

CHINA

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Public Finance Institutions: Structure and Tasks

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I. THE PHILOSOPHY OF FISCAL DECENTRALIZATION

a. Why fiscal decentralization?

When people, the press, or television speak of „government“, „the public sector“ or even „the state“, they almost always think of the central government in a country. Even most of public finance literature deals with the public sector without differentiating it, one way or the other. This is in most cases an adequate procedure, and in a typical public finance textbook a long series of chapters works with this simplification: What are good and bad taxes? Which are the typical public versus private functions in a market economy? How should the public finances be used to enhance economic growth, to smoothen distributional differences, and to tackle business cycles? It is often only towards the end of the book that a chapter on „The levels of government“ or „multi-layer government“ or „the elements of fiscal decentralization“ follows.

Yet in any large country the question is very important, how the public finances should be organized vertically and what role subnational public units are to play. The central government cannot, for simple technical reasons, decide on the size of a local school, on the public investment in a tourist region as opposed to an agglomeration or agricultural region, or on the size of a sea port. If it would try it anyway, the outcome would be widely acknowledged as:

- not meeting the peoples desires (preferences) in that region or community (preference orientation),

- not choosing the right size of an infrastructure installation (economies of scale) and

- not being able to deliver the service at the right moment in the right quantity and quality (administrative efficiency).

For these reasons, which could be spelled out in detail¹, it is widely acknowledged that any large country is well advised to apply sufficient fiscal decentralization in order to avoid these inefficiencies in the organization of the public sector in the country. For the following, it is assumed that this decision has been taken, i. e. that there exists a sufficient number of layers of government, in a large country usually three: central and local governments (which exist in practically all countries) and a middle level, of which the term varies greatly in international comparison: province, state, Land etc.

b. The private household as model

The focus is now on the question, how to organize any such subnational level of government. What is the model after which it should be shaped? Bureaucrats like to think in terms of deconcentration. Their model is for instance that of the defense department of any country. Defense is a typical central government function. But it cannot be governed in all aspects from the country's capital. There must be regional subunits which decide on regional supplies, on the daily use

of the regional defense facilities, etc. But the decision-making leeway of the regional units is very small. They decide along the central ministry's commands, their budgets are allocated in many details there, and they can be dissolved or installed any time by higher orders. This is the type of de-concentrated organization of a centrally determined organization, by the way typical of large business enterprises, which may give their regional units more or less competences, but these can be cut back or widened at any point in time by the head office.

Fiscal decentralization in a large country, if it is to achieve its objectives, has to be different. The individual region or community comprises people who vary in their habits, economic capacities, natural conditions etc. so much between the different parts of such a large country like China that the national objectives of national growth, good services for the people etc. can only be achieved satisfactorily, if the individual units can decide on certain public functions regionally resp. locally.

The adequate model for this is therefore not the unified defence ministry (which has to fulfil a clearly national function) or the large business enterprise (which fulfils an entrepreneurial function). It is rather the situation of a private household, which can in many respects serve as the role model for the organization of a region or a community. This is the perspective of an economist, but empirical evidence has shown that this is a fruitful approach.

The people in a family know very well, how to spend their scarce money efficiently. There are always many attractive ways of spending money for this and that. But spending this money means to give up the possibility to spend it for other desirable things, and the money is not sufficient to fulfil all wishes. By the way, this holds irrespective of whether these people are rich and live in a rich region with high-price opportunities, or whether they are inhabitants of a poor region. One result of this reckoning an economist cannot avoid mentioning: By acting this way, people implicitly also weigh the additional benefit of a purchase

against the additional cost of the income spent. And this economists call allocational efficiency.

And a second experience exists which can be applied to fiscal decentralization: People spend own earned money more carefully than if they can obtain additional money from parents or uncles (windfall gains).

c. By analogy: The decision-making process of subnational units

A good system of fiscal decentralization forms the regional and local units in a way that allows them to act as closely as possible to the private household. This is much easier to achieve at lower levels of government. There people understand as citizens quite well, whether „their“ tax money is spent for the right purposes, i. e. purposes which they deem to be the most pressing at a given moment. And they expect the money to be spent parsimoniously. Taking the two together, economists speak of effectiveness (reaching the objectives) and efficiency (at least cost). Moreover, if the public money is spent too lavishly in general, they will ask for tax reductions. And this way they influence the size of the regional public sector vis-à-vis the private sector, in this case their private income.

To look at it more closely: The voter and its city or regional government should have to look at the additional public service, which in itself is a fine thing, in the light of the additional tax necessary to finance it, and this of course is always a bad thing. In public finance theory it is called the principle of fiscal equivalence (M. Olson). And this corresponds directly to the private household's decision and is the economist's dream of allocational efficiency, why?

