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# Fiscal Decentralization, Chinese Style: Good for Health Outcomes?

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**Summary.** — This study analyzes the effect of fiscal decentralization on health outcomes in China using a panel data set with nationwide county-level fiscal data. We find that more fiscally decentralized provinces have lower infant mortality rates than provinces that are the main spending authority, if certain conditions are met. Key among those conditions are the county governments' own fiscal capacity and intergovernmental transfers. Local spending responsibilities need to be matched with county governments' own fiscal capacity. When the county's government relative spending responsibility is held constant, the ability to spend on local public goods and health outcomes depend upon intergovernmental transfers.

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## 1. INTRODUCTION

Decentralization has become a major trend worldwide in developed and developing countries alike. Transferring authority and resources from central to local tiers of government can bring allocative benefits for the provision of local public goods (Bardhan, 2002; Dethier, 1999). Decentralization can improve access to health care and other social services by enhancing the participation of the community in decision making and implementation processes, by strengthening local authorities who should be able to better tailor staff, resources and procedures to local circumstances compared with the central government (Collins & Green, 1994; Robalino, Picazo, & Voetberg, 2001). Decentralized health programs are said to be closer to clients, face reduced information costs, have a better alignment of needs to local preferences, and allow for increased flexibility and transparency, (Lieberman, 2002; Litvack & Seddon, 1999). However, despite the above listed arguments in favor of decentralization, there is little empirical evidence that countries with a decentralized system have actually experienced improved health outcomes. Moreover, not much is known yet about the enabling or constraining conditions for successful decentralization (Asfaw, Frohberg, James, & Jütting, 2007; Jütting *et al.*, 2005; Rao, 2000).

Against this background, this paper analyzes the impact of fiscal decentralization on health outcomes in China. China is one of the most decentralized countries in the world in terms of the spending responsibility assigned to the local governments. The contribution of this study to the existing literature is threefold: First, while studies on the impact of fiscal decentralization on various outcomes such as growth, poverty, and inequality at the center-province level in China exist, little is known about what is happening at the province-county level. Second, while it is well known that the relation between fiscal decentralization and health outcomes is rather complex, there is a lack of studies looking into enabling and constraining factors making decentralization work. Third, although China is a specific case with respect to its institutional set-up, there are lessons to be learnt beyond the Chinese context.

Two key questions guide our analysis. First, what role do fiscal transfers between the layers of government play in explaining different health outcomes? Fiscal transfers play a substantial role in bridging fiscal gaps, particularly in decentralized developing countries (Shah, 1994). Such a role has been increasingly important in China, especially since the tax sharing system was implemented in 1994. Secondly, do more decentralized provinces perform better, as measured in terms of lower infant mortality rates, than provinces that play a larger role in the provision of public services?

The remainder of this paper is organized as follows. The next section introduces main features of fiscal decentralization Chinese style and reviews key studies discussing the impact of fiscal decentralization in China. The relation between fiscal decentralization, health sector reforms and health outcomes in China is discussed in Section 3. Following this, Section 4 presents the indicators measuring fiscal decentralization, the data used, and descriptive statistics, while Section 5 presents the empirical analysis. The last section summarizes our conclusions.

## 2. FISCAL DECENTRALIZATION, CHINESE STYLE: A SNAPSHOT ON DESIGN AND IMPACT

The intergovernmental fiscal relationship is highly decentralized in China witnessed by the high local share of total fiscal expenditure. Since the 1990s, local governments have financed about 70% of total fiscal expenditure,<sup>1</sup> which is an exceptionally high proportion, even compared with other countries in the world (OECD, 2006). A major milestone in

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the current fiscal institutional set-up was the 1994 tax reform, in which the revenue side of the fiscal relationship was recentralized. This reform was motivated by a decrease in fiscal revenues, in particular a decrease in the fiscal revenue of the central government (Bahl, 1999; Wong, 1997; Wong & Bird, 2008). The ratio of total fiscal revenues to GDP was 22% in 1985 but, by the mid-1990s, it had fallen sharply to about 10%. The major purpose of the 1994 reform was to raise fiscal revenues, achieve uniformity in the implementation of the tax structure, and create the tax assignment system, providing incentives for improved tax effort (Bahl, 1999). The ratio of total fiscal revenues to GDP has gradually increased since 1995, and by 2006 had reached about 18%.<sup>2,3</sup> Based on a calculation using the data in the Fiscal Yearbook of China (Ministry of Finance, China), the central government's share of total fiscal revenues rebounded from 21% in 1993 to 57% in 1994, and it has remained around 50–55% since 1995.

While the revenue side was recentralized by the 1994 reforms, there was no change in the expenditure responsibility alignment between the central and local governments (Ahmad, *et al.*, 2004). The expenditure assignment was not consistent with the revenue capacity of local governments (World Bank, 2002). It generated a large fiscal gap for provincial governments, that is, it widened the vertical imbalance (Ahmad *et al.*, 2004). Such conditions resulted in the provinces becoming significantly dependent on intergovernmental transfers from the central government (Wong & Bird, 2008).

