

## Study on the Relationship Between Central and Local Finance --Based on the Perspective of Tax-sharing System

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**Abstract:** the Tax-sharing reform as an important reform of China's financial filed, which has had a huge impact on the Central and Local fiscal revenue in China . This article first discusses the developments of the financial relationship between the Central and Local before and after the founding of China ,and then briefly reviews the content of tax-sharing system, and finally analyzes the effectiveness of tax-sharing system and the existing shortcomings.

**Keywords:** Financial; Central; Local; Tax-sharing reform

**FIRST** The developments of the financial relationship between the central government and local government

### 1.1 The financial relationship between the Central Government and Local Government before the founding of China

The financial relationship between the Central government and Local government in China has existed for a long time, through review of the financial institutional changes in history between the central and local, It will help us sort out their relationship, solve the financial-match problems between the Central and local and, and provide historical reference for the current financial reform.

After the Qin dynasty unified China, It inherited the results of Shang Yang's constitutional reform, the Central Commission's financial system began, dealing with the taxation and spending, the system was further improved to the Han dynasty. To the early Tang dynasty, highly concentrated financial system was destroyed, property rights began to move down, local government started to share the taxing power. Zhao Kuangyin centralizes the military right to central, brings the quota management of military expenditures of the State budget into practice, the Central share of military spending in fiscal expenditure is huge. Yuan dynasty implemented the three-level management system and each have their own offices, but its central still took charge of the whole fiscal expenditure and taxing power which eventually led to the national

property rights severely fragmented. Centralization of power reached its peak during the reign of Ming dynasty , and began to form the prototype of the modern financial system. Around Guang Xu 34 (1908), the ancient Chinese Tax-sharing system has emerged[1] .

Overall, the ancient central and local fiscal relationship mainly attached to an absolute monarchy political system, centralization and decentralization of fiscal relations also depend on the degree of centralization in past dynasties, the change was not based on the need for effective management, and the modern financial system in China is quite different. The unified financial system between the central and local is formed after the establishment of our nation.

## 1.2 The financial relationship between the Central Government and Local Government after the founding of China

Table 1 shows the relationship between the Central and Local governments in China after the founding of China. The reform of the Central and local fiscal system can be divided into three major periods. First time was in 1950, after the founding of China,the central government deals with whole the taxation and spending,the Central Government required Local Government hand in all the financial revenue,the funds which Local Government needed to provide public goods are allocated by the Central Government; the second period was in 1980 whereby the reform mainly was “divide revenue and expenditure , apply by grading. ”; and the third is the 1994 tax reform, all taxes of the country divided between the Central and Local government, Its essence is based on the Central and Local government’s authority to determine the appropriate property rights.

To adapted to the economy reform from planned economy to socialist market economy,the tax reform was implemented in 1994[2], after 20 years of practice, the Tax-sharing reform has achieved a great success, it relieved the central financial difficulties, enhanced the enthusiasm of local financial management, while China's fiscal system reform gradually stalled, full of risks, and in a sense, the Tax-sharing reform, there are still many problems left over by history. From the perspective of Tax-sharing system, to learn about the specific conditions of China in central-local fiscal relationship,And that is of much significance to the further reform of financial system.

**Table 1** The development of fiscal relationship between central and regional governments

Time	Type of fiscal relationship
1950	Unified state control over income and expenditure
1951-1958	Share of taxes in accordance with the classification