For the simple reason that this way the limit is defined where more public money is less beneficial than more private money. This limit is much better visible and can be much more easily influenced at the regional and even better at the local level, as compared to the far-away central government budget. Of this the individual citizen neither knows to which degree he will profit from it, nor

can he judge whether the additional tax will finally hit him. So in the end he does not care much about what happens in the central budget. It is at the regional and above all local level that the citizen can learn to allocate his scarce money best.

An additional and for China particularly important argument in favor of fiscal decentralization says: It furthers innovation. Innovation occurs in enterprises, individual laboratories, individual innovative governments. This has two ramifications:

1) If one community or province is innovative, e.g. by investing more and consuming less, others will follow it: Yardstick competition. This way innovation will be much higher than in a highly centralized system.

2) And why this emphasis on innovation? It is in advanced economies the major determinant of growth². You think that this may not yet be important for China? I am sure that if each region can develop its own strength, by being able to carry out its own regional development policy, this will be the major source for national growth. As an old German economist, Herbert Giersch, once put it: „Each region has to find its own vocation“.

Finally, one more analogy to the private household has to be taken up: These arguments for more efficiency through decentral decision-making do not – or not equally strongly - hold for grants from upper-level governments. For the recipient regions and communities they are not „own“ revenue. Instead, they represent „cheap money“, and this is spent less efficiently. This whole area of grants is very important and is therefore the subject of a separate paper by Armin Bohnet.

II. AFRAID OF FISCAL DECENTRALIZATION?

So far the arguments were very much in favor of fiscal decentralization. But there are at least two arguments why some people worry about a change towards more decentralization of fiscal authority.

a. Argument 1: „The country might fall apart“

In many countries certain areas tend to separate from the national territory. One and often the strongest reason is the difference between ethnic groups. If the country is strictly unitary, they have the feeling that only a separation could ensure that they can organize themselves by their own preferences. They even aim at separation, if it entails high cost, like withdrawing into a small economic unit with little internal trade and with high barriers at the border. In such countries the term „federalism“ is often associated with this danger of certain groups seeing a chance to finally separate. I have experienced this for instance in Indonesia. Behind this is probably a misconception of what a federal system like in the United States or Germany can achieve under this particular perspective of keeping the country together. Maybe the best example is Switzerland. People of four very different languages live together there, some separated from the other groups by high mountains, which would make it easy to step out of the union by force. But this country is held together by the very fact that the different language and ethnic groups have the chance to organize themselves regionally and locally to a very large degree according to their own preferences and to retain at the same time the advantages of a larger country, which allows free exchange of communication and of economic goods between the areas. The prerequisite for this is simple: One should allocate the right functions to the various levels, the major task in organizing a fiscally decentralized system.

b. Argument 2: „Poor regions may fall back further“

If the competencies of the subnational levels are strengthened, they will compete with each other. This is intended, because this competition for the better solutions, for instance in regional economic development, are for the benefit of the country as a whole. Of course there will be winners and losers among the regions and the communities in this competition. It is also true that natural advantages, like being a city with a

major port, can push this region forward and make its inhabitants richer than the rest of the country. So, there is clearly something valid in this argument.

The argument is, by the way, supported by modern regional economics, with Paul Krugman from MIT being the best-known name in this context. The outcome of the discussion: Large modern agglomerations are, at least in high-income countries, necessary for growth. The answer to this undesirable outcome, certainly in China, is not to put the brakes on the booming agglomerations, like Shanghai. This would obviously hamper national growth, for two reasons. One is the simple fact that they contribute currently much to this growth. The second and in the long run more important reason is the before-mentioned feeling that modern agglomerations may, also in China, be the breeding-places for innovation and thus future growth. But this would be a separate topic for discussion.

The better strategy consists in the development of effective equalization systems. As this line of thought shows once more, this is an important subject, which therefore needs separate treatment (see the paper by Armin Bohnet).

III. HOW TO ORGANIZE FISCAL DECENTRALIZATION PROPERLY

When it comes to organizing fiscal decentralization properly, one has to come back to the basic analogy: The decision-makers at the subnational levels must work in an institutional environment which sets the right incentives for them to work efficiently. This means two things:

- They should follow not their own personal ideas and interests, but those of the people for whom they run their budgets.
- And they should perform this task in the most cost-efficient way.

To achieve this, the classical elements of fiscal decentralization should be set right:

1) Assign the right functions (and concomitant expenditures) to each level (including the central level!),

2) provide each level with as many „own“ revenues as possible,

3) and induce voters and politicians to weigh the advantage of the additional expenditure against the disadvantage of the additional tax.

a. Own functions and expenditures

A well-organized fiscal decentralization assigns all those functions to the central level, which benefit the country as a whole and cannot be efficiently fulfilled by a lower level. Such functions are well-known over the world. They include defense, foreign policy, the issuance of money etc. Also, the task of keeping the country together, as the constitution specifies it, is a central government function.

