

Decentralization, Deregulation and Economic Transition in China

Justin Yifu Lin

China Center for Economic Research, Peking University

Ran Tao

China Center of Agriculture Policy, China Academy of Sciences

Mingxing Liu

China Center for Economic Research, Peking University

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Abstract

In this paper, based on an account of recent economic history of in China, we explore the institutional background and inter-government relationship both in the pre-reform and post-reform period. We demonstrate the centralization-decentralization cycle in the traditional planned system is an inevitable outcome of the regulatory structure endogenous to the overtaking development strategy inconsistent with China's endowment structure. We also argue that the marketization reform since late 1970s can be viewed as a process of deregulation, and the decentralization at that time is only a means of deregulation. We make a critical review of the "Chinese style fiscal federalism" by arguing that the evolution of fiscal arrangements after the marketization reform is, to a large extent, endogenous to China's transitional path and de-regulation sequencing. We propose a framework to explain China's growth in transition and point out that rule-based decentralization in China is yet to be achieved. We argue that the administrative/fiscal decentralization may not promote economic development of China without further reducing government intervention. The existing problems in the current inter-government fiscal arrangement are analyzed from the perspective of development strategy and government regulation.

I. Introduction

China's economic transition has been remarkable in the past two decades. In the two decades, China has transformed itself from a centrally planned economy to an emerging market economy and at the same time has achieved a more than 9 percent average growth rate. During this period, China's per capita GDP has more than quadrupled and the living standard of ordinary Chinese people has improved significantly. At the same time, even after two decade's reform and growth, a lot of problems, such as the low profitability of SOEs, a highly ineffective banking system, widening gap between the rich and the poor and among different regions, and the lack of social security system, still exist, which pose great challenges to further reform and create a host of uncertainties in China's economic outlook. How to understand the progresses and the existing problems in China's economic transition has attracted attention of an enlarging literature.

In terms of the impacts of fiscal decentralization on economic performance in China, economists have presented very different views. Wong (1991 and 1992) argued that decentralization and fiscal contracting seemed to create a variety of microeconomic distortions. For example, decentralization may have induced local governments into over-investment, duplication, regional market protectionism, and more local bureaucratic interventions. In addition, decentralization and fiscal contracting seemed to have increased regional inequality due to the constraints on revenue redistribution by the central government.

However, focusing on incentives of local government, Qian et al (1994a , 1994b, 1997,1998, 1999, 2001), in a series of papers on Chinese transition, emphasize the "Chinese Style Federalism" and show that evaluations of China's decentralization and fiscal reform need to be broadened to incorporate their impacts on the many dimensions of economic development and reform. In the context of the so-called "second generation federalism", the traditional approach is extended by systematically studying the role of government incentives in economic performance (Qian and Weingast, 1997). Because governments in developing and transition economies have often been the central barriers to economic development, providing these governments with the incentives to promote markets is especially critical. Specifically, the "market-preserving federalism" theory (e.g., Weingast, 1995; Montinola, Qian, and Weingast, 1995) argues that by devolving regulatory authority from the central to local governments, the interventionist role of the central government can be limited.

However, different empirical studies have shown that the growth effect of fiscal decentralization is still ambiguous, because different economies have different performances in the process of decentralization. For example, based on the province-level panel data of China, Zhang and Zou (1998) found a negative and significant relationship between fiscal decentralization and provincial growth, while Jin, Qian and Weingast(1999) and Lin and Liu(2000) presented reverse results. Obviously, as argued in a recent literature survey by Bardhan (2002), it is not surprising to observe that the fiscal decentralization plays the diverging role in the institution changes in different countries and different periods, while the influence mechanism of decentralization should be clarified further according to its realistic circumstance.

In this paper, with the focus on the experience of decentralization in China, we try to properly account for China's two decades of market transition from the perspective of decentralization, deregulation and development strategy. By examining the evolution of China's institutional arrangements from the pre-reform period to the current system, we will analyze the roles different aspects of decentralization played both before and after China's economic reform since late 1970s. We argue that the regulatory structure in the planned economy are endogenous to the development strategy adopted by the central government, while the centralization-decentralization cycle before the market-oriented reform is inevitable given the information and the control problems in the planned system, and that the decentralization after the reform is subject to the changes of development strategy. Therefore, without deregulation, or more fundamentally, without the change of distorted development strategy, decentralization may not facilitate the economic development and may even lead to adverse economic consequences. We argue that the impact of fiscal decentralization on China's economic growth since late 1970s have been exaggerated, that China's impressive growth mainly originated from the micro-deregulation and the ensuing changes in resource allocation and market-oriented macro-reform, that fiscal decentralization can be viewed to a large extent as a means to deregulate and is largely endogenous to the process of deregulation. We hold that so far the "Chinese style decentralization" is conceptually different from the decentralization in many other countries since a full-fledged governance structure and market system are yet to be established in China and a more reasonable inter-government system is desperately needed to achieve both economic efficiency and equality in basic public service provision across regions.

The paper is structured as follows: in Part II, we review the economic history from the perspective of inter-government relationship after the founding of the People's Republic. We describe the institutional features of the pre-reform and post-reform

economic system and analyze the reasons behind them. We also describe the deregulations and regional decentralization that the market-oriented reforms since late 1970s entailed. In Part III, we critically reviewed the current literature on China's decentralization after late 1970s and the role fiscal decentralization has played in China's transition. By pointing out that deregulation, instead of decentralization, has played an essential role in China's growth in the past two decades, we analyze the endogeneity of fiscal decentralization in the 1980s and present a theoretical framework of deregulation to explain China's transition and growth in Part IV. In Part V, we describe the impact of the reforms since mid-1990s, and the problems created by the current inter-government fiscal arrangements and necessary steps to solve them from the perspective of decentralization and deregulation. Part VI concludes.

II. Decentralization in China: A Brief History

2.1 China's Long History of Bureaucracy

As a nation with one of the longest history in the world, China boasted a bureaucratic system of more than 2000 years. Since the start of Qin Dynasty in 221 B.C, China has established a centralized bureaucratic system. The First Emperor divided his new empire into 36 commanderies(Jun), each subdivided into a number of counties(xian). (Junxian has been shorthand for centralized bureaucratic rule, as opposed to fengjian meaning decentralized or feudal) (Fairbank, 1998). It is hard to imagine how such a centralized system could persist in a country with huge territory given the extremely poor transportation and communication conditions in ancient times, but it did. The key to the survival of grand bureaucratic regime is twofold: first, at and above the county level, there has been strong political and economic centralization with the emperors controlling the political appointment and most of the economic resources; Second, below the county level, no government agencies were set up, thus rural villages are ruled by local gentry. The tasks of tax collection, basic public goods such as public security, education, and local irrigation and water conservancy system to a large extent, were mainly provided locally with the organization of local gentry. Centralization above and decentralization below the county led to two consequences: first, For higher levels of inter-government arrangements, political and economic centralization usually led to insufficient financial resources for local governments to carry out local responsibilities. This situation usually became more and more serious toward the middle and the end of a dynasty with the central bureaucracy

expansion and heavier military expenditures. What naturally followed are heavy local informal fee burdens and heavy dependence on local gentry to carry out government responsibilities ; At the same time, without democratic election and government accountability as anchors, decentralization at grass-root level is prone to pitfall owing to greater vulnerability of local government or community ruling organizations to capture by local elites. (Bardhan and Mookerherjee, 1999). The problem can easily lead to serious corruption, uneven tax burdens between the rich and the poor, higher frequencies of land annexation, which constitute an important reason for the dynastic cycles in ancient China(Huang, 1997).

2.2 Development Strategy, Regulatory Structure Under Planned Economy, Centralization-Decentralization Cycle.

2.2.1 Development Strategy and China's Comparative Strategy

In the year of 1949, China ended an era of wars of more than 100 years. The founding of the People's Republic marked a new era of the Chinese history. The ambitious government leaders believed that to defend the newly established socialist system, and to keep pace and even overtake western industrial countries, rapid industrial development, especially the establishment of a complete set of heavy industries is essential. Learning mainly from the Soviet experiences, the Chinese government began to formulate and implement the First Five-year Plan that gave priority to heavy industrial development since 1953 soon after the national economy recovered from war damages. ¹ In the First Five-year Plan, heavy industrial development were put in a strategic position. The central and backbone projects of industrial construction in the First Five-year Plan were the 156 key projects designed with aid from the former Soviet Union. During the First Five-year Plan period, investment in the heavy industrial infrastructure accounted for 85% of the total of the industrial infrastructure and 72.9% of the total investment in agricultural and industrial infrastructure.

However, the development strategy of prioritizing heavy industries was inconsistent with China's endowment structure: during the initial period of China's economic development, capital was badly in short supply, hence market interest rate was naturally high while labor forces were rather cheap. The cost of developing capital-intensive heavy

¹ According to Lin, Cai and Li(1995), many developing countries, including those socialist countries such as Russia, East Europe Countries and China, and even many Latin American countries and India that adopted import substitution strategy, were actually adopting an overtaking and leaping forward development strategy after World War II.

industries was extremely high and such industries would have no competitiveness in an open and free competitive market economy.² If resources had been allocated by market mechanism, investment would not have flowed to heavy industry sectors. Then a light industry-led industrialization would follow, which would run contradictory to the goal of implementing heavy industry-oriented development strategy.

2.2.2 Regulatory Structure Under Planned Economy and Centralization

To maximize the resource mobilization for the capital-intensive-oriented industrialization, a planned system had to be established. According to Lin et al (1996, 1999), such a system was characterized by the trinity of a macro-policy environment of distorted prices for products and essential factors of production (e.g. trained personnel, funds, technologies, resources, etc.), highly centralized planned resource allocation and a micro-management mechanism in which firms had no decision-making power. The logic among the macro-policy environment, highly centralized planned resource allocation system and dependent micro-management institution, with production factors and product prices distortion characterizing the strategy of prioritizing the development of heavy industries is as follows. (1) A macro-policy environment with depressed interest rate, exchange rate and prices of much demanded goods was the prerequisite for the prioritized development of the heavy industries. (2) Implementing the planned resource allocation system was the objective demand to solve the contradiction that gross demand exceeded gross supply under the distorted macro-policy environment and to guarantee resources went to heavy industries. (3) The micro-management institution without any autonomy was implemented in order to prevent enterprises from corroding profits and state assets taking advantage their operation rights. In the rural areas, the People's Commune system was to guarantee state monopoly of procurement and marketing of agricultural produces.

Therefore, the traditional planned system, including the fiscal system, was established to serve the purpose of heavy industrial development. Given the distorted macro-policy environment in which capital price is heavily depressed, the financial sector are seriously under-developed and the fiscal system became the major, if not the only channel for resource mobilization under the centralized resource allocation. The public finance function of the fiscal system is only subordinate to its function in resource mobilization for capital-intensive industrialization.

Accordingly, in the early period of industrialization when capital was most scarce, a heavily centralized fiscal system was established: not only the accounting system of

² Lin, Justin Yifu & Tan Guofu, "Policy Burden, Accountability, and Soft Budget Constraint", American Economic Review, Vol. 89, No.2, (May 1999).

SOEs was directly incorporated into the fiscal system with all SOE financial indexes formulated and monitored by the finance departments of the government, but also almost all important resources were highly concentrated in the hands of the central government. The Planning Commission at the central government command the authority in determining local revenue and expenditure plans on an annual basis. This system was known as the principle of "unified revenue and unified expenditure" (tongshou tongzhi), meaning that all government revenue and expenditures had to go through the central government. The local governments did not have independent budgets and their budgets are formulated and monitored item by item by the central government and at the same time as the central budget.

2.2.3 Centralization--Decentralization Cycle under the Planned Economy

The fiscal system and the corresponding inter-government arrangements can facilitate the implementation of state plan and serve the purpose of prioritizing heavy industrial development. However, in a country as huge as China, the working load to formulate, administrate, coordinate, and monitor the plans for the central planning and finance departments is extremely heavy and became more and more so as the economic system became larger and more complicated. For example, the number of enterprises subordinated to the central government increased from 2,800 in 1953 to 9,300 in 1957, and the number of items in material allocation under central planning increased from 55 in 1952 to 231 in 1957.(Qian and Weingast 1996). The classical information problem of control and monitoring emerged soon after the planned system was established. As the economy developed with more and more projects initiated and enterprises started, the planned system became more and more unmanageable and the fiscal centralization becomes less and less attractive. Furthermore, a highly centralized planned system is not only harmful to promote incentives of state owned enterprises and workers, but also harmful to promote the incentives of the local governments since in many respects the industrial projects under construction and operation need the full cooperation of local governments.

As a matter of fact, it was Chairman Mao who realized the problems of over-centralization in early periods of the planned system. In his 1956 famous speech, "On Ten Important Relationships," Mao argued:

“Our territory is so vast, our population is so large and the conditions are so complex that it is far better to have the initiatives come from both the central and the local authorities than from one source alone. We must not follow the example of the Soviet Union in concentrating everything in the hands of the central authorities, shackling the local authorities and denying them the right to independent action. The central authorities

should take care to give scope to the initiative of provinces and municipalities, and the latter in their turn should do the same for the prefectures, counties, districts and townships; in neither case should the lower levels be put in a strait-jacket” (Mao, 1977).

Under this background, China began its first fiscal reform within the planned framework by delegating more powers to local governments since 1957. In 1957 the Third Plenary Session of the 8th Congress of Communist Party of China adopted three decisions for improving management in industry, commerce, and fiscal relationship between the central and local governments. These decisions included: (1) delegating nearly all state-owned- enterprises (SOEs) to local governments, such that the share of industrial output by the enterprises subordinated to the central government shrank from 40 percent to 14 percent of the national total; (2) central planning was changed from a national to a regional basis, with decisions about fixed investment to be made by local governments rather than the central government; and (3) revenue sharing schemes were fixed for five years and local governments gained the authority over taxes. The share of central revenue decreased from 75 percent to about 50 percent.

The decentralization occurred only two years after the basic framework of the Chinese central planning system was fully established in 1956, coinciding with the 1958 Great Leap Forward, which called for a rapid expansion of the economy. Indeed, local incentives responded quickly to decentralization, and local small industries boomed (the classical example is backyard steel mills). This program, however, did not succeed, for the radical decentralization caused serious coordination failures. With the problem of soft budget constraints for local governments and enterprises, investment expanded too rapidly and inefficient duplication was unavoidable. Recentralization had to begin in 1959 and was completed by 1963. All large and medium sized industrial enterprises were again subordinated to the central government, and the share of central revenue increased.

The second wave of decentralization started in 1970. This round of decentralization proceeded along regional lines for two reasons, first, local self-sufficiency reflected military considerations, namely Mao's assessment of the likelihood of a Soviet invasion and the imminence of World War III; Second, to meet the goal of high growth in the Fourth Five-Year Plan discussed in the early 1970s. This second wave of decentralization shared many features of the 1958 decentralization. Most large-scale SOEs were again delegated to provincial and municipality governments (the share of industrial output produced by SOEs under the central government's control went from about 50% in 1965 to only about 8% after 1970). Local governments gained more authority over fixed investment and local revenue included everything except custom duties and revenues from enterprises

subordinated to the central government. A similar, but less serious investment boom resulted from local soft-budget constraints led to recentralization again in the mid-1970s.

As the description above illustrates, the heavy industry oriented development strategy necessarily led to a centralized resource allocation system, which was especially true for the fiscal system since the latter is the major, if not the only, financial channel for capital-intensive industrialization. However, besides low efficiency resulted from the incompatibility between the capital-intensive development strategy and China's endowment structure, this system is also very inefficient in information and incentive provision. To solve the problem, the government resorted to both fiscal and administrative decentralization by delegating more powers to local governments without changing the development strategy and the planned system. However, the decentralization in the planning period has always been followed by a round of investment boom, short supply of raw materials, circular funds and infrastructure, irrational industrial structure with the share of heavy sectors rising too rapidly, higher fiscal deficit, and all in all economic overheating. Then the central government found the situation out of control and had to recall the power delegated to the local governments, thus a re-centralization followed.

Why did the decentralization always lead to economic overheating in the planned system? The reason is the following: the decentralization always led to the break of industrial linkages constructed under the centralized system, thus the interregional segmentation pushed the local governments to establish an independent set of industrial system that can realize self-sufficiency in supply of materials needed.³ Under the soft-budget constraints typical of the planned system, the local governments always tried to get more of the scarce resources from the central planner. At the same time, they will also strive to increase the supply of the scarce materials by establishing small local enterprises such as steel plants, coal mines, machinery building plants. A wave of over-investment naturally followed and economic overheating became inevitable. Under the distorted macro-policy environment, the benefits of light industrial and agricultural development are lower compared to those of heavy industrial development, thus irrational industrial structure that sacrifices the development of light industries and agriculture necessarily followed.

³ However, the decentralization in 1970s did have some impact on the reforms starting from late 1970s. One result of this wave of decentralization was the rise of local small industries (the so-called "five small industries"). For example, more than 300 counties or municipalities set up small steel mills and about 90 percent of counties set up agricultural machinery repair factories. During that period, "mechanization in agriculture" was a catalyst for rural industry, which was the predecessor of township and village enterprises (TVEs) years later.

