

# Fiscal Vertical Imbalances and the Building of Subnational Financial Capacity

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**Abstract:** *Fiscal vertical imbalance is a key feature of the relationship between the central government and local authorities. This paper first provides a theoretical interpretation of the mechanism by which fiscal vertical imbalance affects local government fiscal capacity building, and then systematically introduces the process by which fiscal vertical imbalance influences the intensity of local fiscal capacity building. This process simultaneously exhibits both enhancing and weakening mechanisms. On the one hand, fiscal vertical imbalance may reinforce local governments' efforts to enhance their own fiscal resources through mechanisms such as reliance on transfer payments and policy incentives. Conversely, fiscal vertical imbalance may also undermine local governments' fiscal autonomy and sustainability by creating mismatches between fiscal authority and responsibilities and transmitting fiscal pressures. Based on this analysis, the paper proposes relevant policy implications.*

**Keywords:** Fiscal vertical imbalance, Local financial resources, National governance.

## 1. Introduction

Within China's 'centralised revenue and expenditure' fiscal system, local governments without 'substantive' fiscal authority must adhere strictly to central government directives regarding their revenue and expenditure activities. Evidently, this fiscal system does not exhibit vertical imbalances. Following the implementation of the 'separate budgeting' reform and 'fiscal autonomy' pilot programmes, local governments have gradually gained partial fiscal autonomy. This has led to increasingly complex vertical fiscal relations between the central and local governments. While the 'separate budgeting' reform aimed to break the 'fiscal pot system' and resolve the issue of centralised revenue collection, it proved ineffective in eliminating the drawbacks of centralised expenditure allocation. This resulted in the central government shouldering more expenditure responsibilities for specific tasks. Even during the 'fiscal autonomy' period, the central government was constrained by the prevalent local self-interest mentality and faced dual obstacles: limited fiscal revenue growth and difficulty reducing its safety net responsibilities. Together with local governments that had relatively flexible budgetary arrangements, this created a 'reverse imbalance' in the vertical fiscal relationship between the central and local governments.

Until 1994, the formal implementation of the tax-sharing system established the central government's absolute advantage in fiscal revenue distribution and left local governments with numerous responsibilities. This fiscal and tax system reform, essentially a form of 'fiscal centralisation', completely reversed the long-standing imbalance in the vertical fiscal relationship between central and local governments. Local governments, which only had incomplete tax authority, were required to bear the disproportionate burden of heavy expenditure responsibilities, reshaping the fiscal vertical imbalance into one with 'Chinese characteristics'. This is most evident in the central government's rapidly growing fiscal strength and affluence, whereas local fiscal capacity has weakened to the point of being unable to function without fiscal transfer payments. For example, in 1993, the central government's fiscal self-sufficiency rate was 0.73, while that of the local

government was 1.02. In 1994, the central government's rate rose to 1.66, while that of the local government plummeted to 0.57. By 2019, the central government's rate had reached 2.54, while that of the local government remained at 0.50. Therefore, the primary practical contradiction of China's fiscal imbalance since the implementation of the tax-sharing system is that local governments continue to be constrained by the mismatch between fiscal responsibilities and financial resources. This has led to a widespread 'small horse, big cart' fiscal revenue and expenditure dilemma.

## 2. Mechanisms of Fiscal Vertical Imbalance on Local Government Financial Capacity Building

### 2.1 The Role of Fiscal Vertical Imbalance in Strengthening Local Government Financial Capacity Building

The theoretical logic of the fiscal vertical imbalance that may prompt local governments to fortify their financial structures is predicated on the following: firstly, the fiscal vertical imbalance directly engenders a "self-sufficiency" gap in local finances, thereby engendering financial pressure that can stimulate the local government's demand for financial construction. As fiscal expenditure responsibility exhibits an upward "ratchet" characteristic, an excessive lack of local financial power undoubtedly places local governments in a more and more difficult financial environment. Consequently, the intensity of local financial construction is more likely to become the target of local governments' governance, as demonstrated in the relevant literature, the deepening vertical fiscal imbalance is likely to inhibit local financial expenditure on people's livelihoods, thereby encouraging local governments to utilize their financial resources to cultivate financial resources and expand their financial capacity. Research on the abolition of agricultural tax reforms also confirms that shrinking local fiscal power provides significant incentives for local governments to pursue regional fiscal growth. Research on the impact of fiscal vertical imbalance on regional environmental degradation indirectly indicates that fiscal vertical imbalance consolidates an industrial structure

