



Tax reform, fiscal decentralization, and regional economic growth: New evidence from China[☆]



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ABSTRACT

This paper is the first to examine heterogeneous responses to changes in fiscal decentralization policy associated with the 1994 tax reform in China and the nonlinearity of these responses. Using panel data for 29 Chinese provinces over the period 1990–2012, the paper shows that the effects of revenue and expenditure decentralization on economic growth vary across the three main sectors, with the largest impact on the secondary sector. The results also suggest there is an inverted U-shaped relationship between the degree of revenue (expenditure) decentralization and the growth of the secondary sector. In addition, slow-growing and fast-growing provinces respond differently to changes in both revenue and expenditure decentralization with greater responses from fast-growing provinces. The responses from fast-growing provinces appear to be nonlinear, indicating that fast-growing provinces benefit from appropriate revenue (expenditure) decentralization, but the effect turns negative as the degree of decentralization becomes excessively high. The study provides a way to reconcile the contradicting evidence found in the literature. In addition, the finding on heterogeneous responses to fiscal decentralization has important policy implications.

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1. Introduction

Over the past several decades, the devolution of fiscal powers to sub-national governments has taken place in many countries. As countries continue to decentralize fiscal powers to lower levels of government, it becomes increasingly important to understand various impacts of fiscal decentralization policy. During the transition to a market economy, China has undergone several major reforms. As an important fiscal reform, the 1994 tax reform replaced the previous fiscal contracting system with a tax sharing system. This tax reform has generated significant variation in fiscal decentralization policy, which offers an excellent opportunity to investigate the influences of fiscal decentralization policy. China has made great efforts to decentralize its fiscal system since the tax reform. Despite these significant changes, the effects of fiscal decentralization policy in China are still debatable.

Previous theoretical studies have shown that fiscal decentralization helps improve the efficiency of the public sector and promote economic growth because local governments are better positioned than the central government to provide public services that match local preferences and needs. The theorem depends on key assumptions that the government aims to maximize social welfare and public goods are provided uniformly. Interestingly, empirical studies on the effect of fiscal

decentralization offer conflicting evidence. Some studies find that fiscal decentralization has been conducive to China's economic development. Qi (1992) and Qian (1999) concluded that the fiscal contracting system (1980–1993) provided incentives for subnational governments to promote local economic growth. In contrast, other research shows that fiscal decentralization has been detrimental to China's economic growth. Jin and Zou (2005) demonstrated that expenditure decentralization is negatively associated with economic growth and the finding may imply that local governments are not responsive to local preferences and needs in practice. The lack of consensus in existing studies calls for further investigation into its various potential influences.

This paper offers a new perspective on fiscal decentralization by exploring the nonlinearity of its impact as well as heterogeneous responses across sectors and economic strata. The study contributes to the literature on fiscal decentralization in two important ways. First, the examination of a nonlinear effect provides us a chance to reconcile the contradicting evidence found in the existing studies. The intuition behind the nonlinear impact is that a higher degree of fiscal decentralization promotes economic growth when the degree of fiscal decentralization is relatively low; however, as the degree of fiscal decentralization becomes excessively high, a further increase in the degree of fiscal decentralization may impede economic growth. The rational for the negative impact comes from the possibility that inefficient resource allocation arises as the size of local government becomes unnecessarily large. Second, none of the existing studies explore differential effects across sectors and economic strata in China. This study makes the first attempt to

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investigate the differential impacts of fiscal decentralization across three main sectors. In addition, it also delves into heterogeneous responses to fiscal decentralization policy between fast-growing and slow-growing provinces. The findings on these differential responses enable us to better understand the impacts of fiscal decentralization policy and have important policy implications that help inform future decision making.

Using province-level panel data for 29 Chinese provinces over the period 1990–2012, the paper finds that the effect of fiscal decentralization (measured by revenue decentralization or expenditure decentralization) on provincial economic growth varies across the three main industry sectors in China, with the largest impact on the secondary sector. Interestingly, the impact on the secondary sector is positive when the degree of revenue (expenditure) decentralization is relatively low, but it turns negative as decentralization becomes overly aggressive. In addition, slow-growing and fast-growing provinces respond differently to changes in both revenue and expenditure decentralization with greater responses from fast-growing provinces. Furthermore, the impacts on fast-growing provinces appear to be nonlinear, implying that fast-growing provinces benefit from initial revenue (expenditure) decentralization, but the benefit diminishes with the degree of revenue (expenditure) decentralization and the effect turns negative when the degree of decentralization becomes excessively high.

The remainder of the paper is organized as follows. [Section 2](#) offers a brief literature review summarizing both theoretical and empirical studies on fiscal decentralization. [Section 3](#) highlights important institutional background on the 1994 tax reform. [Section 4](#) introduces the empirical specifications, followed by a brief data description in [Section 5](#). [Section 6](#) presents the results, and [Section 7](#) concludes with policy discussions.

