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## Factor decomposition of sub-provincial fiscal disparities in China<sup>☆</sup>

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### Abstract

With the help of fiscal statistics on sub-provincial public finances in the second half of the 1990s, this paper explores the hotly debated issues pertaining to fiscal disparities in China during this period, and the various factors driving the changes in fiscal disparities. Among them are economic factors (e.g., GDP per capita, economic structure), and institutional factors (e.g., urban–rural dichotomy, ethnic issues).

We adopt Morduch and Sicular's general, regression-based approach to decompose fiscal disparity with respect to per capita fiscal expenditure (Morduch & Sicular, 2002). The empirical results indicate that among all the statistically significant factors, GDP per capita and urban–rural dichotomy are the two most important variables that affects fiscal disparities, with a total contribution of 60%. Other relatively important factors are economic structure and population

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density. Several features of fiscal expenditure in China identified by our empirical findings together with their corresponding policy implications are discussed.

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## 1. Introduction

This paper is an attempt to study the forces shaping sub-provincial fiscal disparities. Putting the latter in the limelight in recent years is the alleged sub-provincial fiscal crisis symbolized by such pathological phenomena as arbitrary charges (*luan shoufei*), wage arrears and local fiscal deficits. To some commentators, the design of the tax-sharing reform in 1994 has induced vertical redistribution of fiscal resources often at the expense of sub-provincial governments and has accentuated the plight of sub-provincial governments especially in poor regions without at the same time putting in place a need-based intergovernmental system to seriously address the problem of fiscal disparities (see, e.g., Jia & Bai, 2002; Lou, Li, & Xiang, 2002; World Bank, 2002). Some pioneering works have already been done on the issue of fiscal disparities, e.g., Park, Rozelle, Wong, and Ren (1996), Wong (1997), World Bank (2002), though most if not all of these studies have only looked into sub-provincial fiscal disparities with respect to specific regions, falling short of a comprehensive picture delineating the country as a whole. Nor is there any study which sorts out the factors contributing to fiscal disparities. The purpose of this paper is to fill this lacuna by using a data set of nationwide sub-provincial statistics to identify the significant determinants of fiscal disparities and quantify their contributions to overall sub-provincial fiscal inequality.

This paper explores the extent to which two sets of factors impinge on sub-provincial fiscal disparities. One of them pertains to economic factors. Cross-country research (see, e.g., Tanzi, 1987) often suggests that inter-country fiscal disparities may be explained by large variations in the levels of economic development and economic structure. Given China's prodigious regional disparities, it is not inconceivable that the same applies to China. Not only is the revenue-generating capacity of a sub-provincial jurisdiction determined by the level of economic development, but also it is affected by the interaction between the local tax system and the economic structure. Local governments governing a primarily agricultural, particularly grain-based, economy are more revenue-starved than those with large non-agricultural sectors deriving revenues mainly from business tax and value-added tax. Large inter-jurisdictional variations in these economic determinants in China may thus help explain China's fiscal disparities. In so far as the Chinese government plays a rather interventionist role in shaping economic development, economic factors alone perhaps do not fully explain fiscal disparities. The evolution of institutions and policies peculiar to China may also be important in exerting their impact on the spatial distribution of fiscal resources. Among the institutional factors is the urban-bias policy, a legacy of the pre-reform planning system. Furthermore, often out of political

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