that is detrimental to environmental enhancement, as it exerts pressure and motivates local governments to accumulate their short-term financial resources. Secondly, fiscal vertical imbalances can also indirectly trigger ‘benchmark competition’ among local governments. This competition is aimed at achieving higher rankings in economic growth, thereby heightening local governments’ enthusiasm for fiscal capacity-building. When local governments elect to pursue economically competitive behaviours in response to fiscal pressure resulting from vertical fiscal imbalances, the ‘GDP-oriented’ top-level policy design concomitantly introduces competitive dynamics into local governments, thereby accelerating economic growth within their respective jurisdictions and promoting the short-term accumulation of local tax bases. The exacerbation of fiscal vertical imbalances may, to some extent, drive an increase in regional economic growth levels. Moreover, China’s official promotion evaluation system encompasses metrics pertaining to economic growth and fiscal capacity building. In the context of this political incentive, local officials have a propensity to advocate decision-making schemes that can expeditiously engender alterations in regional economic development in the short term. This, in turn, serves to reinforce the role of fiscal vertical imbalances in enhancing local fiscal capacity building.

## **2.2 The Mechanism by Which Fiscal Imbalances Weaken the Role of Local Governments in Building Financial Capacity**

The vertical fiscal relationship between the central and local governments that underpins the phenomenon of fiscal imbalance in China also involves the fiscal transfer payment mechanism implemented by the central government towards local governments. The resulting incompatible incentives may distort the fiscal decision-making of local governments. The theoretical logic behind the weakening of local governments’ fiscal capacity-building due to fiscal imbalance can be summarised as follows: first, fiscal imbalance may induce local governments to shift their strategies for alleviating fiscal pressure towards a habitual reliance on central transfer payments, thereby reducing their initiative in fiscal capacity-building. This is due to the fact that, while the tax-sharing system has significantly enhanced the central government’s fiscal self-sufficiency, it also explicitly requires the central government to leverage its fiscal advantages to fulfil its role in balancing fiscal capacities across regions. In this ‘father-son relationship’-like balanced fiscal transfer model, local governments that harbour ‘rescue expectations’ towards the central government may, in response to fiscal pressure shocks resulting from vertical fiscal imbalances, actually reduce their tax collection efforts. Moreover, given the objective existence of horizontal fiscal imbalances and the difficulty of eliminating budgetary constraints, local governments that rely on ‘small fiscal resources’ to fund ‘large expenditure carts’ will become more accustomed to depending on central government transfer payments for fiscal support, thereby amplifying the impact of fiscal vertical imbalances on reducing local governments’ fiscal efforts. Secondly, fiscal disparities between central and local governments can precipitate the ‘public pool effect’, thereby distorting local governments’ fiscal revenue strategies and

diverting their attention from concentrated efforts to build local fiscal capacity. In contrast to the cost-benefit chain of local fiscal capacity building, central government transfers to local governments can be considered as a public pool of resources with no associated costs. The utilisation of fiscal transfer payment funds to discharge local government expenditure obligations results in local governments effectively transferring the financial burden of providing public goods to other regions. This phenomenon not only stimulates local government spending impulses and reduces the efficiency of fiscal fund utilisation, but also gives rise to fiscal competition among local governments for fiscal transfer payment resources. Thirdly, fiscal disparities between central and local governments may prompt local governments to improperly demand central special transfer payments, thereby disrupting the conventional arrangements for local government fiscal capacity building. The management of central special transfer payments is a multi-departmental process that spans various ministries. However, there are identified legal ambiguities in the allocation, management, and supervision of these funds. Consequently, local governments may dispatch representatives to ‘lobby ministries for funds’ to address fiscal imbalances, which may be motivated by rent-seeking behaviour and lead to fiscal misconduct. Furthermore, local governments that excessively rely on ‘political connections’ with central government ministries to indirectly pursue central special transfer payments may also relax the intensity requirements for fiscal capacity building.

## **3. Revelation**

The following conclusions can be drawn from this study with respect to policy implications: (i) It is imperative to elucidate the delineations of fiscal responsibilities between the central and local governments, with a view to enhancing the congruence between local fiscal capacity and fiscal responsibilities. By implementing a reasonable programme of reforms, including the establishment of a local tax system, a modern fiscal system can be established on scientific principles. This would ensure the financial needs of major national strategic tasks are met, while also maintaining the stable operation of local fiscal revenues and expenditures. (ii) It is imperative to enhance the existing fiscal transfer payment system so as to optimise its role as a crucial instrument in the process of correcting fiscal imbalances between central and local governments. In addition to the standardisation of transfer payment fund allocation methods and usage evaluations, it is necessary to gradually phase out outdated special transfer payments and tax rebates while focusing on improving the performance management model for general fiscal transfer payment funds to prevent fiscal transfer payments from weakening local governments’ willingness to build fiscal capacity. (iii) The evaluation mechanism for local fiscal capacity building should be further optimised as part of local government performance assessments. This will allow local governments to fully mobilise their initiative in activating fiscal resources, tapping into fiscal revenue growth potential, and maintaining moderate fiscal revenue growth. This will leverage the institutional advantages of China’s fiscal system for national governance.

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