Therefore, there is an inherent logic of development strategy- centralization-information and control problems, low efficiency –decentralization—over-investment and overheating---re-centralization cycle in the planned system, which actually continued after the reform in late 1990s. It is not mainly the case that chairman Mao disliked the soviet centralized system as claimed by some authors (Qian and Wengast, 1997), but the centralization under the planned system leads naturally to serious control, information and incentive problems, which pushed the government to carry out decentralization. However, without the change of development strategy, the planned system and the corresponding regulatory structure is still necessary to mobilize resource for heavy industrial development. Therefore, the decentralization under the planned system is not so helpful in alleviating the efficiency problem since it does not change the development strategy that is not consistent with the China’s comparative advantage; On the contrary, under the soft-budget constraint of local government and SOEs in the planned system, a cycle of “ decentralization leads to disorder; disorder leads to centralization; centralization leads to stagnation; stagnation leads to decentralization.” necessarily ensued.⁴

In conclusion, either the separation of administrative responsibility, or adjustment of power division only changed the status of region and industries in resource allocation system. The traditional development strategy, the distorted macro-policy environment, the planned resource allocation system and the rigid micro-management institutions were left intact. With the vested interest lost in administrative adjustments, regions, departments and industries resorted to a new round of administrative adjustments to retrieve them. Therefore, economic reforms were always in a cycle of administrative power decentralization and re-centralization (i.e. redefining authority between departments and regions) and the cyclic repetition of administrative organizational expansion and streamline that was closely related to the former (see table 5.1). For decades, domestic and foreign failures to implement the strategy of prioritizing heavy industries in traditional trinity economic system made it quite clear to Chinese policy makers: the existing theories and practices could not serve to unravel problems in socialist development. Reforms must be

⁴ As a matter of fact, the pattern continued after China started its market oriented reform since late 1970s. We will elaborate on this later. The main point here is that the decentralization-centralization(or more generally, the economic) cycle is endogenous to the traditional overtaking development strategy. Without thorough change of the development strategy, the cycle is inevitable. As argued by Hu (2001), the administrative/fiscal decentralization without marketization can only distort the socialist economic structure further, not to improve it. The decentralization under the planned regime could not solve the problem of soft budget constraint of local governments and enterprises, but only aggravate the shortage of economy.

taken to change the fundamental aspects of the traditional economic system in order to achieve economic development.

Table 2.1 Power Delegation-Concentration Cycle Before Marketization in China

	1953	1957	1958 year-end	1963	1971-3
Number of enterprises under direct control of central government	2800	9300	1200	10000	2000
Number of materials allocated by central ministries & departments	227	532	132	500	217

Source: Yu Guangyuan (ed), China's Socialist Modernization, Beijing: Foreign Languages Press, 1984, p.76

2.3 1978-1993: Market-Oriented Reforms Strategy, Deregulation and Decentralization.

1.3.1 Micro-Reforms and its Consequences

Low efficiency in traditional economic system was noticed as early as 1960s, when the first round administrative decentralization were taken. However, it was not until the 3rd Plenary Session of the 11th CPC Congress in December 1978 that fundamental changes took place.

As explained before, there is an inherent logic among distorted macro-policy environment, highly centralized planned resource allocation system and rigid micro-management institution, with production factors and product prices distortion characterizing the strategy of prioritizing the development of heavy industries. However, both the distorted macro-policy environment and highly centralized planned resource allocation system were inherent problems of traditional economic system. Due to the distorted price system from macro-policy environment, the industrial structure in line with traditional strategic objectives still had very strong inertia. What is self-evident to the policy makers in late 1970s was the correlation between production inefficiency of enterprises and People's Communes and lack of stimulus for workers and farmers. That explains why the reforms began with the micro-management institution at the end of 1978 in an attempt to establish a system of stimulus and improve incentive for laborers. In rural areas, household responsibility contract system was initiated in 1978. In cities, a series of

comprehensive and specific reforms on management of enterprises were taken, centering on power delegation and profit sharing.

From 1979 the pilot reform of expanding decision-making powers was carried out in some state-owned enterprises. The reform was to stimulate enterprises to increase production and sales by increasing retained share of profits. If enterprises have the power to decide their internal welfare and rewarding arrangement, they will have the means to reward or punish according to work performance. This improved to some extent the incentive mechanism in state-owned enterprises. Accordingly, incrementally more resources were created.

At the same time, reform on micro operational mechanism in rural areas also made a breakthrough.⁵ The Household Contract Responsibility system chosen by farmers themselves was at first adopted only by poor and remote areas. This system was very efficient in solving the problem of supervision on agricultural work. It linked up farmers' income directly with their performance and dramatically improve farmers' working incentive. This reform generated high profits at low costs both for the government and farmers. Then more flexible policies were introduced. Farmers' choice of the popular Household Contract Responsibility system was recognized afterwards. In just a few years, the system became the common form of micro economic organizations in rural areas, which even finally led to the collapse of People's Commune system.

The reforms in SOEs and rural regions can be seen as a relaxation of the traditional planned system, or more precisely, as a partial deregulation of the system endogenous to the traditional overtaking development strategy. We call them a process of deregulation since they were mainly a process of granting micro-units (the SOEs and rural households) the decision-making powers in production, profit or surplus sharing that had not been available before. In both rural areas and SOEs, the so-called "responsibility system" made the households and enterprises de facto residual controllers and claimers.

2.3.2 Opening Up Policies, TVE and Private Enterprise Development and Deregulation

The micro-reforms since late 1970s or early 1980s were a break to the planned framework, thus they can be viewed as deregulation of the traditional trinity system, that means the residual control and claim rights of SOEs and farmers that had been forbidden

⁵ Agriculture was collectivized in 1955-56, and the People's Communes were established in 1958. Under the commune system and since 1962, the production team, which consisted of about 50 households, was the basic unit for production and distribution, and the commune had the authority for allocating quotas for, say, the acreage for growing rice or cotton. This system survived for 20 years.

before were now permitted. Therefore, the incentives improved greatly, which led to fast growth of agriculture and also the SOEs in the planned track.

However, the micro-reforms in SOEs and rural areas is far from the whole picture of China's reform and development since late 1970s. Another aspect of the reform in late 1970s that made it a typical deregulation process was its association with the policy of opening to the outside. Starting in 1979, many provinces were allowed to set up their own foreign trade corporations. At the same time, foreign investors were encouraged to form joint ventures with their Chinese counterparts. In July 1979, the central government decided that the two provinces, Guangdong and Fujian, because of their geographic location, should pursue reform "one step ahead" of other regions in the country, allowing them to adopt "special policies" and to implement "flexible measures." For example, the two provinces were allowed to retain all foreign exchange incomes after remitting 30 percent from the increased amount of export (Zhou, 1984). This marked the beginning of regional experimentation. In 1980, China established four special economic zones, Shenzhen, Zhuhai, and Shantou, adjacent to Hong Kong in Guangdong, and Xiamen in Fujian across the Taiwan Strait. Not only did these areas enjoy lower tax rates, but also, and perhaps more important, they enjoyed special institutional and policy environments and gained more authority over economic development. Although the rest of China was still dominated by central planning and public ownership, special economic zones were allowed to become market economies dominated by private ownership. In 1984, the central government further declared 14 coastal cities as "coastal open cities," which conveyed to them new authority that paralleled that of the special economic zones. Each of these open cities was also authorized to set up "development zones" inside its limits to implement liberal policies for attracting foreign capital and technology.

A further and no less fundamental development is the emergence of non-SOEs, especially the township and village enterprises into labor-intensive sectors.⁶ Early agricultural reforms contributed greatly to the booming TVEs since it is just the surplus created by agriculture efficiency improvement after the reform helped local governments and quasi-governmental village community organization to accumulate starting capital for TVE development. Another factor that contributed to the TVE development, somewhat ironically, is the impact of decentralization in the planned period. The decentralization wave in early 1970s left a lot of local small industries owned by local governments, which

⁶ As a matter of fact, there is also a large number of SOEs entries into labor intensive sectors. Therefore, it is not only that the old SOEs saw promotion of worker and management initiatives, but also many new SOEs were also established in the more labor-intensive light industries (mainly consumption goods sectors) that were heavily depressed, which contributed to the growth of SOEs as a whole.

laid a foundation for alter TVE developments. Of course, there are more new entries of new non-SOE firms than existing local small enterprises. However, the ultimate reason for the development of TVEs is that the start of new enterprises by local governments were no longer restricted as in the planned period, and they could enter most of the sectors they wanted to. As a result, most TVEs entered into the labor-intensive sectors that were forbidden and developed rapidly since they filled the gap left by the traditional heavy-industry oriented development strategy.⁷ Between 1983 and 1988 total rural enterprise output increased by more than fivefold, in comparison, between 1978 and 1983, it merely doubled. By the end of 1980s, rural enterprises had already become the pillars of national industry. No wonder Deng said in 1987: "The greatest achievement that was totally unexpected is that rural enterprises [both TVEs and private enterprises] have developed" (June 12, 1987).

Therefore, different from the reforms and decentralizations accompanying the Great Leap Forward and the Cultural Revolution, the reforms and decentralization in the 1980s is associated with deregulation and increasing marketization. By 1985, the so-called "dual-track price system" (one planned price, one market price), under which the SOEs could make outside-the-plan transactions at market determined prices, had been legitimized. At the same time, with the development of new enterprises including TVEs, another dimension of "dual track " including the planned track (mainly capital-intensive SOEs in the heavy industrial sectors developed in the planned period) and the market-oriented track(including the TVEs and the SOEs newly started in labor-intensive sectors) emerged since mid 1980s By the mid-1980s, market based transactions involving the non-state enterprises and the state-owned enterprises beyond the plan constituted a majority of transactions in the economy.

All in all, the micro-operational mechanism can be seen as the starting link of the entire reform chain. However, once the control on micro operational mechanism was relaxed, the industries depressed under traditional development strategy began to develop and adjust the distorted industrial structure in an incremental way. The economic growth

⁷ Some scholars argue that the success of TVEs centers on the incentives facing these firms and the township and village governments since the structure of these firms afford residual claim rights to township and village governments, that they face hard budget constraint and may go bankrupt and lay off workers, and that they face fierce competition, due to the fact that local governments do not have the authority or capability to use administrative means to protect their enterprises such as erecting trade barriers to keep out competition.(Qian and Wengast 1997). This argument is true in the sense that it explains why TVEs are more efficient and competitive than some of their SOEs counterparts. However, it has not addressed the question why TVEs, and SOEs as well, grew significantly since the reform started. One fundamental reason for this is deregulation of entry into labor-intensive sectors and products which brought China's comparative advantage into play., which is also true for many foreign-funded(including Hongkong, Taiwan based enterprises) enterprises.

outside the traditional planned economic system exerted further impact upon the traditional system. It put forward new demand and formed new resource allocation mechanism outside the plan track. New price signaling system outside the old macro policy environment emerged. The sectors used to be depressed now became propulsive sectors for reform. Once the reform started from some sectors, it would pass on to other sectors to form the pattern of gradual advance.

Therefore, the reform in micro-operational system necessarily led to at least partial marketization of many important materials and products, even when the government did not change the development strategy at the beginning of the reform and only wanted to improve the efficiency of the traditional system by improving the micro-incentives. However, due to the internal logic of the trinity, once a decentralization was given to the micro-agents, the reforms would evolve in a way to up to the resource allocation system and macro environment, resulting in a de facto change of the development strategy.

2.3.2 Administrative and Fiscal Decentralization under Marketization

Along with the deregulations associated with micro-reforms in rural areas and SOEs, TVEs and Foreign enterprise development due to the opening up policy, a process of administrative and fiscal decentralization has been inevitable. In a large country of the size as China, the micro-reforms and deregulations themselves required administrative decentralization and fiscal decentralization since without the coordination of local government, the reform measures could not have been implemented. Therefore, the decentralization in 1980s was associated with the following: local governments began to assume primary responsibilities for economic development in their regions and enjoyed a wider range of authority, including determining prices, setting up new firms, and making investment with "self-raised funds," that is, funds drawn from the extra-budget or borrowed from banks. There was also the promotion of local governments' role in investment approval, resource allocation, and the establishment of special economic zones and economic development zones.

At the same time, the burden of fiscal expenditure was also decentralized as local government assumed greater responsibility for providing education, health, housing, local infrastructure, and so forth. This is evidenced by the diminishing role of the State Planning Commission, which used to approve most fixed assets investment projects but now approves only "key projects" in the normal time period (Qian and Wengast 1997) .

One important fact warrants special attention in decentralization after the market-oriented reform. In the early 1980s, more state-owned enterprises were delegated to local governments at the provincial, municipality and county levels, mostly to municipality

governments. By 1985, the state-owned industrial enterprises controlled by the central government accounted for only 20 percent of the total industrial output at or above the township level, while provincial and municipality governments controlled 45 percent and county governments, 35 percent (Qian and Xu, 1993). When the state-owned-enterprises (SOEs) were allowed to keep part of their profit, the connection between the state and the SOEs was loosed and the central government had to provide for the local governments with incentives to step up the effort of revenue collection. At the same time, the various responsibilities assigned to different levels of governments were closely related to the ownership of the state-owned-enterprises. The spending for the investment in central-government-owned-enterprises was clearly included in the expenditure of central government, while the local governments were responsible for providing cash flow for both fixed investment and non-fixed investment of local-government-owned-enterprises. Therefore, the SOE ownership transfer from the central to local governments associated with micro-reforms implies the instinct connection between the local governments and local state-owned-enterprises.

Like other reforms, fiscal reform started as an experiment. In 1977, Jiangsu province was chosen to implement a new fiscal arrangement, which is called “eating from separate kitchens” (fenzao chifan). This system represents a dramatic departure from the previous system “unified revenue collection and unified spending” (tongshou tongzhi). In 1978, the central government enacted fiscal arrangement under the name “relating expenditure with revenue, dividing extra revenue with fixed share” in 10 provinces of China. Under this arrangement, (i) the local governments’ expenditures depended on their own revenues; (ii) almost all of fiscal revenues were collected by the local governments, then the total revenues were divided between the central and the local governments according with some pre-determined share which was fixed within three years; (iii) if there were some extra revenues beyond the previous year, then the local governments would be eligible to share them with somewhat preferred ratio. It is clear that there were strong incentives for the local governments to collect revenue in this arrangement. Consequently, in 1978, the local governments’ accumulated remained fiscal funds increased by 64%, whereas the central government failed into a deficit situation in the same year.

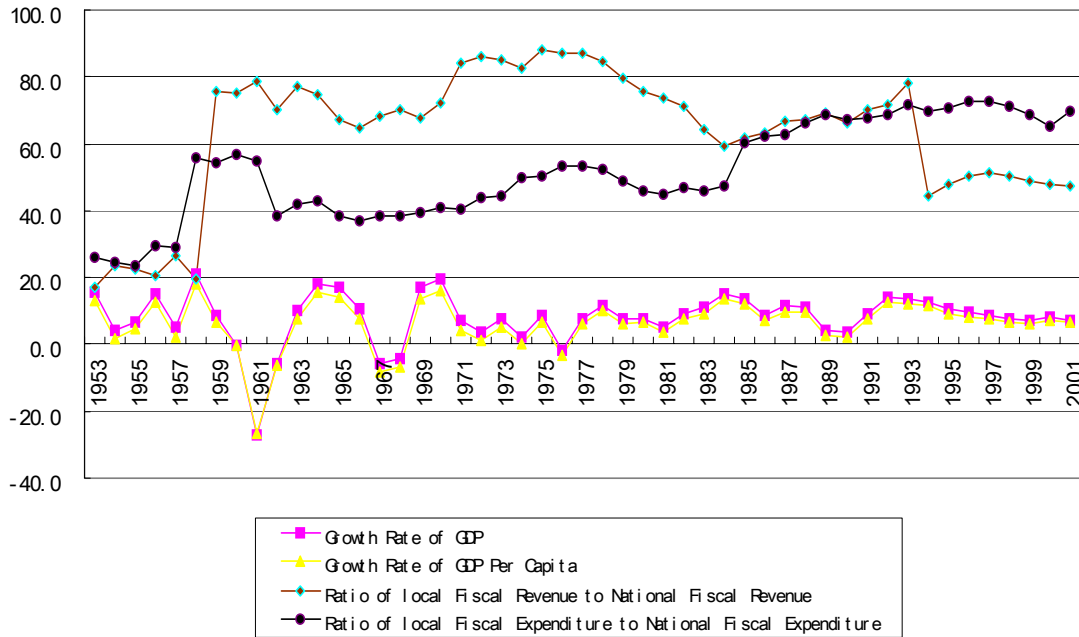
The problem of deficit pushed the central government to modify the fiscal arrangements. In 1980, a new system called “dividing revenue and expenditure with each level of government responsible for balancing its own budget”. This system is different from that of 1978 in the following items: (i) some fiscal sources were clearly specified as the central government’s revenue, among these were custom duties and revenue remitted by central-government-owned-enterprises; (ii) other sources such as salt tax, agricultural

taxes, and the revenue of local-government-owned-enterprises were defined as the local governments' revenues. (iii) for the profits of large-scale state-owned-enterprises under dual leadership by central and local governments, the industrial and commercial taxes (turnover taxes), central government and local government shared them with some fixed proportion. It is obvious that the spirit of the rearrangements in 1980 is to preserve the incentives for the local governments, constraint to the guarantee of the central government's revenue.

