

Review on Economic Impact of China's Fiscal Contract Reform

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Abstract: There is no doubt that a country's fiscal policy plays an important role in stabilizing the economy and promoting growth. Over the past 40 years of reform and opening up, China's economic construction has made remarkable achievements, the growth rate has attracted worldwide attention, the economic scale has leapt to the second place in the world, and the comprehensive national strength has been continuously strengthened. In the process of China's rapid economic growth, along with the changes of economic system, the financial system, as one of the important economic systems, experienced the "separate cooking stoves" in the 1980s, and carried out the reform of tax distribution system in 1994. So, after the reform, what impact has this system had on all aspects of China's modernization process? Based on theoretical research, this paper focuses on frontier research, summarizes existing well-known research achievements at home and abroad, and provides literature retrieval and theoretical reference for subsequent research.

Keywords: fiscal decentralization, tax-sharing reform, literature review

1. Introduction

The tax sharing system is one of the fundamental reforms implemented in the 1990s and is one of the most successful reforms, benefiting from practical decision-making, progressive negotiations, and cooperation from various regions. This paper made a comprehensive study of the literature around the relationship between fiscal decentralization and various aspects.

2. Institutional Background

Since entering the 21st century, due to the uniqueness of reforms and transformations, the fiscal contract system was destined to be unsustainable, causing problems such as the expansion of non-budgetary funds and the weakening of central fiscal functions [1]. The central government has become poorer, the overall finance has also become poorer [2].

Therefore, in order to create a stable environment, reduce regional development disparities, and provide more equal public services, the tax sharing reform was implemented in 1994, based on the stable division of powers. The tax revenue was divided into three categories: the central tax (such as customs duty), the local tax (such as the land value-added tax), and the shared tax (such as the value-added taxes), and two separated tax institutions were established: the state taxation administration and the local taxation administration, with a focus on vertical management. In 2018, they were merged again to reduce organizational duplication.

3. Literature Review

3.1. Fiscal Decentralization and Economic Growth

Studies suggest that China's impressive economic growth over the past 40 years is due to its unique fiscal decentralization system, as the decentralization of finance and fiscal power enhance the efficiency of resource allocation, leading to economic growth [3], [4], [5]. Financial decentralization usually refers to the rational division of authority and responsibility related to public functions among different levels of government, and the decentralization specifically refers to whether local governments have the actual freedom to dispose of fiscal revenue and expenditure [6]. Deepening fiscal decentralization will improve the steady-state level of GDP, total investment, and total social consumption, thereby narrowing the development gap between regions and promoting overall economic output [7]. The fiscal and tax reforms of 1994 increased the proportion of central government finance in total revenue, and the growth rate of budgetary revenue exceeded the economic growth rate from 1996 onwards, indicating that the central government had achieved some success in controlling and allocating financial resources [8]. Some scholars have also paid attention to the Chinese fiscal decentralization is characterized by the local government's possession of actual authority to dispose of public functions without relatively independent tax powers, which provides local governments with greater incentives to promote or protect the market and correspondingly promotes economic growth [9], [10], [11], [12].

There is also opposing evidence that suggests that China's practice of fiscal decentralization while maintaining central authority may not achieve better economic performance, as corresponding supporting systems were not established during the process of decentralization [13]. Financial decentralization has stimulated competition among local governments, intensifying overcapacity problems [14]. Intensified competition among local governments has led to a decrease in the proportion of consumption in GDP and a decrease in the proportion of labor income in GDP. Therefore, local government competition deepens the imbalance of economic structure [15].

3.2. Fiscal Decentralization and Social Development

The fiscal decentralization system, as a highly strategic macro control tool, is an important policy means for the government to perform its economic and public functions. Since China implemented the tax sharing reform in 1994, local governments have greater decision-making authority over fiscal budget revenue. Local governments can use their information advantage to optimize resource allocation efficiency and allocate financial resources to various industries and departments to achieve balanced economic, social, and environmental system development and improve people's well-being [16]. According to the panel data of 29 provinces in China from 1990 to 2012, China's tax reform and fiscal decentralization have the greatest impact on the secondary industry in terms of income and expenditure [17]. The test results confirmed that tax-sharing incentives would increase the allocation of "tax-base enhancing" public goods, but have negative or no significant effects on the allocation of "non tax-base enhancing" public goods [18]. Fiscal reform in China has provided strong incentives for local governments, especially accelerating the process of rural industrialization [19]. The reform coordinated economic activities in different regions, greatly enhanced the macro-control capacity of the central government, laid the foundation for dealing with a series of asymmetric shocks later [20], and also ensured the implementation of various five-year plans and national important projects. In addition, the reform not only created the miracle of economic growth, but also found that fiscal decentralization promoted the reduction of carbon emissions through the study of 1981 counties in China [21]. However, there are also scholars who support the "decentralization suppression theory" [22]. China's fiscal decentralization has not effectively supplied non-economic public goods by local

governments while promoting rapid economic growth [23], having negative effects on economic development.