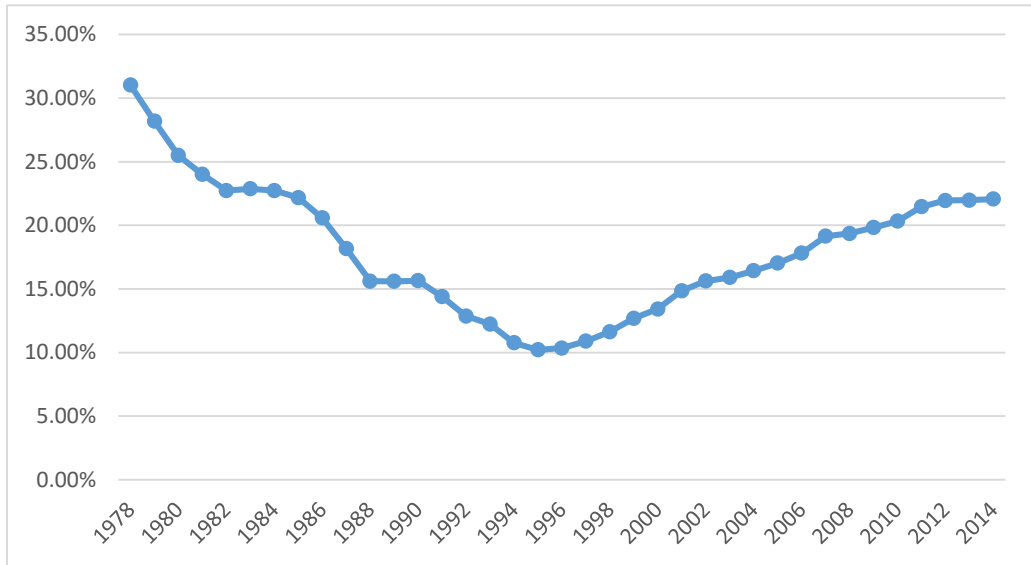
1959-1970	Sharing total revenues
1971-1975	contract system on revenue and expenditure
1976-1979	Sharing total revenues
1980-1984	Share of taxes in accordance with the classification
1985-1987	Sharing total revenues
1988-1993	contract system on revenue and expenditure
1994-now	Tax-Sharing System

## SECOND The reform of Tax Sharing System

### 2.1 The background and reasons of Tax-sharing system

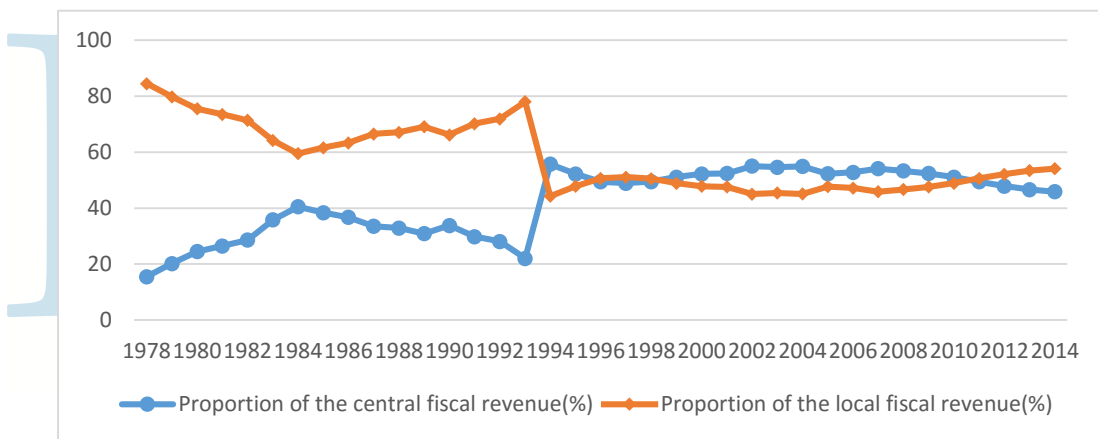
Just before the reform of Tax-sharing system, our country was in a serious financial crisis. Since 1978, China's GDP has witnessed a catch-up growth, but the proportion of fiscal revenue to GDP was directly plummeting. Figure 1 shows the national revenue as a percentage of GDP was directly plummeting, since the reform and opening up in China, at the same time, the Central financial was in trouble. Figure 2 shows that the changes of proportion in the Central and Local fiscal revenue in China, we can see the reduction of national proportion of Central Government revenues. In the beginning of The reform and opening up, China's Central and Local fiscal income maintained at "2-8" level, then the gap gradually narrowed, until 1985, the Central and local fiscal revenues stabilized in "4-6". With the late effects of fiscal responsibility system, local financial revenue as a percentage of national income began rising, declining national proportion of Central Government revenues, and the national proportion of Central Government revenues declined. By 1994, the two share recovered to the level when the reform and opening up began, the central financial couldn't be burdened, it was urgent to reform the financial system.

**Figure 1** The proportion of national fiscal revenues in GDP from 1978 to 1994



**Data sources:** National Bureau of Statistics (annual)

**Figure 2** Proportion of the central and local fiscal revenue in 1978-1994



**Data sources:** National Bureau of Statistics

## 2.2 The content of the reform of Tax-sharing system

The main content of the reform of Tax-sharing system can be briefly summarized as "two apart-one return.",First of all,based on the responsibilities of Central and Local to divide the expenditures.The Central financial mainly bore the national political activities and economic regulation , and the Local financial bore the local government's related institutions normal activities ,and helped with the development of economic and social career; second, based on the tax to divide Central and Local income, while created IRS Council and Bureau two sets tax system; established tax returned and transfer paid system which is fitting in with Tax-sharing system, the Central financial promised that it would take out one-third for tax returned, to make the Local can cover the expenditure .