The "fiscal contracting system" continued until 1985 when the central government determined to replace the state enterprises' profit remittances with income taxes. For this reason, the new fiscal arrangement is called "changing profit remittance into taxes". Although revenues were still divided into three categories – central fixed, local fixed, and shared – the criteria for the division were changed dramatically. Whereas the previous divisions were based primarily on the ownership of state enterprises, the new divisions were related to tax categories.

As a matter of fact, the tax reform in 1985 is a prelude of the more comprehensive tax reform in 1994, the intention of the central government in the tax reforms in the 1980s are the same: that is, to change the declining trend of the central government revenue in the whole fiscal revenue. However, in practice, the effect of the tax reform in 1985 was weakened by marketization and decentralization process. **(Figure 2.1)**. When the tax reform started, two provinces, Guandong and Fujian had actually got the permission to keep the "fiscal contracting system" as before. Faced with the discontent of local governments, the central government had to retreat from the reality to promise that the division of revenue between the central and local governments could be based on some fixed share of aggregate revenue, not on the tax categories. This implies that the back door to fiscal contracting system was opened again. So, it is not surprising that China returned the fiscal contracting system in 1987, which continued until the end of 1993 when the second round of tax reform was implemented.

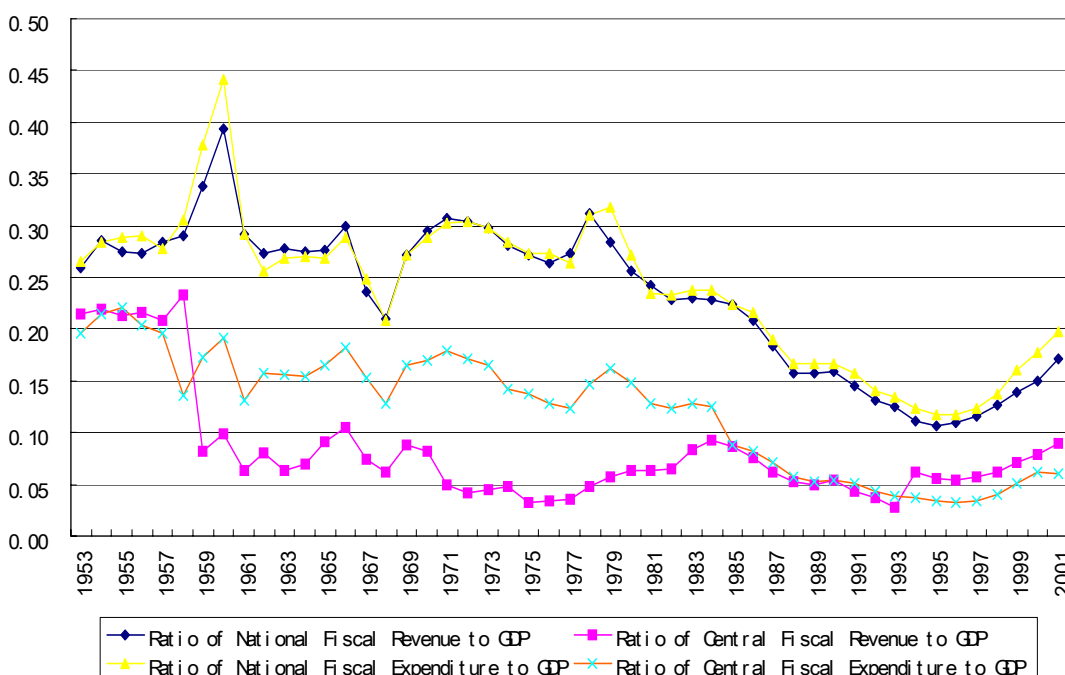
Figure 2.1: Fiscal Decentralization of China from 1953 to 2001



2.3.3 Impacts of Reforms on Government Revenue and Central-Local Government Share

With the marketization process, the government size changed significantly. From Figure 2.2 and Figure 2.3, we can see that the national budget revenue as a percent of GDP has been declining since 1978 and it was only 10.7% in 1995, only 34.3% of the highest year of 1978(31.2% of GDP). However, if we include budget and extra-budget revenue, the government size remained steady in 1978 to 1985. This is mainly due to the urban reforms of enterprise profit sharing and tax sharing system that gave more authority to local government and enterprises and thus many budget revenue shifted to extra-budgets. After 1985, the SOE contracting responsibility reform was implemented more extensively and “profit for tax reform” was replaced by “separation of profit and tax”, the enterprises had strong incentive to reduce profits by accounting manipulation. Therefore, even the budget and extra-budget in total as a share of GDP declined after 1985. For example, the period of 1987-93 was characterized by a variety of fiscal contracting experiments in China. It was in this period that the share of formal government budget revenue in the GDP declined consistently. In the last three years of the 1980’s, that share was about 15% of GDP, and it decreased to 12% in 1993.

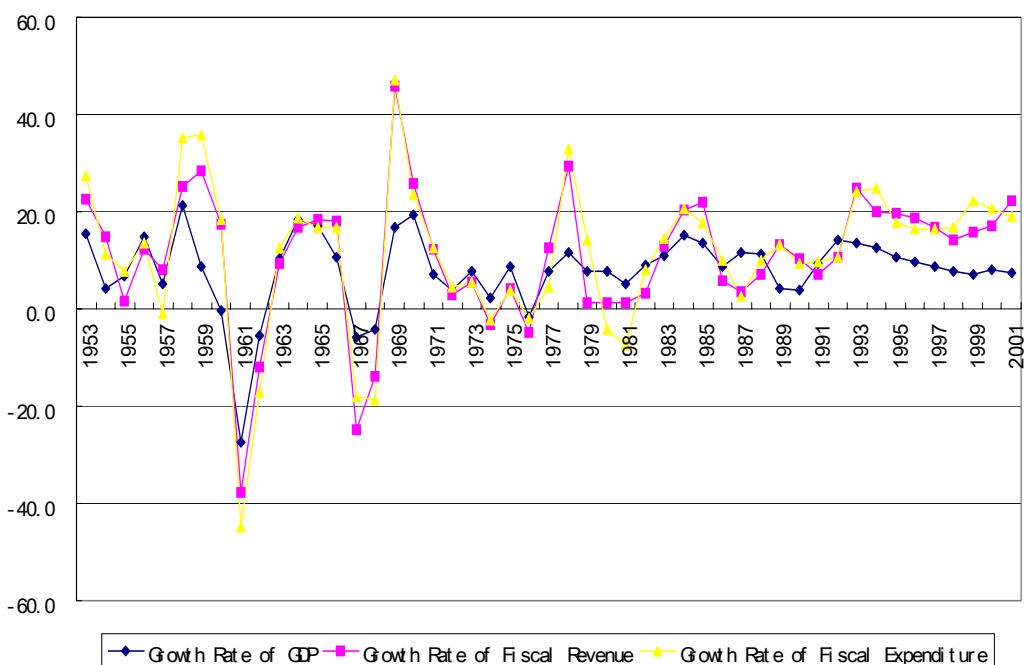
Figure 2.2: The Fiscal Revenue and Expenditure / GDP Ratio



As to central and local share, the central budget share as a percentage of total budget increased between 1978 to 1984, but declined significantly from 1985 to 1993. For Figure 2.2, the share of revenue collected by the central government in the whole budget revenue decreased to 22% in 1993. Only after the reforms in 1994, it rose to 50%. If we compare the share of 1959 to 1982 to that of 1985 to 1993, we find that the latter is not so abnormal as it appeared. The lowest share occurred in the period of 1971 to 1978 (less than 20%), but the lowest share in the latter period occurred in 1993 (22%).⁴

⁴ As the content of 1994 reform, the assignment of fiscal revenue among the central and local governments will depend on the revenue of local governments in 1993. Along with the remittance system, the central government promised to return some grants to the local government. In general, the actual revenue of the local governments is regarded as the base, and the central government should return a lump-sum grant to the local government to make sure that the local revenue will at least be as large as that in 1993. If the tax revenue of the consumption tax and value-added increases by 1 percent, then the return grant would be increased up to 0.3 point. So, the incentive for local governments to collect the fiscal revenue should be very high, and the financial position of central government suddenly dropped in 1993.

Figure 2.3: Growth Rate of Fiscal Revenue and Expenditure vs. GDP



Anyway, it was in the period of 1987 -1993 that the share of formal government budget revenue in the GDP declined consistently. The worry of “losing control” had significantly affected the central government’s decision-making. Consequently, the new tax reform was introduced in 1994.

However, if we include the extra-budget revenue, the central share has not declined from the beginning of the reform to 1992. From 1985 to 1992, the central budget and extra-budget as a share of national total is not significantly lower than that of before 1985. As a matter of fact, it is higher than that of 1982 and 1983. In 1993, the share is only 2.78 percentage lower than that of 1985. The real decline occurred in 1985, 6.49 percentage points lower than that in 1984, which is due to reforms that transfer central SOEs to local governments and replacing fiscal allocation to credit. In 1993, only after the change of definition of extra-budget revenue that deducted the SOE and related administrative department revenue, the central extra-budget revenue was significantly reduced and the central share declined. It must be added that the year of 1993 is already very close to the comprehensive fiscal reform in 1994. From Figure 2.1, we can see that the central share decreased significantly in 1985. The central budget as a percentage of national total was only 39.68% in 1985, 12.84 percentage points lower than that in 1984.

2.3.4 Centralization and Decentralization Cycle after the Marketization Reform

With the reforms since late 1970s, China witnessed a rapid development of market elements. However, the gradualism approach in the reform means that the government did not abandon the traditional development strategy and the inertia of traditional planned economy still existed, thus a dual track system emerged with the market track and planned track operating at the same time. To a significant extent, the SOEs and local governments still faced soft budget constraints as in the planned economy. Therefore, the decentralization since early 1980s to promote enterprise and local government incentives still easily led to loss of control on the macro-economy. Therefore, the decentralization-disorder—centralization—stagnation—decentralization cycle still repeated itself until mid 1990s, although with marketization it has displayed some different features.

With the reform of micro management, enterprises began to have independent interests with strong motive to pursue production growth and profit. Since the macro-distortion still existed and the capital price is still artificially kept at a low level, every enterprise is enthusiastic in obtaining loans for expansion as soon as government relaxes restrictions on credit and investment.⁸ It stopped until a “bottleneck” is formed due to short supply of energy, transportation and raw and processed materials. By this time, the government has to take measures to restrict blind investment expansion.

As in the planned economy, the main restrictive factors on high growth since the reform have been insufficient supply in basic industries, plus the lack of market mechanism in energy, raw and processed materials and transportation price formation. As a result, obtaining such resources and service depends not on firm competitiveness and the high growth was not accompanied by efficiency improvement. Then with partial price liberalization, inflation emerged.^{9 10}

⁸ That means after the reform the soft budget constraint comes more and more from financial sector instead of fiscal system, which is also related to China’s financial decentralization in 1980s. We will elaborate on this later.

⁹ Although inflation took place a number of times during the past 20 years, the rate were not very high compared with those in some other countries. This is partially due to financial deepening of the Chinese economy after the market-oriented reform that created huge seigniorage revenue, and it also has some implications on the central-local fiscal arrangements. We will come back to this point later in Part III.

¹⁰ The first serious inflation took place in 1985 when the reform featured by deregulation in credit system moved a step forward in the year but without change of interest rate. The loosening of credit control under conditions of low interest rate gave rise to grave expansion in investment in 1984 and 1985. Compared with situation in 1983, investment in fixed assets in 1984 saw an increase of 37.6% with an increase of 120% in circulating funds; In 1985 the increases were of 94.4% and 110% respectively. With excessive demand for money, the central bank issued huge amount of money and prices were rocking. Another round of inflation in 1988 was directly caused by low interest rate policy and the general expectation of high inflation; The 1993 inflation was related to low interest rate policy, credit management decentralization and multiple channel fund-raising.(Lin et al 1993).

When decentralization leads to disorder and the bottleneck restraint and inflation reached a grave level, the government take various measures to readjust the overheated economy. Under the preconditions of maintaining the traditional development strategy and keeping price distortions, the readjustment measures include: including strictly control prices; recall the power that was delegated to lower level governments and enterprises, strengthen the control on credit size, restrain the non-state sector development that tends to compete for resource with SOEs and go against its strategic goal. The basic methods used in these readjustments were intended to “strengthen macro regulation and control” by strict administrative means, thus the planned resource allocation was strengthened again and price reform had to be stopped. Once again, the traditional economic system played a greater regulating role. Resources flowed from the non-state-owned economy of higher efficiency and comparative advantages to the state-owned departments with low efficiency and comparative disadvantage. The “centralization leads to stagnation” emerged. Once the economy get into such a situation, the enterprise would be short of vitality and serious losses would incur. Inefficiency in resource allocation would show up, growth rate would go down by a large margin, and government finance would be in deficit.. Then, the voices and efforts from micro level for decentralization would become louder and stronger. The non-state-owned sector would strengthen its competition for resources. Political leaders would once again become aware of the saying “development is the absolute truth.” By this time, the reform featured with power decentralization and profit sharing would be encouraged again. Short of thorough transition in economic development strategy, a new round of cycle would logically begin to ferment.

In China’s case, financial decentralization in 1980s is an important factor for the centralization-decentralization cycle. The banking system in China was decentralized when the central bank and the specialized banks were separated in 1983. Between 1984 and 1988, each regional branch of the specialized banks was required to link its total credit extension to deposits collected within the region. If deposits fell short in a specialized bank, the regional branch of the central bank, not the general office of that specialized bank, was responsible for reallocating funds within the region or for asking the central bank for refinancing loans. One consequence of financial decentralization is that the regional governments at provincial, municipal, and county levels gained great influence over credit decisions through the regional branches of the central bank and specialized banks. The local bank branches were under the "dual subordination" (shuangchong lingdao) principle, in that they were subordinated to the banking hierarchy as well as to the local government. As reform proceeded, the local government carried more weight, for ex ante, they were directly involved in the credit plan formulation and might impose loans on specialized

banks. Ex post, the local government had the authority to decide whether the enterprise should pay back the loan. Another important economic effect of financial decentralization was that of decentralizing decision making to households and enterprises. As a result, there has been a dramatic change in savings in China, with the household, not the government, becoming a major source of financial savings. For example, total households bank deposits alone increased from 6 percent of GDP in 1978 to about 50 percent in 1993. The most significant source of capital now comes from the banking sector, not the government. In fact, capital expenditure from all governments fell dramatically, from 15 percent of GDP in 1978 to less than 5 percent in 1992. This shift in the source of financing has also had important macroeconomic implications: the financial system, especially the banking system, has become the most significant source of the soft budget constraint of governments and state-owned enterprises.

2.3.5 Evolution Of the “Extra-Budget Revenue” and Centralization-Decentralization Cycle.

The concept of “extra-budget revenue” is very subtle China, because the change of its definition means significant change in the allocation of the fiscal resources among different tiers of the governments. Table 2.2 below shows the historical changes of extra-budget revenue between the central and the local government.¹¹

From [Table 2.2](#) and [Figure 2.5](#), we can find that there were two reduction (in 1993 and in 1997) in the profiles of extra-budget revenue and a stable from 1989 to 1990. Actually, these three transformations represent some significant policy (and definition) changes of the central government on extra-budget. Four periods can be identified.

The first period is from 1979-88. Before the reform, the extra-budget revenue was consisted of several forms of tax-added, administration fees collected by local governments, and some special funds for state-owned-enterprises. The extra-budget revenue had been growing even in the period before the reform, although its ratio to the budget-revenue never exceeded 40% before 1979. With the micro-reforms on the SOEs after 1979 and the implementation of the fiscal contract system, the remained profit funds of the SOEs and accumulated funds of the local governments grew rapidly. As a result, the ratio of extra-budget revenue to the budget revenue had risen to more than 100% in 1988

¹¹ Besides the extra-budget, there is also so-called off-budget, i.e., the fiscal sources which are neither included in the budget control, nor are included in the extra-budget control, hence, they are called as “off-budget” fiscal sources. It includes various forms of the fees. In Part V, we will get into one important type of these fees: rural informal charges and discuss its connections to government regulations and decentralization.

(see column (3) in Table), and in particular, the share of local governments in the entire extra-budget revenue were about 60% over the 1980's.

The fast growth the extra-budget revenue of the local governments weakened the control of the central government over the fiscal sources, which pushed the central government to draw some extra-budget revenue from the local governments by force. At first, the central government temporally borrowed from provinces in early 1980's, but never paid back. Then with the establishment and adjustment of the fiscal contract system, these quotas of borrowing were included in the base of revenue remittance, implying that some of the local extra-budget revenue was regularly incorporated into the central budget. In order to reduce the size of local governments' extra-budget, the "construction fund of energy and transport" was imposed on the all of industrial firms in 1983, and it continued until 1996.

The second period in the evolution of the definition of extra-budget revenue started in 1989 when the policies the "fund of revenue adjustment" was adopted by the central government. This policy forced the local governments to remit a proportion of the extra-budget revenue to the central government. The total amount was RMB 9.1 billion Yuan in 1989 and it lasted until 1996. With this new policy and the growth of the "construction fund", the extra-budget revenue kept stable around 1990.