The intergovernmental fiscal relationship between the province and the lower tier of government, i.e., the county, is more complex (Bahl & Wallace, 2003). In general, heavy responsibility for providing public services is borne by lower tiers of government, below province level (Wagstaff & Lindelow, 2008; Wong & Bird, 2008). In particular, the major responsibility for providing health care services is carried by the county (Martinez-Vazquez *et al.*, 2008).<sup>4</sup> Meanwhile, fiscal instruments, such as local taxation, tax sharing, and grants, as well as expenditure assignments below province level, vary across provinces, and hence some provinces are more centralized than others (Bahl, 1999; Bahl & Wallace, 2003). Some provinces use local taxation to distribute revenues to counties, whereas others use tax sharing or fiscal transfers (Bahl & Wallace, 2003). Such fiscal instruments structure the intergovernmental fiscal relationship between province and county, and affect the fiscal autonomy of county governments.

Most studies analyzing these complex features of fiscal decentralization in China have used province-level fiscal data, focusing on the relationship between center and province. They have analyzed the impact of fiscal decentralization on fiscal revenues/expenditures, economic growth or inequality. For example, Jin, Qian, and Weingast (2005) described fiscal decentralization as the ratio of provincial expenditure to central expenditure and provincial fiscal incentives as the retention rate of provincial marginal revenues. They found that the reforms from 1982 to 1993 (fiscal contracting systems) considerably strengthened the fiscal incentives for provincial governments, and were generally conducive to provincial economic development. Tochkov (2007) focused on the role of fiscal transfers in decentralized China. Using a data set covering the period from 1952 to 2001, this study examined the smoothing of regional expenditure through the fiscal system by estimating the fraction of revenue shocks absorbed by interregional transfers. The study found that the fraction of shocks in a province absorbed by net transfers declined over time. In addition, the percentage of province-specific revenue shocks buffered by net transfers was larger for rich provinces than for poor provinces in every period of the data sample,

and this regional discrepancy increased significantly after 1994. Jin and Zou (2005) analyzed the impacts of fiscal decentralization on economic growth, using the relative importance of the provincial government on the revenue and expenditure sides as fiscal decentralization indicators. Contrary to general arguments in the decentralization literature, they found that divergence in revenue and expenditure at provincial level was associated with higher growth rates.

Zhang (2006) is one of the rare studies examining the effects of fiscal decentralization below the province level by using county-level fiscal data. This analysis showed that, along with fiscal decentralization, the regional distribution of expenditures, particularly public capital expenditures, had greatly deteriorated. Based on a quantitative analysis, Zhang pointed out that fiscal decentralization may bring about detrimental distributional consequences given the unequal economic and social development between regions.

### 3. FISCAL DECENTRALIZATION, HEALTH SECTOR REFORMS AND OUTCOMES

Relatively few studies have focused on fiscal decentralization and health issues in China. Among those, OECD (2006) and Zhang and Kanbur (2005) pointed to increasing spending inequalities among Chinese provinces that translate into widening spatial inequalities in access to health care. Zhang and Kanbur (2005) particularly focused on the distributional changes in education and health care across regions or between urban and rural areas after the economic reforms. They pointed out that fiscal decentralization reduced the redistributive power of the central government, and hence many local (provincial) governments, in particular those in poor regions with insufficient revenues, had largely withdrawn from their roles in investing in social development.

The systems of health financing and health service provision substantially changed in China after the economic reforms started in the late 1970s. Central and local governments came to require direct financing for the health system, and individuals came to bear the financial burdens of obtaining health care services (Li, 2004; Wong *et al.*, 2006). Before the economic reforms, health care service provision was basically financed through state-owned enterprises (SOEs) in urban areas, *via* a system known as the labor insurance system (LIS), and through the cooperative medical scheme (CMS), based on people's communes, in rural areas (Li, 2004; Wong *et al.*, 2006; World Bank, 1997). Along with rapid economic development, socioeconomic conditions significantly changed in China. Such changes brought about decay in the conventional health system based on SOEs or people's communes.

Instead of SOEs or people's communes, governments were required to take substantial responsibility for financing the health system. However, the central government tightened its fiscal investment in the health sector over the 1990s, and left most responsibilities for health service provision to local governments (Blumenthal & Hsiao, 2005). For instance, while the central government has responsibility for subsidizing prevention of highly infectious diseases in poorer areas, provincial governments are supposed to pay for the costs of planned vaccination, and county governments have to pay for all other public health services (Martinez-Vazquez *et al.*, 2008). Local governments in poor regions, suffering from a lack of fiscal resources, did not take sufficient responsibility (Smith, Wong, & Zhao, 2005; World Bank, 1997). The revenue and expenditure alignment below province level, in particular the fiscal capacity and the design of expenditure responsibility at the county government

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