### **THIRD the effect and shortcomings of Tax-sharing reform**

Tax-sharing reform relieved the shrinking problem of central fiscal revenue , and made the power- centralized problem continue to weak. In general, the Tax-sharing reform has made certain achievements, promoted the improvement of China's financial system . But it is worth to say that the reform is not perfect, it cannot effectively solve the problem of local fiscal and expenditure responsibilities, these problems still remain to be resolved.

### **3.1 The effect of Tax-sharing reform**

(1) It helps the Central fiscal out of trouble,and improves our financial system.entirely changes our country's financial system,it raises revenues as a percentage of GDP and the central fiscal revenues as a percentage of national revenue,at the same time through this reform,it establishes the dominance of the Central Government to ensure reasonable growth of State revenue.the year of 1994 becomes the change-point of Central and Local financial. As shown in Figure 2, after Tax-sharing reform, the central fiscal income witnesses a significant jump, and maintains at a high level and local fiscal income drops significantly.

(2) It enhances the regulation ability of Central Government to Local government,strengthens the role of Central Government.First, due to Central revenue increased, Central Government has more capacity to do transfer payment on Local Government , this is the basement of for macro-control and economic governance ; second, Tax-sharing reform makes Central and and Local according to tax belonging to divide income, the contradictions between Central and Local reduces, increases the central revenue from the tax sources, retains the Local Government 's revenue of enthusiasm and regulates the non-rational intervention. and, finally,for the developed regions and underdeveloped regions ,the tax returns and transfers produce different forces to ensure that the developed area keeps enthusiasm ,at the same time, increases the supports of Western areas.

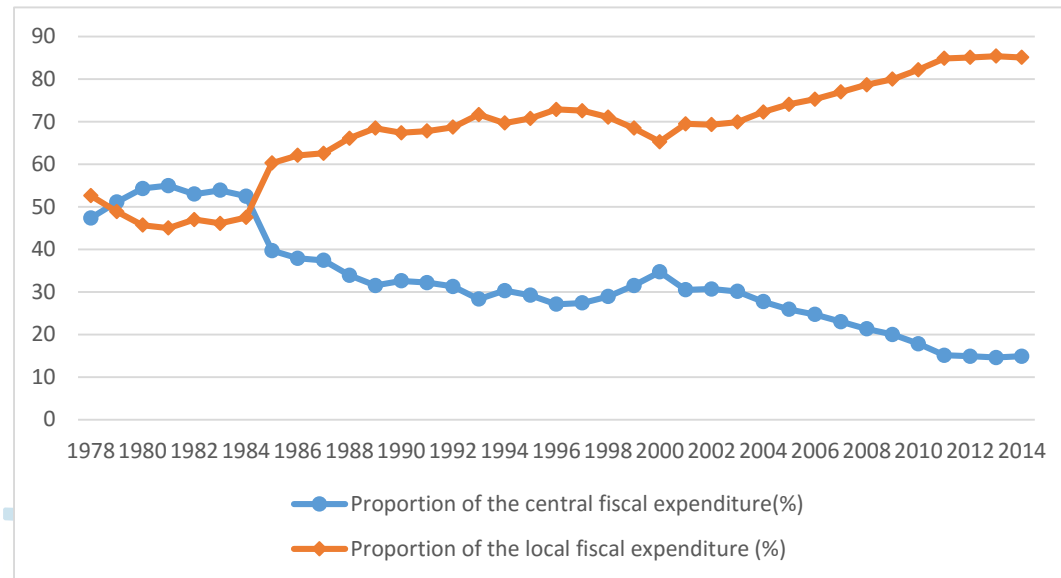
(3) It unifies the country's allocation of financial resources. before the Tax-sharing reform , due to the big difference of all provinces,the Central Government carried out six different types of lump which are applied into 37 financial units.This has resulted in a complex financial system. And the Tax-sharing system has broken the existing system,, the national financial system was consolidated, greatly simplifying the financial system of China.