The third stage started in 1992 when a reform on the accounting system was introduced. With the new accounting system, the SOE retained profit funds were excluded from the definition of the extra-budget revenue, leading to a significant reduction in the total extra-budget revenue. It is necessary to note that the new definition of the extra-budget revenue implied not only a change in accounting terms, but also a break of the connection between local governments and the SOEs they used to supervise: since the exclusion of the retained profit funds from the extra-budget reduced local governments' control over local fiscal sources. thus can be viewed as a significant step toward liberalization.

Despite this, the growth of the extra-budget revenue refreshed after 1994. As shown in [column \(7\) of Table 2.2](#) (after 1994) that, the share of local governments' extra-budget revenue is normally above 80%.

The fourth stage started in the July of 1996 when the central governments start a new round trial to reduce the size of local governments' extra-budget. A document was issued by the state council to re-define the scope of extra-revenue. According to the new criteria, more than 13 items of administrative fee and tax-add such as the fee of road, the fund of electricity, and several other items of tax-add were shifted from the local governments'

extra-budget revenue into that of budget revenue. Consequently, the absolute value of the extra-budget collected by the local governments was reduced again.

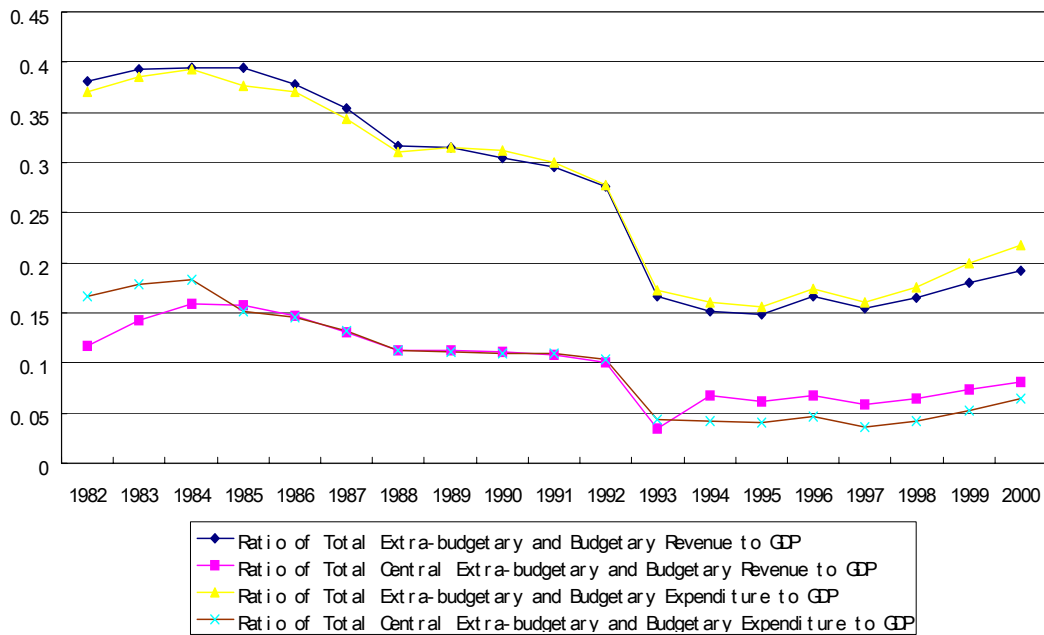
Table 2.2: The Changes of Extra-Budget Revenue 1978-1998 (100 million yuan RMB)

Year (1)	Budget revenue (2)	Whole Extra- budget revenue (3)	Ratio of extra-budget revenue to budget revenue (%) (4)=(3)/(2)	Extra-budget revenue of the Central government (5)	Extra-budget revenue of local governments (6)	Ratio of extra- budget revenue of local governments to the whole extra- budget revenue (%) (7)=(6)/(3)
1978	1132.3					
1979	1146.4	452.9	39.5			
1980	1159.9	557.4	48.1			
1981	1175.8	601.1	51.1			
1982	1212.3	802.7	66.2	270.7	532.0	66.3
1983	1367.0	967.7	70.8	359.9	607.8	62.8
1984	1642.9	1188.5	72.2	470.5	717.9	60.4
1985	2004.8	1530.0	76.3	636.1	893.9	58.4
1986	2122.0	1737.3	81.9	716.6	1020.7	58.8
1987	2199.4	2028.8	92.2	828.0	1200.8	59.2
1988	2357.2	2360.8	100.2	907.2	1453.6	61.6
1989	2664.9	2658.8	99.8	1072.3	1586.6	59.7
1990	2937.1	2708.6	92.2	1073.3	1635.4	60.4
1991	3149.5	3243.3	103.0	1381.1	1862.2	57.4
1992	3483.4	3854.9	110.7	1707.7	2147.2	55.7
1993	4349.0	1432.5	33.0	245.9	1186.6	82.8
1994	5218.1	1862.5	35.7	283.3	1579.2	84.8
1995	6242.2	2406.5	38.6	317.6	2088.9	86.8
1996	7408.0	3893.3	52.6	947.6	2945.7	75.7
1997	8651.1	2826.0	32.7	145.1	2680.9	94.9
1998	9875.95	3082.29		164.15	2918.14	
1999	11444.08	3385.17		230.45	3154.72	

2000	13395.23	3826.43		247.63	3578.79	
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Source: *A Statistical Survey of China (1999)*. China Statistics Press. Beijing, 1999.

Figure 2.5: The Financial Position of Fiscal System in the Economy with and without Consideration of Extra-budgetary Revenue



As a matter of fact, the periods when the size of extra-budget revenue grew faster were normally the periods of decentralization in the decentralization-centralization cycle, whereas the declining period of extra-budgets represents the centralization phase with the central government imposing stronger control over the fiscal sources. We can also find when the central government found itself under deficit pressure in decentralization period, it changes the rules of extra-budget and tried to draw some fiscal source from the local governments by rearranging its relationships with the local governments and the SOEs.

Part III. A Critical Survey On the Literature of China's Decentralization

3.1 Decentralization Literature in China

According to the World Bank (1999), there are different types of decentralization, such as political, administrative, fiscal, and market decentralization, whose concepts

overlap considerably and can appear in different forms and combinations across countries, within countries, and even within sectors. But in general, decentralization in the economic literature means the transfer of authority and responsibility for public functions from the central government to subordinate or quasi-independent government organizations or the private sector. Thus the key to this concept is the **transfer of authority of public functions**, with the latter generally means provisions of public goods and services. Although the definitions of “public functions” have been changing with institutional and technological innovations,¹² the hard core of this concept has been limited, that means the competitive sectors (a dynamic concept itself) should not be included. It is in this sense that the “decentralization” in the Chinese transition literature has been quite different from the concept in the general decentralization literature: as a socialist economy in transition, the Chinese government in 1980s and 1990s was involved in many competitive sectors that are usually private-run in other market economies. This point actually constitutes the starting point of our critical review of the decentralization literature.

As Part II shows, in the planned period, the state set up a comprehensive regulatory structure to implement the overtaking development strategy. Therefore, reforms in 1970s started with micro-reforms to give more autonomy and initiatives. The micro-reforms, opening up policy and free entry of SOEs, TVEs and FFEs into the labor-intensive sectors, as we described before, are all breaks into the traditional system and can be viewed as typical deregulations. These reforms were aimed to liberalize the economic activities that typically are of private nature in market economies. Therefore, it is really hard to define the process of giving more power to micro-units as decentralization in the usual sense.

Of course, accompanying the deregulations was giving more administrative and fiscal autonomy to local governments, which, in China’s case, mainly refers to provincial governments. However, two aspects need special attention:

First, much of the administrative and fiscal decentralization in China was related to the transfer of SOE ownership from the central government to local governments. The reason for this is that central governments found it hard to monitor the SOEs, especially after the micro-reforms: when the state-owned-enterprises (SOEs) were allowed to keep part of their profits, the connection between the state and the SOEs was loosed and the central government had to provide the local governments with incentives to step up the

¹² Bardhan (2002) points out that Technological changes have also made it somewhat easier than before to provide public services (like electricity and water supply) relatively efficiently in smaller market areas, and the lower levels of government have now a greater ability to handle certain tasks. As Tanzi argued, it is generally ignored that many governmental activities can be either transferred to the subnational governments (through fiscal decentralization) or, alternatively, they can be transferred to the private sector, which, in addition to deregulation in some public sectors, is what the World Bank (1999) called market or economic decentralization.

efforts of revenue collection. Therefore, the various revenues and responsibilities assigned to different levels of governments were closely related to the ownership transfer of the state-owned-enterprises, thus the administrative and fiscal decentralization is endogenous to the reform sequencing that started with micro-reforms.

Second and perhaps more important, the reforms taken in a large country as China must be implemented through lower level governments. A typical province in China is larger (in size of population or even territory) than most countries in the world. Therefore, any policy implemented through the hands of local governments and their impacts should not be considered as decentralization, thus decentralization here is only a means to implement central policies. Even if we limit ourselves to the typical public functions (public goods and services provision), larger countries shall find it better to decentralize since local government may know better the preferences and the needs of citizens and taxpayers for public sector activities. It is worthwhile to elaborate on the second argument with some concrete examples.

3.1.1 Opening Up and FDI

Besides the obvious political reasons, the small share of China's foreign trade in GDP before the reform also resulted from the over-valued exchange rate to lower the costs for imported goods to facilitate the heavy-industrial development. In 1979 the government decided to expand foreign trade and welcome foreign investment. The two provinces, Guangdong and Fujian, were granted "special policies" (*teshu zhengce*) and "flexible measures" (*linghuo cuoshi*). For example, the two provinces were allowed to retain all foreign exchange income after remitting 30 percent from the increased amount of exports (Zhou, 1984). In 1980 China established four special economic zones: Shenzhen, Zhuhai, and Shantou adjacent to Hong Kong in Guangdong Province, and Xiamen in Fujian Province across the Taiwan Straits. Not only did these areas enjoy lower tax rates, but more importantly, they enjoyed a special institutional and policy environment and gained more authority over their economic development. While the rest of China was still dominated by central planning and public ownership, special economic zones were allowed to become market economies dominated by private ownership. For example, they were granted the authority to approve foreign investment projects up to \$30 million, while the authority of other regions remained much lower.

Apparently, the decision to choose these provinces and cities in opening up is because of their special geographic location—close to Hongkong and Taiwan where most of China's early FDI came from.

With the success of Guangdong and Fujian Provinces and the four special economic zones, the central government in 1984 to declare additional fourteen coastal cities as "coastal open cities," which gave them new authority similar to that of the special economic zones. Two coastal open cities, Shanghai and Tianjin, obtained authority to approve foreign investment up to \$30 million; Dalian up to \$10 million; and the remaining 11 cities up to \$5 million. Each of these open cities also has the authority to set up "development zones" inside their regions to implement more liberal policies for attracting foreign capital and technology. In 1988, Hainan was added as the largest special economic zone when it became a separate province. Then afterwards, the policies adopted in these special economic regions spread to all over the country.

The early sectors FDI entered into were dominantly labor-intensive industries, such as textile, toys, small machinery building, and much of products used imported materials and were export-oriented. From the description above, we can see that the measures taken are typical deregulations of industrial entries, and these measures had to be implemented in certain regions with better initial location conditions, thus giving more autonomy to these special economic areas (decentralization) is only a means to deregulate.

3.1.2 TVEs and Entry Liberalization

Although the commune and brigade enterprises in rural areas emerged long before 1979, they did not begin to obtain the freedom to seek profits in industries other than those related to agriculture until after the reform. In July 1979, the State Council issued the "Regulation on Some Questions Concerning the Development of Enterprises Run by People's Communes and Production Brigades," which allowed provinces to grant tax holidays of 2-3 years to new commune and brigade enterprises. They were no longer restricted to the industries that served agriculture, such as producing chemical fertilizer and farm tools, and they were allowed to enter into most industries unrelated to agriculture where previously only state enterprises had accessed. They also no longer used only local resources and could sell beyond local markets. The industrial structure of rural enterprises became more diversified. Because light and consumer goods industries were characterized by huge profit margins and short supply, commune and brigade enterprises chose to enter these industries. The share of light industry has risen from 44% in 1979 to 52% in 1984.

Among the fastest growing industries were food processing, textiles, garments, building materials, and coal mining (Wong, 1988).¹³

Therefore, in the reform, true liberalization was applied to rural enterprises, and previous administrative restrictions against rural enterprise entry and expansion were removed from almost all industries. After the abolishment of the commune system, township and village governments enthusiastically supported rural industrialization because they relied heavily on the development of rural industry as the way to generate their revenue.

3.1.3 Agriculture Reforms

The major change was the introduction of "household responsibility system," which emerged spontaneously in poor areas by the peasants themselves. The first recorded practice of this kind took place in December 1978 in the Xiaogang Production Brigade of Fengyang County in Anhui Province, where 20 peasants representing 20 households put their fingerprints on a "contract" to divide the commune's land among the households. By doing so they also promised to fulfill the procurement quota of grain to the state. Under the household responsibility system households became residual claimants and obtained almost all control rights over production, except for the right to dispose of land. This practice soon spread to other parts of the Province, and received strong support from the provincial governor, Wan Li, at a time when no official endorsement was given by the central government. In fact, the 1978 Party meeting, which initiated reform, actually explicitly prohibited such a practice. It was not until late 1980 that the Communist Party for the first time officially allowed the household responsibility system to exist but only in poor areas (Party document #75 of 1980). The Party started to actively promote the household responsibility system only in early 1982. By the end of 1982, 80% of households adopted the household responsibility system nationwide, and by 1984, almost all of them had done so. By that time, the contracts of the household responsibility system were all extended to a period of 15 years.

3.2 Fiscal Federalism Literature on China

¹³ As to private enterprises, those employing fewer than 8 people had been allowed to exist since 1980. It was not until 1984 that private enterprises employing more than 8 people became legal. In 1985, the first wave of "jumping into business" (*xia hai*) began. Joint ventures between domestic and foreign investors mushroomed, especially in the development zones, to take advantages of the more liberal policy.

Qian et al (1994a , 1994b, 1997,1998, 1999, 2001), in a series of papers on Chinese transition, emphasized the “Chinese Style Federalism” in explaining the Chinese miracle. The main point of this line of literature is that China’s successful performance in transition (compared to that of other former socialist countries in transition, especially Russia) is not that China established the best system, but that China has some special starting institutional arrangement, i.e, regional decentralization which later led to “Chinese Style fiscal federalism”.

In the context of the so-called “second generation federalism”, the traditional approach is extended by systematically studying the role of government incentives in economic performance (Qian and Weingast, 1997). Because governments in developing and transition economies have often been the central barriers to economic development, providing these governments with the incentives to promote market development is especially critical. Specifically, the "market-preserving federalism" theory (e.g., Weingast, 1995; Montinola, Qian, and Weingast, 1995) argues that by devolving regulatory authority from the central to local governments, the interventionist role of the central government can be limited. They argue, following Kornai(1980, 1986), that soft budget constraints (SBC) constitute a major incentive problem in socialist economies and remain an important concern in transition economies.¹⁴ Qian et al utilize this framework in the setting of Chinese central and local government. They note that government’s incentive to soften budget constraint depends on the extent of decentralization of fiscal and/or monetary power.

According to them, the Chinese reform is characterized by delegating power from the central government to the local governments. Thus two effects of federalism are derived: first, fiscal competition among local governments under factor mobility increases the opportunity costs to bailout and thus serves as a commitment device (the competition effect) ; Second, monetary centralization, together with fiscal decentralization, induces a conflict of interest, and thus can harden the budget constraint and reduce inflation.(the checks and balances effect). By utilizing models of the commitment game, they argued that these two effects are important in Chinese reform and thus constitutes the basis for Chinese success. And just because of the commitment effect of the Chinese style fiscal federalism, in the short-run, there is certain commitment effect from the government side not to predate and the dual track approach can work in China even in the absence of the credible commitment mechanism to constitutional order.

¹⁴ According to Dewatripoint and MasKin(1995), the fundamental reason for SBC is the inability of the rescuers to commit to no bailout ex ante.

According to Qian(1994a 1994b 1998, 1999) , the devolution of authority in China was also accompanied by the provision of fiscal incentives and local governments were encouraged and rewarded by promoting the economic development of their local economies. For the formal budgetary revenue starting in 1980, the "fiscal contracting system" (*caizheng chengbao zhi*) known by the nickname of "eating from separate kitchens" (*fenzao chifan*), replaced the previous system of "unified revenue collection and unified spending" (*tongshou tongzhi*), known as "eating from one big pot" (*chi daguofan*). Under the new fiscal system local governments entered into long-term (usually five-year) fiscal contracts with higher level governments, and many were allowed to retain 100 percent at the margin to make them "residual claimants." In addition, local governments also received "extra-budgetary funds," which were not subject to sharing, and "extra budget funds," which were not even incorporated into the budgetary process and thus not recorded.