2. Literature review

There have been rich discussions on fiscal decentralization from both theoretical and empirical perspectives. Earlier theoretical work has shown that decentralization, whether in the form of fiscal federalism or in the form of reduced government intervention, can help improve economic performance. Existing empirical studies on the influence of fiscal decentralization do not always support this argument. This section provides a brief overview of existing theoretical and empirical research on fiscal decentralization, and discusses how this paper helps reconcile the contradicting evidence.

2.1. Theoretical literature

Oates (1972) developed a theoretical framework for the analysis of decentralization policy and considered the trade-off between centralized and decentralized provision of public goods. The study shows that the decentralized provision improves social welfare given heterogeneous preferences across regions and no spillover effects. The theorem depends on key assumptions that the objective of the government is to maximize social welfare and public goods are provided uniformly. In the absence of externalities, local governments perform better than the central government when delivering public services and matching local preferences and needs (Tiebout, 1956). In contrast, Brennan and Buchanan (1980) examined fiscal federalism from a public choice perspective and proposed the Leviathan hypothesis stating “Total government intrusion into the economy should be smaller, *ceteris paribus*, the greater the extent to which taxes and expenditures are decentralized”. They argue that Leviathan governments operate like monopolists to increase their control over local resources instead of maximizing social welfare, and thus a decentralized fiscal system may not produce better outcomes.

More recent theoretical work takes the political process and asymmetric information between political agents into account. Some studies consider the trade-off between centralized and decentralized provision in a principal-agent model of electoral accountability. The presence of

asymmetric information results in inefficient government performance. In this framework, decentralization encourages yardstick and tax competition among local governments; therefore, it can improve accountability and lessen information asymmetry (Besley and Case, 1995; Bordignon et al., 2004). In addition, increased electoral accountability ultimately translates into more efficient government performance. However, Tanzi (1996) argued the assumption that local governments are more likely to respond to local preferences and provide local public goods more efficiently than the central government does not necessarily apply in a non-democratic political system. Consequently, fiscal decentralization may lead to misallocation of resources. Other studies reconsider decentralization theory in a political economy. Lockwood (2005) developed a model where the decision is made through majority voting over alternative levels of public goods provision. The benefit of decentralization comes from rising efficiency in the decision-making process. Neyapti and Bulut-Cevik (2014) investigated the welfare effects of institutional mechanisms and concluded that welfare and the effectiveness of redistributive policy rise with the degree of revenue centralization. To sum up, existing theory suggests that the effect of fiscal decentralization depends on assumptions about government's objectives and institutions.

2.2. Empirical literature

Empirical studies that examine the impact of fiscal decentralization on economic growth in China also show conflicting results.¹ A number of studies argue that fiscal decentralization promotes China's economic development. Qian and Weingast (1997) showed that the fiscal contracting system protected local governments from revenue predation by the central government, and thus helped retain necessary resources for economic growth. Lin and Liu (2000) claimed that fiscal decentralization contributes to China's rapid economic growth and this effect comes from increased efficiency rather than rising investment. Shah (2004) noted that the merit of fiscal decentralization depends on both revenue and expenditure assignments as well as the specific stages of economic development. Jin et al. (2005) argued that fiscal decentralization policy has substantially strengthened the fiscal incentives of provincial governments which are associated with faster provincial economic development and more reforms. He and Sun (2014) examined the influence of fiscal decentralization on foreign direct investment in China. Using provincial panel data over the period 1995–2002, they show that fiscal decentralization encourages the inflow of foreign direct investment.

In contrast, other research suggests that fiscal decentralization impedes China's economic growth. Davoodi and Zou (1998) reported a negative relationship between fiscal decentralization and economic growth in developing countries. Young (2000) demonstrated that fiscal decentralization has led to market fragmentation and hindered economic growth. Jin and Zou (2005) showed that expenditure decentralization was negatively associated with economic growth under the previous fiscal contracting system. The result may indicate that local governments are not responsive to local preferences and needs in practice. This is especially true if local officials are not selected by local voters or “voting by feet” is not practical.

To sum up, the lack of consensus in existing empirical studies can arise from differences in empirical specifications as well as different sample periods. To my knowledge, these existing studies focus on estimating an average effect on the economy. None of the previous studies have investigated differential effects across sectors and economic strata. It is important to explore heterogeneity in the responses to fiscal decentralization policy. As Zhang (2006) stated, the impact of fiscal decentralization is likely to vary across regions given differences in economic structures and fiscal burdens. Furthermore, fiscal policy has often been

¹ See Shen et al. (2012) for a more detailed literature review on fiscal decentralization in China.

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