal Transfers

- No single formula is used for distributing these transfers
- FCE is applied to distributing only a small share of total transfers
- A large share is returned to rich provinces in which tax revenue is mostly raised.
- The rest is distributed according to central government programs.

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Overall Distribution: Summary

- No clear pattern in distribution
- Several wealthier provinces receive above average transfers per capita, as well as several poorer provinces receive below average transfers
- A pattern emerges, however, when provinces with ethnic minority populations are excluded

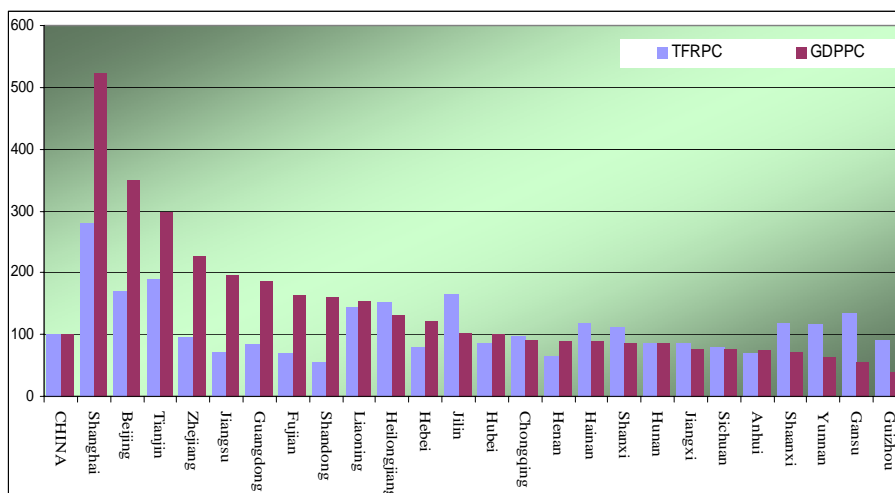
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Actual Distribution 2004 (100 m. yuan)

Region	Actual Distribution	Per Capita Distribution (yuan)
Eastern Region	3352	814
Central Region	4080	698
Western Region	2990	948
National Total	10422	805

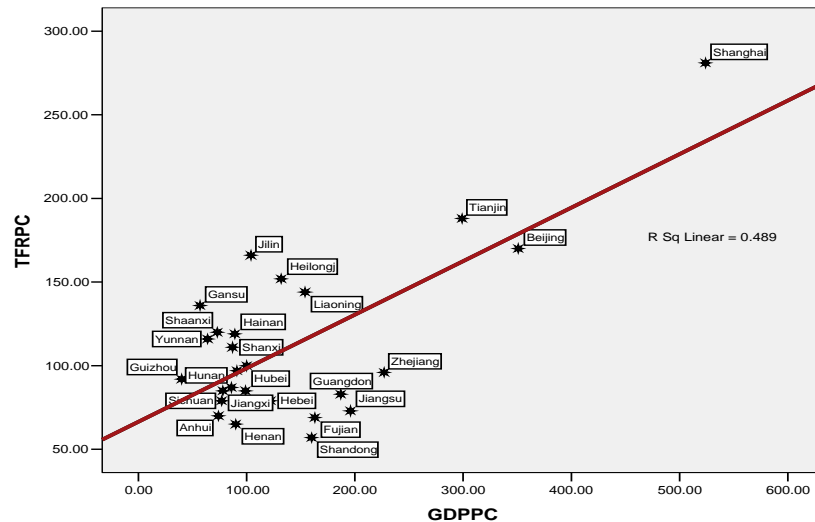
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Overall Distribution - 1



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Overall Distribution - 2



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Fiscal Capacity Equalisation

- Ahmad et al (2004); Wong (2002); World Bank (1997) & others advocate more fiscal capacity equalisation
- FCE implies that grant entitlements of the provinces are strictly based on measures of fiscal capacity.
- It also implies that negative entitlements may be assessed for provinces with above average fiscal capacity (e.g. Ahmad et al 2004)

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Fiscal Capacity Equalisation: 1

- The aim of FCE is to enable every local jurisdiction to provide standard level and range of government services
- Under FCE, no attempt is made to equalise service levels
- Grants are for general purpose to be spent at the discretion of local government

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Fiscal Capacity Equalisation: 2

- FCE is used in Australia, Canada, Germany, and Japan. Some use in China too.
- The underlying assumption is that provinces have the right to determine actual level and range of government services.
- Australia and Japan also seek to equalise service costs, but Canada and Germany do not do that.

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Is Fiscal Capacity Equalisation Feasible for China?

- FCE is not suitable for China. As provinces have little power over tax rates or tax bases, capacity equalisation becomes meaningless
- Capacity equalisation is focused on capability, not on outcomes. In China, transfers need to be focused on outcomes in health, education and the environment

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Spending on Priority Areas (as % of Total Fiscal Expenditure)

Function	1994	1998	2002
Education	17.6	16.0	14.1
Health	4.4	3.8	2.9
All Areas of Priority	40.5	40.4	33.4

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Disparities in Spending on Health

- Budgetary spending on health is not only low, but also has wide disparities across regions
- In 2004, national average per capita spending on health was 63 yuan, ranging from 28 yuan in Hunan to 364 yuan in Beijing
- The population of provinces with below average spending was 67% of total

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FCE Based Distribution of 2004 Transfers

	Actual (100 m yuan)	FCE Based	Redistribution
Eastern region	3352	969	-2383
Central region	4080	5084	1004
Western region	2990	4369	1379

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Can China Afford Cost of FCE?

Basis of Distribution	Cost	Cost (% of total pool)
Full Fiscal Equalisation	243 Billion Yuan	23.3
Comparable cost of Equalisation in Australia	\$3.2 Billion	7.7

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Why Is Cost of FCE so High in China?

- Provincial income disparities are so wide
- The population distribution also makes full equalisation extremely expensive
- Population of provinces with below average GDP per capita is 53% of total population. This means that every 100 Yuan per capita paid by wealthy provinces equates to only 89 Yuan per capita in the poorer provinces.

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Feasible Alternative to FCE

- Tied grants for health and education aimed at ensuring minimum spending per capita in all provinces
- Currently China has the unlikely combination of revenue centralisation, expenditure decentralisation, and no minimum standards of basic services such as education and health care

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What About Regional Disparities?

- Narrowing regional GDP disparities requires capital investment in infrastructure, which is outside the tax revenue sharing
- Regional disparities in basic services such as health care can, however, be targeted through tied grants
- Targeted grants would achieve better outcomes for a given amount of funds

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An Alternative Approach

- Under the proposed alternative distribution the fiscal transfer pool is divided into two pools – with 30% distributed on capacity equalisation, and 70% given as specific purpose grants for health, education etc, allocated on the basis of fiscal need
- Fiscal need measured by population shares of 0-15 and 65+ age groups in provinces

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Alternative Distribution (100 m. yuan)

Region	Actual Distribution	Proposed Distribution
Eastern Region	3352	2563 (-789)
Central Region	4080	4341 (+261)
Western Region	2990	3518 (+528)
Total	10422	10422

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Conclusions

- China's urgent need is to raise standards of essential services (eg health & basic education)
- China cannot afford the luxury of FCE, which does not equalising service standards.
- The alternative approach targets health & education etc, and will involve a more acceptable amount of redistribution of funds

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THANK YOU

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