Using provincial panel data between 1982 and 1992, Jin, Qian, and Weingast (1999) reported three major findings about the role of decentralization and fiscal incentives in the central-provincial relationship. First, they found a very strong correlation between marginal budgetary revenue collection and marginal budgetary expenditure under the fiscal contracting system, as compared with a very weak correlation in the 1970s, 0.75 vs. 0.18. Thus, China's fiscal contracting system provided local governments with strong (marginal) fiscal incentives. Second, even so, they found some evidence that horizontal distribution in per capita budgetary spending actually improved over time, the coefficient of variation falling from 0.68 in 1982 to 0.52 in 1992. This is because strong marginal incentives were provided together with the infra-marginal redistribution of budgetary revenue. Third, they also found that stronger fiscal incentives, measured in terms of a higher contractual marginal revenue retention rate, were associated with faster development of non-state enterprises and more reform in state-owned enterprises (such as a faster increase of the share of contract workers in total state employment). These results were compared with Russia's. Using the data of 35 cities for 1992-1997, Zhuravskaya (1998) regressed the change in "shared revenues" (with the upper level government) on change in "own revenue," and found the coefficient was -0.90, which means that any increase in a city's budget by 1 ruble is offset by the decrease in shared revenues by 0.90 ruble. She also relates the perverse incentives of local governments to their predatory behavior towards private businesses. It is this "grabbing hands" of local governments that were regarded as a major cause of the failure of Russian reform (Shleifer, 1997; Frye and Shleifer 1997).

In an early paper, Qian and Xu (1993) also argued that China's regional decentralization has its historic background. Just as Sachs, Woo and Yang (2000) explained in detail, in the pre-reform period, Mao's socialist system is substantially different from the

Soviet style socialist system before both countries started their transition. It is argued that the rivalry between the Chinese and Russian communists created a sort of check-and-balance in the international political arena that involves the design of institutional arrangements. According to them, Mao's political instinct, which was sensitive to the rivalry, led him to create his administrative decentralization proposed in his 1956 speech "On Ten Important Relationships" (Mao, 1977a). The rivalry is the grand background from which the differences between the reforms in China and Russia emerge. During the Great Leap Forward in 1958-1961 and the Cultural Revolution in 1966- 1970, and since the Cultural Revolution, an effective central planning system has not existed in China. Five year plans and annual plans were virtually only on paper. The success of the first five-year plan in China in the 1950s misled Mao to conclude that the success was due to the merit of the socialist system that was created by communists. As Sachs, Woo and Yang (2000) argued, Mao did not understand that the success was based on Russians' imitation of the capitalist economy. Hence, Mao tried to invent his own communist institutions, such as the commune and mass eating halls.¹⁵ According to these authors, Mao had a strong anti-Soviet Union sentiment. He advocated for administrative decentralization against central planning, for self-sufficiency of each firm, each county and each province against specialization and division of labor, for a mass line against professionalism, for small scale, self-sufficient communes and brigade firms with indigenous technology against large-size state firms with advanced technology, and so on (see Mao, 1977b).¹⁶ As Sachs, Woo and Yang (2000) argue, this, on the one hand, slowed down the evolution of division of labor in China and

¹⁵ As a matter of fact, the success of China's first Five-Year plan was not due to the imitation of the capitalist economy. Instead, the success was due to the investment-led growth by the mobilization of surplus through price distortions and administrative control of material flows. The further success depended on the possibility to accelerate the mobilization of surplus, which was constrained by the per capita endowment of natural resources and population size. The Soviet Union could sustain the type of resource mobilization until the early 1980s because of its rich natural resources. China's per capita natural resources was very poor. Therefore, after the first Five-Year plan, China started to face the resource constraints, which led Mao to adopt more radical institutional arrangements, such as people's commune, the greater reliance of local initiative, and so on. However, because the basic structure of price distortion was not changed, the decentralization would inevitably lead to over-investment and economic over-heating, ensued by another round of re-centralization.

¹⁶ We believe using certain leader's personal preference to explain China's central-regional relationship is at least misleading, if not wrong. If this was the reason for the decentralization, why there were re-centralizations later on? As we argued before, there is an inherent logic in China's centralization-decentralization cycle endogenous to China's traditional development strategy.

kept rural China a traditional autarchic society.¹⁷ On the other hand, it created a vacuum in coordination mechanisms in Mao's China: neither central planning nor the market could coordinate the division of labor developed in the first five-year plan. These authors believe that the vacuum was filled by quasi-private firms and collective firms during the Cultural Revolution and by commune and brigade firms, which are later referred to as township and village enterprises (TVE) after 1984, and by a decentralized bilateral and multilateral bargaining system in the 1970s. Therefore, procurement fairs that implemented decentralized bargains were developed in the Mao era. Barter were very common in the fairs and sometimes commodities in short supply were used as commodity money.¹⁸

According to Qian(1999), China experienced the shock process during 1958-1961 and 1966-1970, when the central planning system was paralyzed by Mao's Great Leap Forward and the Cultural Revolution, and during 1971-1976, when Mao's policy of administrative decentralization prevailed. Mao's administrative decentralization divided the ownership of state firms among the central, provincial, and county governments and communes. In contrast, in the Soviet Union, there was a uniform ownership of all state firms. Deng's regional decentralization consolidated Mao's administrative decentralization by institutionalizing the fiscal relationship between the central and provincial governments. Government revenue from tax and state firm profit was divided between the central and provincial governments according a certain division rule. In the early stage of Deng's regional decentralization, a fixed amount of provincial government revenue was delivered to the central government. In the later stage, a fixed proportion of the tax revenue was delivered to the central government. A Chinese style fiscal federalism emerges from the evolution, which provides a driving force for China's reforms in the 1990s. This fiscal federalism separates tax categories and a collection institution of local governments from that of the central government, with help from the World Bank (Qian and Roland, 1998, Qian and Weingast, 1997, Li, Li, and Zhang, 1998). Deng's fiscal federalism is in striking contrast with the much more centralized fiscal relationship between the federal and local governments in Russia (Zhuravskaya, 1998 and Qian, 1999). This could be used to explain the difference in reform performance between China and Russia.

¹⁷ This argument also has serious problem. An alternative explanation is: if the government adopted the heavy industrialization strategy, due to the limited availability of scarce capital was allocated to build up the capital intensive industries, the remaining capital for the rest of economy would be too little. Therefore, the rest of the economy would remain autarchic and primitive.

¹⁸ According to our view, the development of TVEs were not to fill the vacuum of coordination but to fill the vacuum of supply of light industry products due to the lack of state investments in the light industries). In addition, Barter were used because TVEs' production and marketing were outside the state plans

Blanchard and Shleifer(2000) agreed with Qian etc. that Chinese style federalism play an important role in Chinese success, but with an important caveat. They argue that the experience of Russia indicates that another ingredient is crucial, namely political centralization, transition in China has taken place under the tight control of the communist party. As a result, the central government has been in a strong position both to reward and to punish local administrations, reducing the risk of local capture and the scope of competition for rents.. They note, echoing the theme first developed by Riker (1964), that for federalism to function and to endure, it must come with political centralization.

The Chinese style fiscal federalism literature is mainly game theoretical models that are inherently logical, but it is hard to tell whether they hold empirically. As we will see, some main arguments do not fit very well in explaining Chinese higher and relatively smooth growth compared to Russia's performance in transition. In the following section, we will make a critical review of them.

3.3 A Critical Analysis on the Chinese Style Fiscal Federalism

We believe there are several fundamental problems in the Chinese style fiscal federalism literature on China.

First, the existing literature has not fully understood and the process of decentralization before and after the reforms in late 1970s. It also ignores the endogenous nature of the decentralization waves both before and after the reform in late 1970s and its interaction with other aspects of economic system transition. As Qian and Xu(1993) , Sachs, Woo and Yang (2000) see (see Part 2.2), it is mainly Mao's political instinct and personal characteristic led him to create his administrative decentralization. However, as we see from the description in Part I, the centralization-decentralization cycle is endogenous to the overtaking development strategy the socialist planned system, and the resource constraints After the reform, the administrative and fiscal decentralization was also associated with the break of the planned system from micro-reforms and deregulation of industrial entries.

Second, the current literature has not found the root of China's relative success in transition, and thus could not identify the unsolved problems at the present stage. For example, the advocates of the Chinese fiscal federalism had strong doubts about the fiscal reforms in mid-1990s since it re-centralized fiscal resources and thus reduced local incentives. However, the problem of this reform is not that whether the government should recentralize revenue, but that the center shall have also re-centralized expenditure responsibilities by more equity transfers and paying more for the restructuring costs for

SOE reforms, but they did not and wasted a lot of money on center-directed capital investment (we will elaborate on this in Part V). Without this, we cannot explain why the regional/urban-rural disparity has been enlarging with the fiscal re-centralization in mid-1990s?

3.3.1 Commitment Effect of the Chinese Style Fiscal Federalism

From the historical review in Part I, it can be seen that China's fiscal decentralization was gradually taking shape in 1980s. However, it was not really a committing device since politically the government was, and still is highly centralized. The central government had, and still have the power to change local leaders, not to say revenue-sharing contracts.

As a matter of fact, the central government had imposed several policies to restore the relative "selective centralized fiscal control" in both the 1980's and the 1990's. For example, soon after the 1978 fiscal reform in which the central government enacted fiscal arrangement under the name "relating expenditure with revenue, dividing extra revenue with fixed share" in 10 provinces of China, the central government found it in trouble of deficit, then the central government modified the fiscal arrangements in 1980 with a new system called "dividing revenue and expenditure with each level of government responsible for balancing its own budget". The 1985 fiscal arrangement change called "changing profit remittance into taxes and divide taxes into central, local and shared taxes" was also intended to increase the central share and strengthen the central control. In 1988 and 1999 several another changes were made as a prelude to the 1994 fiscal reform. When the central government found in early 1990s that these attempts were not successful and small changes could not stop the declining trend of central share, it did resort to a new tax-sharing system which increased the share by central government.

As a matter of fact, the change to a new system was quite drastic. Although local governments did bargain the terms with the central government and did gain points in inter-government transition period transfers and the specific purpose grants(Richardson 2000 IMF draft paper) , they have no bargaining power in whether to accept or reject the central government's new tax-sharing system and the overall fiscal arrangement. The main reason for that is very obvious: the country is still ruled by the one party system and all local leaders are appointed from above rather than elected from below. In this case, facing central government's determination to change the tax system and inter-government finance arrangement, local leaders have no choice to take the overall new system and at most can

bargain on the margin. Therefore, the commitment effect of fiscal decentralization should not play such a big role on China's economic growth in the transition.

The historical review in Part 1.3.5 also revealed that there was no commitment in extra-budget that were not subject to sharing (thus is a high-powered incentive instrument according to the fiscal federalism argument): when the central government found itself under deficit pressure in decentralization period, it changes the rules of extra-budget and tried to draw some fiscal source from the local governments by rearranging its relationships with the local governments and the SOEs.

3.3.2 Regional Competition Argument

The Chinese style "fiscal federalism" view also holds that competition among local governments under factor mobility increases the opportunity costs of bailout and thus serves as a commitment device (the "competition effect"). Theoretically this effect should be important since politicians in every political system tend to bail out inefficient firms and spend on wasteful public consumption. While in a decentralized system, the mobility of resources across regions raises the opportunity cost to local government of bailing out inefficient firms and wasteful public consumption. As Qian(2000) argued, in recent years, especially after 1994 fiscal reform, local governments' budget constraint became harder, partly due to the government's competition to attract investment, especially FDI, partly due to the centralization in the financial system. However, both arguments were not true in 1980s and early 1990s. Therefore, if the regional competition for investment and other mobile factors and its impact on harder government budget constraints is used to explain China's relatively smooth transition since late 1970s to early 1990s, the fiscal federalism argument is doubtful.

As a matter of fact, on the one hand, the fiscal arrangement in 1980s aligned the local revenues with development of local enterprise, especially the local TVEs; on the other hand, it did give local government strong incentive to protect local enterprises by establishing inter-regional trade barriers since local governments depended heavily on local enterprise taxes and profits, which hindered the development of national market and interregional economic integration.

There has been a lot of evidence that local government intentionally chose to close local markets by implementing restrictive policies for non-local commodities, sometimes even by intentionally not connecting inter-regional transportation channels (Young 2000). Due to the gradualism "dual track" reform approach, many goods, especially the raw materials in short supply had both market price and planned price. In the 1980s, the growth

of rural industry as the arbitrager of artificial wedges inevitably led to development of interregional trade barriers. Local governments in regions that traditionally produced raw materials moved downstream into processing, diverting outward bound raw material shipments, at low planned prices, to their own factories. Traditional processors, starved of material inputs, responded by sending buyers to raw material districts, offering above plan prices directly to raw material producers such as farmers. Since their financial interests were linked to processing and not raw material production, governments in raw material producing districts moved to prevent these sales, using trade barriers to turn themselves into monopsony buyers of raw materials at low prices. This led to the development of “wars” over coal, cotton, jute, silk worm cocoons, and tobacco, among other materials. In the area of finished goods, such as high margin light industrial consumer products, the duplication of production throughout the country led to growing overcapacity. As central controls over prices were relaxed and private marketing channels developed, rural producers found themselves in competition with producers of finished products from other regions.

To protect their industrial interests, provincial, county and city government found it expedient to erect barriers to trade so as to maintain high local final industrial goods prices. Aside from tariff barriers (i.e. special charges levied at road blocks), non-tariff methods such as physical barriers, outright prohibition, low interest loans and other financial benefits for commercial establishments marketing non-local goods, legal restrictions on price differences between local and non-local goods sold in commercial establishments, local purchasing quotas, and administrative measures (e.g medical, sanitation, epidemic prevention, product quality, measurement and other such licenses and certificates) were used to hamper trade in products as varied as textiles, automobiles, trucks, perfumers, beverages, plastics, matches, household electrical appliances, electrical machinery, bicycles, pens, alcohol, washing powders and soaps, tires, tractors, engines, processed foods, and food flavourings. The legal system was also subverted, as enterprises were encouraged not to pay non-local bills, the courts ignored non-local pleas, rulings and fines were issued against non-local producers, and judges who ruled in favor of non-local firms were punished.

As Young (2000) showed, in the 1980s and early 1990s, there were duplication of industrial structure and growing dispersion of prices. Through variance composition analysis, Young found that while China’s provinces became more similar in terms of the composition of final output, they became increasingly dissimilar in terms of sectoral productivities and sectoral labor allocation, with the decline in the variance of outputs only appearing as a consequence of the development of a strong negative covariance between

productivities and factor allocations, If the convergence in the composition of output across China's provinces is driven by a convergence in patterns of comparative advantages, then one should observe a growing similarity of labor allocations and productivities. But this is not present in data, which signals serious interregional trade barriers rather than the interregional competition as argued by the fiscal federalism views.

Many economists may disagree with Young regarding the extent of adverse effects of interregional trade barriers on China's growth, however, there is a consensus that the duplication of production structure among different provinces did lead to serious over-investment and inefficiency(a government soft-budget problem). As a matter of fact, both sides (trade barriers or interregional barriers) can be used to argue against the Chinese style fiscal federalism regional competition argument: **On the one hand**, if it is true that many local governments chose to close local markets to commodities from other regions and limit factor mobility by various measures, then the facts clearly did not help Qian's argument that competition hardens government budget constraint since competition was not significant. **On the other hand**, there had been over-investment in infrastructure by regional governments to attract investment (Li and Zhang 199?). However, this maybe a soft-budget problem of local governments under the financial decentralization environment in 1980s and early 1990s: Due to the financial decentralization before the middle of 1990s, local governments competed for credit from local banking branches, which actually composed a serious soft-budget problem.¹⁹ Only after 1993 China centralized its monetary authority and the central bank refused to accommodate monetary policy to the local governments' behavior (World Bank, 1996).

To repeat, the main argument for fiscal federalism is: incentive for development came from hard government budget constraint, hard government BC came from federalism and interregional government competition for capital and labor. As argued, it seems not fitting the facts and the timing of Chinese performance and sequencing in reform.

3.3.3 Endogeneity and Causality Problem

Perhaps as an outlet for the problems in commitment argument, Bai, Li, Qian and Wang proposed that information decentralization by anonymous banking and mild financial depression makes it possible for the government commit not to predate. This is a retreat from the previous argument, since the institutional arrangement for commitment now

¹⁹ Before 1993, China experienced a *de facto* monetary decentralization when some local governments forced the central bank branches in their regions to extend credit and print money; and on other occasions the central bank made a monetary expansion hoping to correct distortions made by the local governments (Wang, 1991; Qian and Weingast, 1996).

changes from fiscal decentralization to depressed financial system. Compared to the ever-changing fiscal system, the financial arrangement of anonymous banking and mild financial depression were at least relatively stable since the reform started, which potentially constituted a commitment device for the government not to predate heavily. However, that situation has also been gradually changing as financial reform deepened, including the establishment of a relatively independent central banking system, commercializing state-owned banks and the most recent removal of anonymous banking.²⁰

More important, as we observe, anonymous banking may just be a minor factor that led to information decentralization. The deregulation in micro-units, the opening up policy and the ensuing entry liberalization into labor intensive sectors, and in general, the marketization process and the rapid growth of market-oriented track and non-state sectors, is the main contributor to the process of information decentralization. It is just the deregulation and development of market elements in the Chinese economy that made it very difficult for the government (that had been managing a planned economy, still not adapted to new market economy and thus has very limited administrative capacity) to levy taxes and predate. Therefore, the problem of causality emerged: did information decentralization led to growth or the vice versa?