### **3.2 the shortcomings of Tax-sharing reform**

(1) The responsibility of fiscal expenditure is not clear.After the Tax-sharing is reformed, the Central Government revenues increased,and the local revenues decreased.but in parallel with the changes in revenue,all levels of governments' responsibility and fiscal expenditure did not produce a corresponding change,when the Central Government stressed a lot of control on the Local Government,it failed to share the local financial pressure.the expenditure of Local Government didn't reduce,but the fiscal gap of Local Government was growing.Figure 3 shows the

Central and Local fiscal expenditure's share from 1980 to 2011. As we can see from the diagram, the proportion of expenditures in the central budget is decreasing, while local fiscal expenditure continues to increase. The higher Local expenditure pressures makes a heavy debt burden, increasing Local government 's debt risks.

**Figure 3** Proportion of the central and local fiscal expenditure in 1978-1994

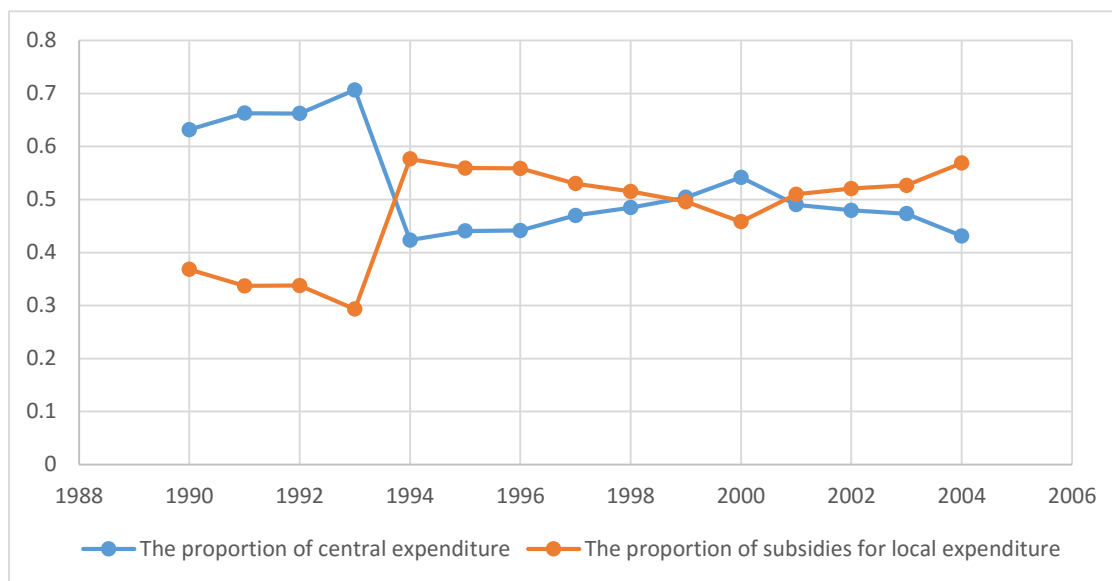


**Data sources:** National Bureau of Statistics

(2) No below-province is involved in the Tax-sharing reform, the grassroots governments are short of financial resources. China is a five-level administrative divisions, but only the provinces have reformed the tax, which also means that below the province level, the Tax-sharing reform failed to be carried out, this created a incoherence on the budget as a whole .

(3) The transfer payment system still has a serious shortcomings. Due to the transfer payment in China is still lack of scientific and normative, therefore provincial transfer payments cannot as a whole show a clear re-distributive effects and equalization effect[3]. On the other hand, various types of special transfer payments are scattered in the various ministries, giving a chance for power rent-seeking and corruption , the equity of fiscal is not guaranteed, which severely weaken the effect of the Tax-sharing reform. Figure 4 shows the expenditure of central level and the change of the proportion of subsidy to local spending .Although there is a higher elevation to local transfers, later there is a downward trend, and, ultimately, with a modest rise. This shows our country's financial transfer payment does not completely meet the needs of Local Government finance, equity still needs to be further strengthened[4].

**Figure 4** The proportion changes between central expenditure and subsidies for local expenditure in 1990-2004



**Data sources:** Finance year book of China (2005)

#### FOURTH Conclusions

This paper gives a brief introduction of the development of China's financial and study the content of Tax-sharing reform as well as the achievements and existing problems and shortcomings. Throughout the development process of Tax-sharing reform, we can see that tax-sharing system has make the Central Government out of trouble, and enhances the ability of Central Government to local, and unified the country's allocation of financial resources. However, the Tax-sharing reform at this stage, there are still many problems, including fiscal responsibility is not clear, no below-province is involved in the financial system reforms, transfer payments remained seriously inadequate, above all, As an important exploration of China's financial reform, the Tax-sharing reform still needs to be improved.

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