Equally easy is the assignment of functions to the local level. Local streets, the utilities, education below the college level, fire-fighting, local police etc. are internationally established local functions. It is much more difficult to list the possible, not to speak the unavoidable functions of a middle level. In Germany, education is the main Land function, if the share in total Land expenditure is used, followed by social expenditure, especially welfare payments.

More important than lengthening or shortening this list for a given country is the question to which degree a subnational level can fully decide on each of these functions. In all countries the question of mandating is discussed, meaning that the upper level decides fully or to a degree, how a lower level may or must fulfil this function. There are cases where the local level is merely used as the administration to administer a Land function. In that case the money to finance this should also be fully supplied by the Land. It is hard work to reduce such mandates, once they have been introduced. Therefore it is important to apply them cautiously from the beginning.

b. Own revenues, but no borrowing

Certainly own functions are at the heart of a well-conceived fiscal decentralization. But to act responsibly, meaning that the additional expenditure is weighed against the additional tax, a subnational level must have revenue sources of which it can raise or lower the rates. This holds for fees and charges, unless the upper-level government has narrowed their scope (which would be unfavorable). But the more important own revenue are own taxes. „Own“ means in the extreme that the tax may be introduced or abolished at will. But even if the tax is levied universally on a nationally determined tax base, it is sufficient to be able to lower or raise the tax rate, because this way the tax burden can be varied. Even if a tax is national and has a national unified tax rate, this is still better than a grant, because in this case at least subnational tax base policy is possible. It means that regions and local governments care for their businesses and wage-earners, which in itself is an incentive for growth in that area.

Why „no borrowing“? Borrowing is a controversial revenue source all over the world. It carries with it the fiscal illusion that the benefit of the additional expenditure occurs now and makes voters and politicians happy, whereas the repayment happens much later and possibly hits other people. Borrowing is a sweet and slow poison, and the literature is full of bad examples and vain restrictions. The best way out is to forbid it right away, with truly self-financing projects as a possible restrictive exception³.

IV. GERMANY AS POSITIVE ROLE MODEL?

The text up to this point, being written by a German, might be interpreted as if the arguments were gained from positive German experience with its fiscal decentralization. The short time for the presentation did not permit to describe the German system in detail, but it is probably expected to learn some good and bad examples.

The good part is that after the strictly centralist Nazi regime until 1945 Germany started in 1949 with a rather strong decen-

tralization. Lander and local governments all have budgets of their own, at least some own functions and at the local level quite some own revenues. The Lander have no tax source of which they can vary the tax rate, clearly a major flaw. In general more than 80% of all tax revenue stems from shared taxes, and only some of the local shares can be varied in their tax rate. Though this tax regime has long been regarded as in need of reform, the political forces against it were strong enough to prevent reform. Also on the revenue side: Borrowing is clearly excessive at all three levels. The Maastricht criteria of the European Union (no more than 3% of GDP for annual borrowing and not more than 60% for accumulated debt) are constantly violated. The reason is that so much social expenditure has been accumulated over the past 30 years that it is very difficult to reduce it.

This leads to a last consideration. In general, distributive decisions in any field of policy are difficult to take back later, when you feel that you can no longer afford the expenditure. This is the typical situation of the European welfare states, which makes reforms to streamline the economy very difficult and constitutes a disadvantage in international competition, not least with China.

This also holds for fiscal decentralization. The large degree of shared taxes without tax-rate setting authority was distributionally motivated: Make the poor Lander better off than they would be under internal tax competition. Now we need more regional competition, but the reduction in tax sharing as in any other distributional benefit is hard to accomplish now. One can deduce a general rule from this: Beware of too early and far-reaching distributional policy. It is introduced in good times and constitutes a burden in hard times. Of course some regional as well as personal redistribution may seem advisable in China. In that case it is helpful to try reversible schemes, with 5-year-programs as an example if they expire automatically unless they are re-instituted by a new law.

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In general, there are many good elements in the Chinese system of levels of government so that a careful further development should lead to good results that help this great country to move forward further.

Notes

¹ For an introduction see Zimmermann, Horst, Kommunal Finanzen, München 1999. A Chinese translation of an updated version is under way.

² For an introduction to this and other regional determinants of national growth, also the role of agglomerations, see Horst Zimmermann, Agglomeration tendencies and national growth: A primer on recent developments, Philipps-University Marburg, Public Finance Group, Discussion Paper Series "Fiscal federalism and economic growth", No. 5, Marburg, January 2004. - The paper can be downloaded under: www.wiwi.unimarburg.de/Lehrstuehle/VWL/FluW/, then via Forschung/DFG-Projekt/Arbeitspapiere/Nr. 5 Horst Zimmermann (then choose English, the link in brackets).

³ The author just wrote an article in German on this line of thought (Zimmermann, Horst, Kommunale Verschuldung – Wozu?, in: Wirtschaftsdienst, 86. Year, p. 391-397).