As a matter of fact, the problem of causality and endogeneity is more serious in the fiscal federalism argument: Was growth due to the fiscal decentralization or the vice versa, or is it possible that they are both endogenous to something else? Take Russia as an example, the Russian central government has been continuously broke and consequently eager to renegotiate its tax agreement with local government.²¹ The reason for this may just lie in the fact that there was no growth but economic downturn after the reform. While in China, although the central government also tried to change the revenue sharing rules several times in 1980s and 1990s, the effect was not so devastating since the economy was

²⁰ The anonymous banking system might have done more harm than good since it made many illegal activities such as off-budget revenue hiding (xiaojinku), tax evasion, state asset stripping possible. That is also why China changed this system in 1997.

²¹ As a matter of fact, since 1995 when Russia started a stabilization program, the central government in Russia has been continuously broke and consequently eager to renegotiate its tax agreement with local government. The reason for this may just lies in the transitional path Russia went through. *As Strobe Talbott commented: Russia had experienced "too much shock and too little therapy. And all that shock hadn't moved Russia toward a real market economy at all. The rapid privatization had allowed a small group of oligarchs to gain control of state assets. By paying insufficient attention to the institutional infrastructure that would allow a market economy to flourish--and by easing the flow of capital in and out of Russia--Russia had laid the groundwork for the oligarchs' plundering. While the government lacked the money to pay pensioners, the oligarchs were sending money obtained by stripping assets and selling the country's precious national resources into Cypriot and Swiss bank accounts.* Through the mid-90s, the Russian economy continued to implode. Output plummeted by half. While only two percent of the population had lived in poverty even at the end of the dismal Soviet period, "reform" saw poverty rates soar to almost 50 percent, with more than half of Russia's children living below the poverty line.

always growing due to the rapid development of market track. Even in case of ever decreasing share of central government revenue, the absolute level of central revenue still kept increasing. At the same time, the continuous growth of SOEs lowered (or at least delayed) the restructuring costs that must be paid by the central government. This made government budget constraint much less harsher than that of Russia. In this case, the high percentage of local share in total revenue is partly due to the economic growth, and partly due to the political process between central and provincial government.²² In this sense, Qian's argument that growth resulted from revenue sharing might just get the causality wrong.²³

In the Chinese style fiscal federalism argument, the players in the models they constructed are central government and the provincial governments, and the contracts they "commit to" were between these two levels. In their empirical study (Jin and Qian 1999), the two level of governments that each has certain marginal share of revenue are also the central and provincial governments. However, when Qian et al (Qian and Weingast 1997) talked about the engine of economic growth, they mainly referred to township and village owned enterprises (the TVEs). The government who owned the TVEs are two or even three levels below the provincial level (between them are prefecture and county government). It is hard to attribute the economic growth at township level to fiscal contract between central and provincial governments. Of course it can be argued, as Wong did (Wong 1997), that township level government also has similar fiscal contractual relationship with upper level of government which prevent upper level government from predated and therefore, the outcomes, may be similar to those for the relation between

²² However, the declining share of central budget did create some problems in practice. As Richardson (2000) argued, "China's fiscal system has also given rise to dysfunctional behavior, such as the hiding of revenue in extra-budgetary funds and the consequent inadequate system of fiscal transfers, which has slowed the reform of the SOE sector. Local governments, though forbidden to borrow openly, have attempted to do so through window corporations and banks, with the result that the central government is not in a position to monitor, much less manage, gross public debt. Further, the incentive to hide revenue has meant that the central government, which must finance a variety of expenditures that are difficult to adjust (such as national defense and interest on government debt), has had at its disposal a relatively small share of overall fiscal resources. Although China's political system is highly centralized, in a number of areas the fiscal system would seem to give rise to a risk of excess deficits". Therefore, even the larger share of local revenue were not endogenous (which must hold if the fiscal federalism argument), its favorable impact on performance of China's transition needs to be discounted.

²³ As Bardan (2002) argued, "there is the commonly encountered endogeneity problem. Before being too quick to claim that decentralization brought about certain outcomes, it is worth considering that decentralization may have resulted from on-going political and economic changes that also affected these same outcomes. Separating decentralization from its political and economic causes, so that decentralization is not just a proxy for an ill-defined broad package of social and economic reforms, is a delicate problem." As we argued here and more later, the larger share of local revenue is endogenous to China's transition path which features SOEs and non-SOEs grew simultaneously so that the restructuring costs the central government had to pay before mid-1990s was not huge, and the central government still enjoyed revenue growth in absolute terms, thus was not in a rush to raise the central share for a long time until mid-1990s.

central and provincial government. However, this argument itself will discount to some extent the fiscal federalism argument, since the latter are talking about fiscal arrangement at much higher levels. In addition, it is hard to believe that TVE's development should be mainly attributed to commitment of no predation due to fiscal arrangement with upper level of government (the county level in China's context), since at this level, the revenue share between these two level are not so important any more. The level of government that owned the TVEs earned their revenue mainly from their ownership instead of taxes while the upper level government can benefit from taxation on TVEs. In practice, the latter may choose not to tax since it want to help TVEs or lower level of government to finance itself, or it may not be able to tax since it is hard to monitor. In both cases, it is not commitment of no predation that matters, but rather good intention or inability to predate due to information constraints.

3.3.4 The Conditions of Fiscal Federalism: Can China Meet Them?

According to Montionla , Qian and Wengast (1995) and Qian and Wengast, 1996) the market-preserving federalism is a vertical separation of political powers and is characterized by five conditions concerning the allocation of authorities and responsibilities among different levels of government:

(F1) There exists a *hierarchy* of governments with a *delineated scope of authority* (for example, between the national and subnational governments) so that each government is autonomous in its own sphere of authority.

(F2) The subnational governments have primary *authority over the economy* within their jurisdictions.

(F3) The national government has the authority to police the *common market* and to ensure the mobility of goods and factors across subgovernment jurisdictions.

(F4) Revenue sharing among governments is limited and borrowing by governments is constrained so that all governments face *hard budget constraints*.

(F5) The allocation of authority and responsibility has an *institutionalized degree of durability* so that it cannot be altered by the national government either unilaterally or under the pressures from subnational governments.

According to them, these conditions represent an ideal type of institutional arrangement of a market-preserving federalism. All of the five conditions are necessary for federalism to have the desired economic effects.²⁴ For example, without the common

²⁴ Condition 1 defines characteristics that establish minimal or necessary conditions for the hierarchy of a federal system. But it alone is not sufficient. Although condition 1 defines a system of political decentralization, it says

market condition 3, each subnational government would become something of a *de facto* "national government" in its jurisdiction, and its discretionary authority over the economy limits its ability to make credible commitments to secure markets.

However, these conditions were far from satisfied for China in the 1980s and in the 1990s. As to condition 1, it defines a system of political decentralization, but China has been and still is a politically centralized system. The Central Government seems to retain considerable political discretion, including the ability to reverse suddenly the reform process or to impose onerous exactions on successful enterprises.

As to condition 2, from the perspective of preserving market incentives, the authority of the national government over markets is limited to policing the common market across regions and providing national public goods, which should not be left to the subnational level governments (e.g., monetary policy). Less. However, in China, the national government still actively pursues (although less and less aggressively even in now-days as the reform goes on) the traditional development strategy by prioritizing some key sectors(Lin et al 1996, 1999), and did not realize the monetary centralization until 1993 or 1994.

As to condition 3, the institutional arrangements of federalism recognize a critical difference between the national government and the subnational governments: there is only one of the former but many of the latter. The natural limits on the discretionary authority of the subnational level governments are induced by competition among jurisdictions. But this competition is beneficial only if there are no trade barriers and the entire nation becomes a common market. However, as our discussion in Section 2.3.3 shows, this condition was hardly met before mid 1990s.

Without condition 3, each subnational government would become something of a *de facto* "national government" in its jurisdiction. And the central government's discretionary authority over the economy again deprives its ability in making credible commitment. Condition 2 thus enhances the effects of condition 3. If decentralization remained at the discretion of the national government, the latter could intervene in the economy first by using its discretion (in the absence of condition 2) to compromise the system of federalism and then to intervene. As a matter of fact, this is what happened.

In mid-1990s when the Chinese government changed the system to strengthen its

nothing about the authority over economic issues. This raises the critical issue of the relationship between the political system and the economy, for markets are not self-sustaining but are easily destroyed by political forces. To have market-preserving economic effects, federalism must also place particular limits on the authority of the various governments. Systems of market-preserving federalism do so by limiting the central government's role in regulating the economy (condition 2), by preventing the lower governments from using their regulatory authority to erect trade barriers against the common market (condition 3), and by imposing hard budget constraints on the national and local governments to prevent endless overspending for political purposes (condition 4).

regulation and increase its share in the total government revenue. In part IV, we will get into this more detail.

As to condition 4, the constraint of condition 4 has two parts, one for fiscal revenue transfers between levels of governments, and one for borrowing through the financial system. The hard budget constraint in the fiscal channel limits revenue sharing and equalization among governments, especially through soft grants. The hard budget constraint in the financial channel restricts open-ended access to capital markets, especially borrowing from the central bank. Condition 4 applies to both the national government and the sub-national governments. A hard budget constraint for the latter is necessary because it directly ties local revenue to local economic prosperity. A local government's financial problems remain its own. This provides important incentives for local officials, for their government's fiscal health is directly related to local economic prosperity. If, in contrast, local governments were readily bailed out of their financial problems, they would have considerably fewer incentives to worry about the consequences of their choices. The constraint on the national government is necessary in part because a soft budget constraint would allow it to use monetary discretion to get around the constraints on its authority. From our discussion of the Section of 1.3.4 on financial decentralization and central-local fiscal arrangement, there were not hard budget constraints both for central and local governments (the central government always wanted to change the fiscal system, although did not succeed until 1994, and local governments did not have hard budget constraints since they used financial decentralization and extra-and-off-budget, the central government also used the financial system and inflation to overcome deficits.)

For condition 5, it provides for credible commitment to the federal system and thus for limits on the national government's discretionary authority. Not only must there be decentralization, but that decentralization need not be under the discretionary control of the national government. Therefore, condition 5 concerns the enforcement problem and is critically important. However, as Section 2.3.1 and 2.3.5 show, there was no credible commitment to the federal system.

Therefore, non-of the conditions mentioned above can be satisfied in China before mid-1990s, and even after several years from 1994 fiscal reform to now, the condition 1 cannot be met. Condition 2 is at most half met since central government still intervenes frequently into local economy. Condition 3, 4, and 5 are also not fully satisfied since there are still some inter-regional barriers, and discretionary transfers and arbitrary changes of central government fiscal rules. Therefore, it is really hard to use the fiscal federalism story to explain what happened in China in the past two decades.

As Bardhan(2002) argues, much of the fiscal federalism literature focuses on the

economic efficiency of inter-governmental competition, which often starts with a market metaphor that is rationalized by the well-worn Tiebout (1956) model. In this approach, different local governments offer different public tax-expenditure bundles and mobile individuals are supposed to allocate themselves according to their preferences. The assumptions required for the Tiebout model are, however, much too stringent, particularly for poor countries. The crucial assumption of population mobility (fully informed citizens 'voting with their feet' in response to differential public performance) that enables governments in the Tiebout framework to overcome the well-known problem of inducing citizens to reveal their preferences for public goods largely fails in poor countries. In addition, even in the relatively few democratic developing countries the institutions of local democracy and mechanisms of political accountability are often weak, not to say a socialist country like China.

3.3.5 Commitment Effect Revisited

As we see from Part II, one important reason that the central government did not succeed in increasing its revenue share in the 1980s is the fast growth of the “extra-budget” and “off-budget revenue” by local governments. The sources of the “extra-budget” and “off-budget revenue” are mainly local SOEs and non-SOEs, as well as fees imposed by local government. As argued by Qian, central government permitted extra-budget and off-budget operated by local governments, thus it is an important feature of Chinese Style Federalism. However, the fact that the central government permitted these budgets to exist might either result from the central government’s intention to boost local economic development, or it might result from the inability of the central government to monitor, or it may be due to both. What mattered more can only be solved by empirical work. However, it seems to us that to explain any of the two possible reasons for fast growth of the “extra-budget” and “off-budget revenue”, one need not to resort to the commitment effect. On the one hand, as we will argue in more detail latter, the central government, in trying to defend its legitimacy and win political support from local government, may in certain period permit and even encourage fast growth of the “extra-budget” and “off-budget revenue” of local governments, even when the central government has the power, information and ability to remove them; On the other hand, if the second possibility holds, i.e. the central government had to bear the fast growth of the “extra-budget” and “off-budget revenue” due to the inability and lack of information to monitor, then also the commitment effect should not be so important and it would be misleading to attribute economic growth to the commitment effect.

From what happened in 1980 and 1990s, we can see a clear clue that the central government did have stronger and stronger intention to change the revenue-sharing system and collect a larger share not only from the growing economy, but also from the total government budget. But this does not necessarily mean that central government wants to predate whenever possible and as much as possible, and it does not necessarily mean that the central government has the information and administrative capacity to predate. In 1980s, with a market track gradually growing out of and developing outside the plan system, the traditional tax system cannot effectively collect revenues from new sectors and especially cannot guarantee the central government's tax share since central government must depend on local tax agency in taxation. Local government had the incentive to exempt enterprises from central taxes. The development of market track made it possible for local governments to charge fees for extra-budget and off-budget.²⁵

With all these in mind, besides the conclusion that Chinese high growth lies not mainly in the commitment effect of Chinese style federalism, we may also find it safe to say that the sequencing of the Chinese transition is not explained in the fiscal federalism framework, since the embryo of fiscal federalism was not even initiated until mid 1990s when central governments began to carry out reform on its macro-economic framework with federalism characteristics.²⁶

A major problem with Qian et al's "commitment matters" argument is that, it seems to us, the "commitment" effect of certain institutional arrangements is overemphasized. It is a grand theory that appropriate institutional arrangements can ensure that government (or central government) commit not to predate enterprises (or local governments), so that the latter will have incentive to invest and accumulate wealth(or promote local development). And in this sense, a federalism system, or further, a democratic system can do best "in the long run". However, it is only in the long run that this point holds. In the short run or even in medium run, it is not necessarily true.

We have seen a lot of experiences in recent history that a non-democratic economy, such as Taiwan and South Korea, did continue high grow for 30 year or longer, in their political system, there is no such institutional arrangement that can prevent the government from predation. So why were these economies still growing so fast? In our opinion, even a

²⁵ Only After the 1994 fiscal reform with significant modification of revenue sharing rules, along with a substantial increase in the importance of fiscal transfers in which central government has the edge in bargaining, the central government began to reform the extra-budget and off-budget revenue collection system by taking a lot of measures in removing different fees imposed by local government.

²⁶ We will argue in Part III that even the 1994 fiscal reform is far from fiscal federalism since it only defined the revenue division between the central and the local, but still had a long way to go to define the expenditure side appropriately. And even the revenue side has been subject to the central discretion from time to time since then.

non-democratic regime could promote economic growth or at least not to predate too heavily due to concerns in consolidating government legitimacy. As Olson (1993) argued forcefully, if we think of state as a “stationary bandit” who monopolizes and rationalize theft in the form of taxes, a stationary bandit, in maximizing government tax, has an encompassing interest in his domain. It will, on the one hand, tend not to impose too high tax rate since it will lead to higher distortion, which in turn will further decrease the total tax revenue; on the other hand, have incentive to provide certain public goods (such as law and order, and some other infrastructure services which is productive in inducing private investment) at the same time, so that it can extract the largest net surplus from economic development. In this case, a non-democratic government might not necessarily kill economic growth thoroughly by predation although there is no institutional arrangement to bind itself.

With the above argument in mind, we would tentatively like to go one step further to argue: under certain context, especially when there is strong competition from other neighboring economies regarding government legitimacy, it is very possible that a non-democratic government will strive to promote economic growth to consolidate its political legitimacy. In our view, the Taiwan and South Korea case of high economic growth for more than three decades can be better explained by its geographical location under the ongoing world political climate. In specific, these regions were at the frontlines of the cold war between the socialist block and the capitalist block. The governments were under strong political pressure domestically from its people and in economic competition with its neighboring socialist countries (China and North Korea respectively). The governments had to defend their legitimacy in such a climate by promoting economic development. The Chinese reform, and to some extent, the Vietnamese case, also helps to illustrate this point. In China, just before the reform, the economy is close to collapse after over two decade’s of central planning and the devastating Cultural Revolution. The government had no choice other than reform and economic development to defend its legitimacy.

In conclusion, even if there is no institutional arrangements for the government to commit not to predate, it is still very likely to promote economic efficiency with the intention to maximize economic surplus grasped by the government or to defend its political legitimacy. One need not resort to these “committing ” (actually not so committing, as we argued before) institutional arrangements to explain China’s growth in economic transition. At the same time, it must be clear that we do not intend to conclude that political regime (dictatorship versus democracy) does not matter in the long run. As Olson (1993) argued, in the long run a lasting democracy did tend to perform better and

show more stability in economic growth due to security of property and contract rights.²⁷ However, in the short or even medium run, democratic political regime is neither necessary nor sufficient condition for economic growth.