3.3. Fiscal Decentralization and Officials Promotion

In a system with highly centralized politics and decentralized economics, the promotion of government officials in China is similar to a tournament [24], [25], [26], [27], [28]. The promotion tournament concluded that China's official promotion tournament is a vertical power structure that advances step by step and eliminates at each level [29]. He also proposed that this model would undergo transformation. Nowadays, senior leaders have repeatedly emphasized that GDP should not be the sole measure of performance, but it remains an important evaluation indicator because economic performance is easy to measure. Fiscal decentralization has led to a shortage of local fiscal resources, forcing local governments to rely on "land finance" to increase local fiscal revenue, ultimately driving up housing prices, and political promotion incentives will amplify the effect of rising housing prices [30]. Under the promotion incentive mechanism of the GDP championship, the expansion of economic scale has become the most important behavior orientation of local officials with the attribute of "political man". In order to promote, government officials tend to devote more energy to the field of productive expenditure and ignore the field of scientific and technological innovation [31].

3.4. Fiscal Decentralization and the Level of Public-Service Supply

It is generally believed that local governments have an information advantage and a better understanding of the diverse demands and costs of public services for local residents. Therefore, fiscal decentralization can promote local government efficiency and effectively contain the expansion of government expenditure [32], [33], [34]. However, the reduction of government levels and the increase in number of local governments will reduce the scale of local government spending, and that fiscal revenue decentralization has a negative effect on the scale of local government spending [35].

Fiscal decentralization would encourage local governments to experiment and innovate with institutions [36]. Fiscal decentralization will lead to improved public service quality [37]. The current fiscal decentralization system in China, education, healthcare and other public services are mainly provided by prefecture-level cities, but empirical research results show that the current fiscal decentralization system in China is not conducive to improving the efficiency of local public service supply [38].

3.5. Fiscal Decentralization and Regional Innovation

Due to the local government's fiscal autonomy which can influence its financial expenditure decision-making. So, whether government's investment in fiscal technology will affect regional innovation capacity has been a topic of concern among scholars in recent years. The fiscal decentralization system, local governments have formed a mechanism of "competing for growth" and "competing for innovation", the latter of which can stimulate local government's technical input and improve efficiency [39]. The higher the fiscal decentralization, the stronger the intensity of enterprises' R&D investment through mathematical analysis and empirical analysis [40]. However, after the central government partially devolves financial power to local governments, local governments will have self-interested preferences due to pressure from superiors' targets, policies or rent seeking, making them more inclined towards production investments with quick and visible results in the short term [41], [42], [43]. This can promote rough-and-ready economic growth, but is not conducive to the development of technological innovation. Fiscal decentralization not only directly inhibits urban innovation level but also indirectly suppresses improvement, using fiscal technology expenditure as

an intermediary variable [44]. Fiscal decentralization will lead to corruption, thus reducing the preference from governments for financial investment in areas related to scientific and technological innovation, weakening the leading and supporting role of governments in regional innovation activities, and leading to the loss of innovation efficiency [45].

4. Conclusion

Over the past 40 years and more since reform and opening up, China has made remarkable achievements in economic development. Its growth rate has attracted worldwide attention, its economy has become the second largest in the world, and its overall national strength has been continuously enhanced. However, it should also be noted that a series of gratifying achievements have been accompanied by the emergence of economic structural imbalances. China's economic development is faced with the triple pressure of demand contraction, supply shock and weakening expectation, as well as the agglomeration of financial risks, the expansion of local government debt risk and the escalation of demand structure contradictions. "Structural adjustment" has been one of the key tasks emphasized by the Central Economic Work Conference in the past five years, and has also attracted the attention of the academic community for a long time. It can be seen from the existing studies that there is a great debate on the impact of fiscal decentralization on the economy since the reform and opening up. Most of the literatures believe that decentralization can significantly promote economic growth after the tax sharing system. Different fiscal systems would produce different macroeconomic effects [46]. Then, as one of the important economic systems in the past 40 years of reform and opening up, would fiscal decentralization have an impact on economic structure? Fiscal decentralization affects the behavior of local governments, thus promoting aggregate demand and aggregate supply and promoting the growth of local GDP [47]. Since total demand and total supply each have their own structural elements, fiscal decentralization is bound to further affect the economic structure by influencing the demand structure and factor supply structure according to the transmission chain mechanism. Therefore, there is an inevitable logical relationship between fiscal decentralization and the imbalance of economic structure. However, most of the existing literatures on fiscal decentralization at home and abroad are empirical analyses, lack of analysis and unified logical explanation from the perspective of government behavior and fiscal system, especially in theory, lack of discussion on the transmission mechanism of this role, which is expected to be further studied in the future [48].

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