Fiscal Transfer and Local Public Expenditure in China: A Case Study of Shanxi Province*

Haiyan Duan and Jing Vivian Zhan

Abstract

Given the vertical fiscal imbalance between the Chinese central and local governments and the overwhelming tasks imposed on local governments after the 1994 tax reform, intergovernmental fiscal transfer has become crucial for alleviating local fiscal shortages and funding local public services. Then how does fiscal transfer affect local

* Author names are in alphabetical order. The authors wish to thank Wang Shaoguang, Li Lianjiang, Zhang Guang, and the three anonymous reviewers for their invaluable comments on earlier versions of this article. All errors remain the authors’ own. The authors gratefully acknowledge the financial support from the Hong Kong Institute of Asia-Pacific Studies, the Chinese University of Hong Kong, and the National Social Science Foundation of China.
public expenditure? Does it facilitate better public services? This article answers these questions by examining the spending behavior of county-level governments in Shanxi Province. The data analysis reveals that fiscal transfer does not necessarily motivate the recipients to provide better public services but rather encourages spending on economic construction. The findings suggest that to improve local provision of public goods and services, the management of fiscal transfers must be strengthened so as to prevent the diversion of funds to unintended uses, the transmission of fiscal transfers must be streamlined to guarantee timely payment, and local officials must to be motivated to invest more in public services.

Countries with multiple levels of government invariably rely on intergovernmental fiscal transfer to coordinate the fiscal resources and responsibilities of different levels of government.\(^1\) China, a country with a vast territory and an extensive governmental hierarchy, has seen centralized revenue collection but decentralized fiscal spending following

---

**Figure 1** Share of Transfer in Subnational Government Expenditure (1985–2007) (%)

Source: Figure compiled using data from *China Statistical Yearbook 2006.*