All that said, we want to make it clear that we do not intend to argue that fiscal decentralization did not have positive impacts on China's growth and transition. After all, if we only judge from the perspective of local government incentive, higher shares of local revenue is better than lower shares. What we want to argue is: first, decentralization has many aspects, such as administrative decentralization etc, and the fiscal decentralization and the commitment effect it has is not the main factor in explaining China's high economic growth in transition; Second, for a large socialist country in transition like China whose government has many levels and gets involved in many competitive sectors, decentralization should not be confused with deregulation, and in many ways, the decentralization measures taken are means of de-regulation. Or put another way, it is the (de-)regulatory aspect of decentralization (such as give more autonomy to local governments such as in investment approval, local SOE supervision, preferential policy and other regulation policies to enterprises), i.e. the locus of authority to effect changes that is more important. Third, we will also argue in more detail later (in Part IV) that China's fiscal arrangement is endogenous to China's transitional path and the political game between the central and the local governments.²⁸

A final point to make regarding the commitment effect of some special institutional arrangement is that in a transitional economy, institutional arrangements must be subject to continuous change. One fundamental problem with the argument we critically reviewed is: in a transition process when institutional changes are taking place, static arguments that certain institutional arrangement lead to growth or no growth might be very misleading since the institutions under discussion cannot be treated as given or stable. We are not denying that certain institutional features might help a country to grow or hinders a country from realizing smooth transition, however, the effects should not be overemphasized, just like the impact of starting economic structure on transition should not be overemphasized. Since all institutions under discussion are also under transition, different transitional paths

²⁷ Even this view is not so sure according to Bardhan(2002).

²⁸ As Hu (2000) found, the fiscal decentralization index usually have negative coefficients or no significant effect on economic growth rates of different regions, the economic decentralization ratio(represented by the ratio of provincial revenues used in economic construction, including basic construction, enterprise technology improvement and agriculture development, to total national fiscal revenue used in economic construction) always have positive impact for regional economic growth. Since in China's case, local governments were directly involved in local investment not only for infrastructure but also for local enterprises, the economic decentralization in this sense rather than fiscal decentralization in general is more important for local economic development.

to marketization(either designed intentionally or forced politically) might shed some new light on the performance differences in transition. It is here we begin the next part.

Part IV. Deregulation and China's Economic Transition

4.1 Deregulation and Dual-track Reform

If we reject the Chinese style fiscal federalism argument as a good explanation for China's successful transition, an alternative explanation must be offered since it is always easier to be destructive than constructive.

According to our view, the fundamental nature of China's reform in the past two decades is deregulation in the economic system, which includes two parts: the first is to permit both market-oriented Non-SOEs as well as SOEs to develop outside the traditional planned track (firm entry deregulation) that gradually brought China's comparative advantages in labor-intensive sectors into full play, the second is to introduce various reforms, such as dual-track price reform, enterprise responsibility contracting reform, into the traditional planned track, thus the coverage of the planned track can be narrowed and market mechanism can be more and more dominant in resource allocation.

Most scholars pointed out that the traditional economic sectors under the planned system are very inefficient since there is no decision-making power at micro (firm and individual) level. Actually this point is emphasized (perhaps over-emphasized) by all scholars that take the paradigm of "soft-budget constraint".²⁹ It seems to us that for these scholars, the most important improvement from market-oriented economic reform is the efficiency gain from the micro level, and they overlook the fact that the efficiency gain also comes from overall resource allocation improvement and reduction of macro-policy distortion.

However, as Lin et al (1996, 1999) pointed out, the incentive and micro-efficiency problem is only one aspect of inefficiency in the traditional planned system; and the micro-inefficiency, together with the distorted macro-policy environment, and the planned

²⁹ As a matter, if the enterprises in the planned system did not have any decision-making power, there would not be soft-budget constraint. Before the marketization reform, the SOEs were deprived of most of the decision-making power because the central planner wanted to alleviate the SBC problem.

resource allocation system as a trinity are all endogenous to the traditional capital-intensive heavy-industry development strategy. Therefore, there is also another major source of inefficiency, i.e., the loss of comparative advantages in the planned economy. Since the reform was firstly initiated at micro level, it would break into the resource allocation mechanism and finally shifted to macro-policy level. The development of market track in China finally changed the resource allocation economy-wide and gradually brought the nation's comparative advantages into full play.

Many scholars are aware that the China's transition have been associated with the so-called "dual track", i.e., develop the "new market track" first without destroying the "old planned track", and then as the economic structure changes, gradually deepen the reform in the planned track. However, there are many dimensions of the "dual track reform", such as the dual track of prices, the dual track of regional development (such as special economic zones in China etc).³⁰

Take dual track of price as an example, according to Lau, Qian and Roland (1997), as long as the rights and obligations under the plan are all fulfilled, there was full liberalization of market track or full market liberalization if a planned supplier or a rationed user allows all market resales and market purchases for redelivery, which did happen in China. In this case, the introduction of the market track provides the opportunity for economic agents who participate in it to be better off, whereas the maintenance of the plan track provides implicit lump sum transfers to compensate potential losers from the market liberalization by protecting the status quo rents under pre-existing plan. Thus, the dual-track price reform approach, is, by design, Pareto-improving.

However, one assumption needs to be made for the above argument to be convincing: that goods produced shall be in short of supply for the market price is significantly higher than planned price. It is with this we start our discussion in the next section.

4.2 Inter-industrial Linkages and the Interaction Between Plan Track and Market Track.

In our view, the fundamental dimension of "dual track" in China's transition is not mainly the dual track price reform, but the free entry of both SOEs and Non-SOEs into labor-intensive sectors (a type of deregulation associated with micro-reforms as described in Part I). With the entry deregulation, there is a creation of a new market track in labor-intensive (mainly final goods sectors) outside the planned track of capital-intensive sectors.

³⁰ This was cited by Qian and Litwack (1998) as a special form of decentralization that helped to promote smooth transition in China.

With the traditional development strategy and the associated trinity, there was efficiency loss in resource allocation across sectors and products: some industries such as the consumer goods, services and infrastructure were heavily depressed under the distorted macro-environment and planned resource allocation system. Thus with entry deregulation into labor-intensive sectors, there must be strong efficiency gain in resource reallocation. Since there had been depressed demands in these markets (including consumer goods and services), this type of efficiency gain can be realized directly.

However, this is far from the whole story. We believe a major characteristic of the traditional economic system and the heavy industries have been largely overlooked by the transition literature: i.e.; the heavy industries are mainly industries with certain technological economy of scale; they provide intermediate goods for each other, and they provided intermediate goods for the final goods sectors (such as light industries and consumer goods, service industries and infrastructure industries. Significant technological economy of scale, combined with significant forward and backward linkages to other sectors, can lead to pecuniary externalities.³¹ With the technological economy of scale in heavy industries, and the fact that they provide capital goods, raw materials and other intermediate goods for previously depressed labor-intensive consumer goods sectors, if there is free entry into the latter, efficiency gain both from market competition and resource allocation improvement would surely enlarge the market of intermediate goods produced by the capital-intensive heavy industries in the planned track and bring their technological economy of scale into play.

Therefore, for the traditional sectors under the planned system, its production could maintain and even grow,³² which helps to avoid output loss in the case of immediate privatization, although these sectors still have some efficiency problem at firm level due to principle-agent problem.³³ Therefore, due to extensive industrial linkages between the final

³¹ The pecuniary externalities was internalized in the traditional economic system since it is administrated by one central planner, but it could not easily be internalized under a decentralized system if developed market institutions and contractual framework are not available. This characteristic can be used to partly explain the short-run economic collapse in Russia and East Europe after the shock therapy. See Li Wei (199?)

³² In China, the SOEs grew at 7.8% annually from 1980 to 1992. In the same period, the contribution of SOE to the total industrial output was over 50%. The SOE output growth has been about 5% since 1992. At least up to 1992, the employment, output, profit and taxes in SOE manufacturing sector kept increasing. If we also include SOEs in construction, power plants, gas and water production sectors, the growing trend continued to 1997. Only after that, i.e., about two decades after the Chinese reform started, a large scale SOE restructuring began with a lot of laid-off and unemployment created. This is in sharp contrast with the situation of the former Soviet Union and Eastern European transition economies (with privatization or not) where transition led to immediate output shrink and huge unemployment.

³³ According to Zheng et al (2002)'s research on about 600 SOEs from 1980 to 1994, there has been significant productivity growth for these SOEs although their pace lagged behind that of private and foreign-funded enterprises. And the productivity growth of these SOEs mainly came from technological improvement instead of operation efficiency. In addition, they found that large SOEs had more productivity growth than small and medium-sized ones, which could be used as indirect evidence that SOEs have some technological economy of scale. However, the

goods sectors in market track and the intermediate goods industries in plan track, the development of the former promoted the development of the latter and helped to utilize the latter's technological economy of scale,³⁴ thus there is efficiency gain in the whole economy; In addition, since there were also new entry of SOEs in the final goods industries, the development of market track promoted competition and harden the budget constraints of these SOEs and helped to solve their incentive problem.

4.3 Dual-track Growth, Monetarization, and Central-Local Revenue Share

If we can go one step further, we can even argue that the relatively stable central-local share of government budget government in China is also endogenous to the growth and transition path China took instead of being the major explanations for China's growth. As shown, China grew mainly due to development of a market track outside the planned track, the market track (mainly final goods industries) provide huge demand for the planned track and at the same time improve the latter's efficiency both by promoting the former's technological efficiency (since in many intermediate industries there is significant economy of scale from a technological point of view) and by imposing competition on the planned track, which further helped its transition. In this case, the economy is growing quickly in transition, and most SOEs also grow, although at a lower rate than non-SOES. Therefore, the government could still get increasing tax revenue in absolute terms due to economic growth even its share in GDP decreased. Hence, the government (especially the central government) can still maintain a growth in fiscal revenue. The central government can also increase its revenue even when its share in total government revenue was declining. At the same time, since the SOE was still growing, there was not huge restructuring costs (such as costs for social security for layoffs and unemployed) and hence less fiscal expenditure requirement. In this case, the central government, although it wanted to get a larger share in total government revenue, were not under huge pressure to take decisive steps in increasing

research did not differentiate up-stream and down-stream SOEs, thus further research is necessary to prove our theory.

³⁴ There are some caveats here. As Liu et al (1998) argued, after the reform, many SOEs downsized its scale instead of growing in scale. Does this mean that the previous argument is invalid? Not necessarily. In some industries such as machine building industry, due to the so called "shortage economy", many SOEs had to adopt vertical integration (Shen 1993) and produce many of the parts by themselves to avoid the inefficiency resulting from transition costs. After the reform, some SOEs did downsize since it can subcontract the production of many parts to other SOEs or even TVEs, which increase economic efficiency. But this does not necessarily means that there is no economy of scale in these industries. There is some economy of scale in certain production procedure, so although the SOEs replace vertical integration by long-term contract with other firms in producing some of the parts, it is still valid that in the key procedure of its production, its technological economy of scale is still significant. In some other industries, like iron & steel industry, some chemical industries, many SOEs did grow in size in providing intermediate goods to more market-oriented final goods industries. Therefore, we need to do careful empirical work at industry or even firm level to test our theory.

central share before mid-1990s (although it did have the power to do so by replacing provincial governors, which was manifested in the 1994 government tax reform). While in Russia, although at local level there were elections after the collapse of communist regime, the central government still face great social security demand and needed continuously to subsidize the capital-intensive industries after the mass privatization process and had to resort to non-committing renegotiation with local government by repeated increasing its share in total revenue.³⁵ In conclusion, the relative stable central-local budget share is, to some extent, endogenous to China's transition path, the same is true for Russia.³⁶

The monetarization process following China's dual track growth transition path also has deep implications for the fiscal arrangements. Although tax revenue as the share of GDP declined, it was accompanied, and thus partially compensated, by an increase of "quasi-fiscal" revenue from impressive financial deepening. This provides a basis for China's macroeconomic stability and avoids a financial crisis like Russia's (McKinnon, 1993). In China, consolidated government budgetary revenue as a share of GDP declined from 31 percent in 1978 to 13 percent in 1993. Taking into account the extra-budgetary and off-budget revenues, total tax revenue also declined dramatically, from 40 percent of GDP in 1978 to about 19 percent in 1993 (Bai et al., 1999). On the other hand, cash in circulation as a percentage of GDP was less than 6 percent in 1978, and increased to 16 percent in 1993. Total household bank deposits were less than 6 percent of the GDP in 1978, and they increased to about 50 percent in 1993 and further to 62 percent in 1997. The M2 to GDP ratio continued to climb, from less than 50 percent before the reform to more than 100 percent in the 1990s (*Almanac of China's Finance and Banking*, 1996). What seems to be

³⁵ Sachs (1999) argued that Russia's extremely unstable macro economy is due to the failure of Russia government to pursue any sustained macro-economic policy. However, it should be noted that if the non-viability issue and the social burdens of the SOEs were not resolved, the government needed to subsidize the firms even after the firms were privatized unless the government were willing to let the firms bankrupt. Bankruptcy might not be a feasible option because either the firms were considered strategically important or the bankruptcy might result in mass unemployment. However, after the privatization the government's ability to collect taxes greatly reduced. Under such circumstance, the government could only meet the needs for subsidies by inflation taxes. The macro stability could not be achieved. Moreover, legal framework and market institutions in Russia have not even begun to develop when it started its Big bang transition. Under such circumstances, effective market operation could not be carried out and a complete replacement of the traditional system only led to chaos. Without a market track gradually developed to absorb capital and labor into market-oriented sectors, any reform attempt would impair the interests of the establishment and have to be adjusted right after implementation. Therefore, no consistency can be kept during the transition paths. As a matter of fact, since 1995 when Russia started a stabilization program, the central government in Russia has been continuously broke and consequently eager to renegotiate its tax agreement with local government. The reason for this may just lie in the transitional path Russia went through.

³⁶ Of course, besides raising the central share, the central government in deficit in transition could also assign more expenditure responsibilities to local governments. (That is partly what happened in China after mid-1990s which increased the central budget share but left many expenditure responsibilities to local governments. See Part V for more detailed discussions). Therefore, it is not necessarily true that slower reformers have higher central shares. According to Dabla-Norris and Wade (2002), in several countries, the process of fiscal decentralization occurred at a time when central governments faced intense pressures to curb their fiscal deficits. As a result, expenditures, in particular in capital and social outlays, were devolved to local governments. However, in the absence of an adequate assignment of revenues, this resulted in inter-governmental fiscal imbalances.

surprising is that the financial buildup lasted much longer than most economists expected. The result has been that the government was able to benefit from this financial buildup. By one estimation, between 1986 and 1994, the government collected quasi-fiscal revenue from the banking sector, averaging about 9 percent of the GDP, or more than one half of the budgetary revenue (Bai et al., 1999). Therefore, the central government also benefited a lot from the monetarization process, which helped to maintain a relatively stable central-local fiscal arrangement before 1994. It must be noted that the monetarization process itself is an outcome of the dual-track growth mode since it is the growth of both SOEs and non-SOEs that promoted the financial deepening and the monetization process, which further helped the government to collect seigniorage income.³⁷

4.4 A Brief Summary

From the discussion in this part and in previous parts of the paper, we can draw the following conclusions tentatively:

1 The fast development of TVE and FDI, non-state enterprises constitutes the engine of Chinese growth in transition for the past two decades. The high growth of the enterprises is mainly due to the deregulation of entry into the labor-intensive sectors consistent with China's comparative advantages.

2 In addition to the deregulation of entry of non-SOEs, China's reform is also special in the sense it is a break into the traditional planned system and started with micro-reforms of farming system and SOEs to improve incentives, which increased the availability of resources for outside-plan investments by the state and non-state enterprises, later inevitably led to the change of resource allocation mechanism and macro-policy environment as more market elements were introduced.

3 For a large country like China, any reform policy (enterprise entry liberalization, opening up and SOE reforms) had to be implemented through local governments and it is natural to start with some regions with special location advantages (the special economic zones etc). The administrative and fiscal decentralization during the transitional process is endogenous to the deregulation process and could be viewed as the means to deregulate.

4 There was significant length of periods with productivity improvement for both new and more market-oriented SOEs (mainly in labor-intensive final goods sectors) and the old and more capital-intensive SOEs that already existed in the planning period. For the

³⁷ In Russia, one of the most surprising phenomena is rise of barter trade after macroeconomic stabilization in 1994 from 5 percent of GDP to 60 percent in 1998. Barter is only one aspect of Russian economy's demonetization process, along with dollarisation, growing arrears and the widespread use of veksel's and offsets. See Linz and Krueger (1998). The economic decline made it impossible for the government to rely heavily on printing money without causing high inflation as China did.

former, efficiency gain came both from resource allocation improvement and harder budget constraints under market competition. For the latter, it came from both incentive improvement and better utilization of technological economy of scale due to the demand spillover from the development of more market-oriented labor-intensive (final goods) sectors.

5 The dual track price reform could work partly because there were huge demands for the more capital-intensive intermediate goods produced by SOEs, which came from the fast growth of labor-intensive sectors after the reform; otherwise the low demand would only depress the traditional planned track and lead to output shrink.³⁸

6 The relatively stable central-local fiscal arrangement was endogenous to the dual-track growth path China took in transition. Central revenue growth, low restructuring costs the central budget needed to pay, and the significant monetization process that China experienced is all due to the growth of both the market track and plan track, which helped to maintain the relative stability in inter-government fiscal arrangements before 1994.

Part V. Decentralization in the Usual Way: Has China Started?

As the previous three parts show, not only the literature on China's decentralization since the reform in late 1970s has been largely unconvincing to explain China's relatively successful performance in transition, but also it has been not quite related to the general decentralization literature since the latter is mainly a field of studying the transfer of public functions to lower level government, but in China, the government was, and is still involved (although to a less and less extent) in many non-public functions. So the question to ask is: regarding the decentralization of public functions usually denoted in the general decentralization literature, has China really started. A brief answer is: yes, but we still have a long way to go.

5.1 1994 Fiscal Reform

³⁸ However, the SOE reform still lagged behind that of the Non-SOEs. As reform went on, especially after mid-1990s, the market competition effect began to be more important and the government had less means to subsidize the SOEs. The government has tried many measures to improve the SOE's corporate governance and ownership structure. However, due to the continuous existence of policy burdens, those reform measures have failed to produce the expected results (Lin, Cai, and Li, 1998; Lin and Tang 1999), thus led to loss of SOE share in market and large scale restructuring.

The fiscal reform of 1994 was a comprehensive package of measures designed to address three areas of concern: to stem the fiscal decline and provide adequate revenues for government, especially the Central Government; eliminate the distortionary elements of the tax structure and increase its transparency; and revamp the central-local revenue sharing arrangements. Therefore, the 1994 reform can be viewed as a first step to establish a more progressive rule-based fiscal system that tries to establish a preliminary modern fiscal system that deals with central-provincial relationship. However, as we will argue later, although the 1994 reform basically set the lines of revenue sharing between the central and provincial governments, the expenditure responsibility division is still not well defined. In addition, below the provincial level, even revenue sharing is still subject to frequent change, not to mention the expenditure responsibility, and a fully-fledged local governance structure and inter-governmental relationship (below provincial level) is still far away.

5.1.1 The Content of Fiscal Reform in 1994

The centerpiece of the reform was introduction of the Tax Sharing System (*fenshuizhi*), which fundamentally changed the way that revenues are shared between the central and provincial governments. Under the Tax Sharing System (TSS), taxes were assigned either to the central or local governments. Under the reformed fiscal system, tax revenue assigned to the central government boiled down to the following: 75 percent of the newly introduced VAT, excises, trade related taxes (customs duties, excises and the VAT levied on imports), the enterprise income tax collected from central SOEs, banks and non-bank financial intermediaries; the remitted profits, income taxes, business taxes, and urban construction and maintenance taxes of the railroad, bank headquarters and insurance companies; resource taxes on offshore oil extraction; most of a securities stamp tax. Local governments were assigned the following: $\frac{1}{4}$ of the VAT, the business taxes (excluding those named above as central fixed incomes), income taxes and profit remittances of local enterprises, urban land use taxes, personal income taxes, the fixed asset investment orientation tax, urban construction and maintenance tax, real estate taxes, vehicle utilization tax, the stamp tax, animal slaughter tax, agricultural taxes, title tax, capital gains tax on land, state land sales revenues, resource taxes derived from land-based resources, and the securities trading tax.

The fiscal reform in 1994 has strengthened the control of the central government over revenue in three aspects. First, the fiscal contracting system was actually terminated now. The central government has independent tax base, many tax categories such as income tax of central-government-owned enterprises, customer duties, value-added tax (the share of central government is 75%), and consumption tax (sale tax) are belong to the

central government. Second, the authority of tax collection of central government is no longer delegated to local governments, the central government has its own independent agencies in all provinces, with the establishment of a national tax system (NTS) to collect Central Government revenues, and a local tax system to collect local taxes, so the problem of tax-diversion by local governments can be corrected to some extent.. Thirdly, a series of arrangements of revenue transfer has been established, the figures in Table5.1 (from 1994 to 1998) are the remittance by local governments up to the central government. Because of these institutional changes, the share of central government revenue in total revenue has risen to around 50%.

To a large extent, the direct goal of this reform was to increase the “two ratios” – revenue to GDP and central revenue as a share of the total. The state budget revenue to GDP ratio fell by 4 percent of GDP between 1991-5. (And local government revenues – including transfers – fell as well, from 11 ½ to 9 ¼ percent of GDP.). In 1994, the one-time transfer of the bulk of VAT and CT revenues to central coffers boosted the central share from 22 percent of total revenues to 55.7 percent. In 1996, it began to rise slowly, and has risen more rapidly in 1998-99 as a result of improved tax administration, especially the anti-smuggling effort³⁹. In 2000 revenues were approximately 15 percent of GDP.

As to the expenditure side, in 1978, the share in consolidated expenditures of the Central Government (46 percent) was quite close to that of sub-national governments (54 percent), In 1995 the share for sub-national government expenditures had increased to two-thirds and the share of the Central Government had fallen to one-third of the total, which was roughly stable until 1999. That means the central government has significantly expanded the inter-government transfer since the 1994 reform.

³⁹ The expectation was that the long-run trend under the TSS would be toward centralization of revenues, given that the VAT was the most productive tax in the system, and one that would be fully administered by the NTS. Surprisingly, however, even though the revenue buoyancy of the VAT has been high (1.365 over the 1994-1998 period), its share in total tax revenues has slipped from 43 to 37.4 percent of tax revenues, while the consumption tax has slipped from 9.1 to 8.4 percent. In contrast, the business tax, a local tax (except on the banking sector), has risen from 12.6 to 16.2 percent of tax revenues, while the personal income tax, an insignificant tax in 1994, collected 34 billion yuan and accounted for more than 6 percent of local taxes in 1998. Due to the higher income elasticity of local taxes, the central share of revenues fell during the mid-1990s, but recovered some ground in the past two years with strong customs revenues due to the Government's success in curbing smuggling, along with some revisions of tax rules and assignments.

Table 5.1: Central Budgetary Revenue and Expenditure After Reallocation between Central and Local Government (Unit: 100 million Yuan)

Year	Total Central-Govt Revenue	Central Government Revenue		Central-Gov Expenditure	Central Government Expenditure	
		Revenue From Central Government	Revenue From Submitting of Local Government		Expenditure for Central Level Government	Expenditure for Allocation to Local Government
1990	1474.61	992.42	482.19	1589.75	1004.47	585.28
1991	1428.55	938.25	490.3	1645.56	1090.81	554.75
1992	1538.15	979.51	558.64	1766.94	1170.44	596.5
1993	1557.82	957.51	600.31	1856.69	1312.06	544.63
1994	3476.55	2906.5	570.05	4143.52	1754.43	2389.09
1995	3866.63	3256.62	610.01	4529.45	1995.39	2534.06
1996	4264.95	3661.07	603.88	4873.79	2151.27	2722.52
1997	4830.72	4226.92	603.8	5389.17	2532.5	2856.67
1998	5489.13	4892.0	597.13	6447.14	3125.6	3321.54

Note: Revenue in the table excludes foreign and domestic debts revenue, expenditure excludes payment for the principal and interest of foreign and domestic debts and expenditure for capital construction which is financed by foreign debts.

Source: New China Fifty Years' Government Finance Statistics, 2000, Beijing.

5.1.2 The Reason Behind the 1994 Fiscal Reform

Why did the central government carry out the 1994 fiscal reform and increase the central share? As described above, the increase the “two ratios” – revenue to GDP and central revenue as a share of the total were the direct goals. However, why the central government wanted to do is something needed to be further explored.

As our arguments in Part II and Part IV go, the relatively stable and low share of the central budget is due to the transitional path China has taken after the reform. And an

essential element of the transitional path is that the SOEs had grown rapidly after the transition, which led to steady growth of both the central and the local fiscal revenue (in absolute terms) and relatively small pressure on fiscal expenditure in economic restructuring (both for SOEs and state-owned commercial banks that accumulated huge amount of non-performing loans) at least before mid-1990s.

However, as the market-oriented reform deepened and more sectors opened to non-state investment, the SOEs both in labor-intensive and in capital-intensive sectors have been facing more and more fierce competition from non-SOEs since early 1990s. Many SOEs lost their monopoly positions, led to the drop of their output prices, whereas the competition for inputs from non-state enterprises raised the inputs' prices. Moreover, due to the corporate governance problem arising from the policy burdens on many of the SOEs,⁴⁰ the financial positions of many of the SOEs began to deteriorate since early 1990s and some restructuring seemed to be inevitable. At the same time, the widening urban-rural and inter-regional disparity had been alerting. The ratio for per capita incomes declined from 2.87 in 1978 to 1.86 in 1985 due to the rural farming reform and the TVE development, then it gradually increased through the early 1990s. In 1990, the ratio was 2.2; while in 1995 and 1999 it reached 2.72 and 2.65 respectively (NBS, 2000). Therefore, after a significant long length periods of good days after 1978, the central government began to face larger and larger responsibilities in economic transition. The perspective deficit that the central government faced in early 1990s was quite large.

As a matter of fact, one of the explicit arguments for the 1994 reform was to meet the fiscal capacity needed to cover the transitional costs of economic reform. According to this point, larger SOE loss, higher income inequality and thus higher demand for central government transfer necessitated a more centralized fiscal system.

However, what was said is not what was necessarily done. The interesting question to ask is whether the central government has really allocated much of the centralized resources to compensate the losers in the reform in 1990s.

A direct answer is no, and a more subtle answer is a little bit, and hopefully more in the near future. The answer lies in the following trends: in 1990s, the income disparity, urban-

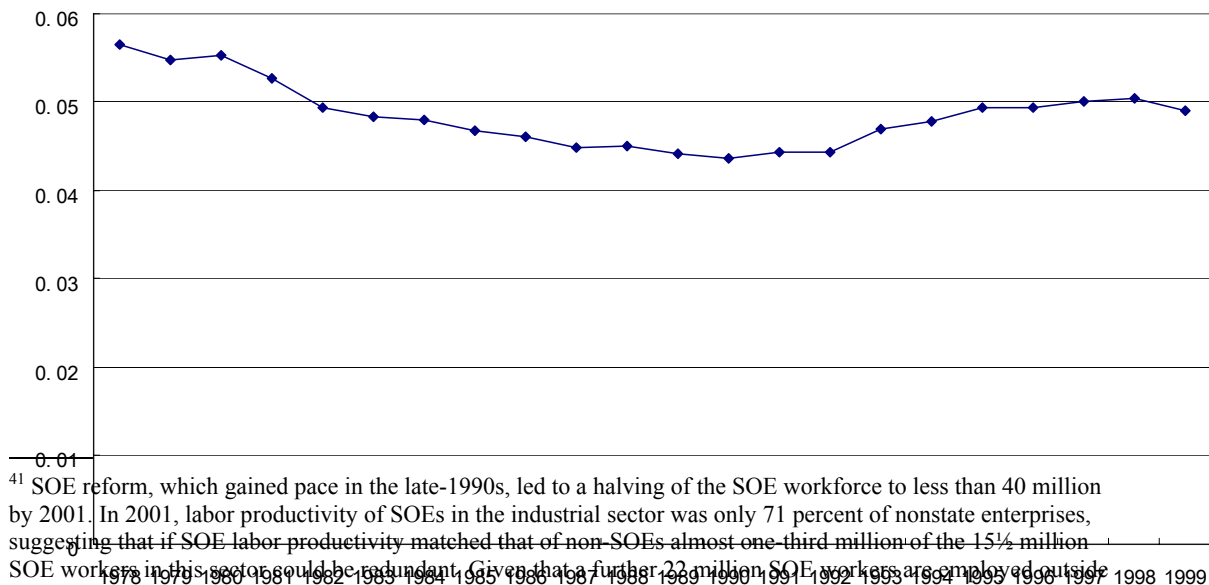
⁴⁰The policy burdens mainly come from the traditional development strategy that was in the plan period, and still is remaining (though to a much smaller extent) for the SOEs in the capital-intensive, strategic sectors, which are not viable because of their violation of China's comparative advantages. In many of the old SOEs, the pension of the old workers and other restructuring costs including those needed to lay-off workers burden these SOEs largely and make these enterprise less competitive than the non-SOEs, and even less competitive than some of the new SOEs that has less redundant labor and retirees.

rural and inter-regional divide, and the local fiscal and governance problem became more and more serious. In addition, since 1997, the central government began to implement large scale SOE restructuring,⁴¹ but there have been a lot of problems, especially insufficient (central) fiscal inputs in SOE retiree pension payments and social security expenditures for laid-off workers and improving the assets of the State-owned banks with huge Non-performing loans.

5.1.3 Re-strengthening Macro-Control Through Recentralization

Coming back to the original idea on the relationship between deregulation and decentralization, we hypothesize here again the following: if the deregulation will, to some extent, induce the decentralization, it is possible that the recentralization might mean the center's re-strengthening macroeconomic control on (or re-regulation) to realize its overtaking strategic goals through fiscal channel. The fiscal recentralization-led re-strengthening macroeconomic control since mid-1990s created the problems of enlarging interregional income disparity (Figure 5.1), more serious local fiscal imbalance, and the problem of local governance, while the fiscal system adjustment can be viewed as a means to for the government to control the economy.

Figure 5.1: σ -convergence across Chinese Provinces



⁴¹ SOE reform, which gained pace in the late-1990s, led to a halving of the SOE workforce to less than 40 million by 2001. In 2001, labor productivity of SOEs in the industrial sector was only 71 percent of nonstate enterprises, suggesting that if SOE labor productivity matched that of non-SOEs almost one-third million of the 15½ million SOE workers in this sector could be redundant. Given that a further 23 million SOE workers are employed outside the industrial sector, this implies a total SOE labor surplus of about 10-11 million. (Brooks and Tao, 2003). Since 1999, four asset management companies were set up to transfer about 1.4 trillion RMB in NPLs from the four state owned commercial banks, which constitute half of the total NPLs in these banks. Most of the NPLs will have to be paid through government revenue. As a matter of fact, the SOE and State Bank restructuring were somewhat delayed until late 1990s, at least three or four years after the fiscal reform, and the central government has not committed to pay for the costs of this delayed transition.

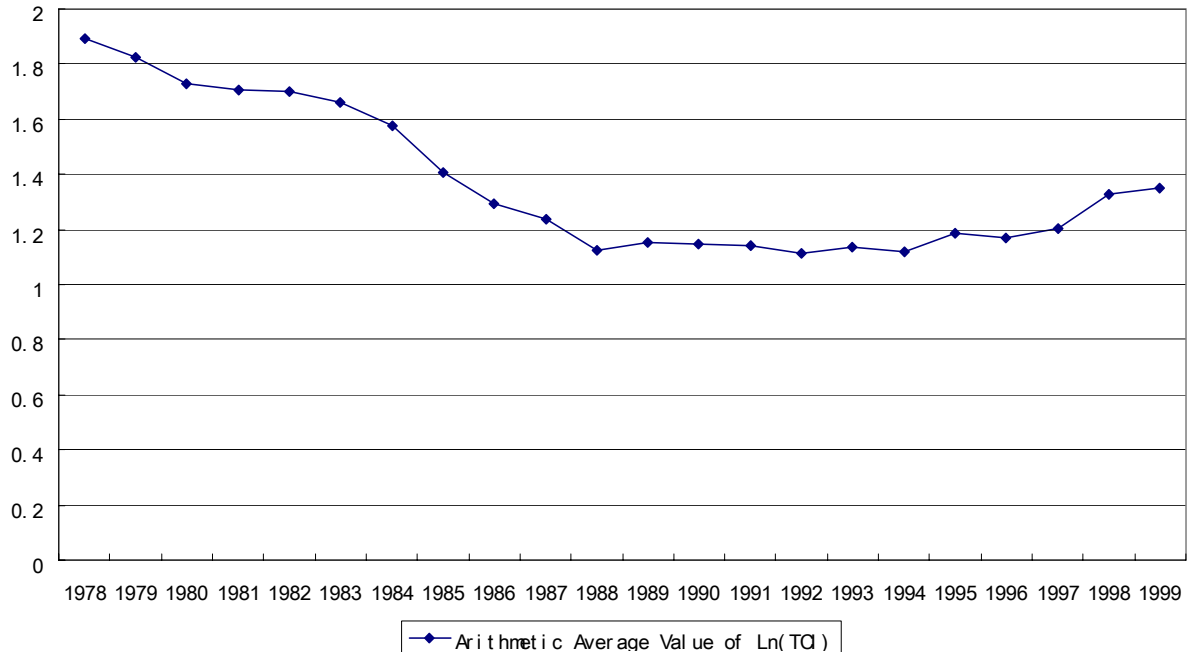
As we see from discussions before, if we include the extra-budget funds, the share of central government has been relatively stable since the reform started. (Figure 2.5 , also see Hu, 2001). However, most of the central extra-budget was not controlled by the central government, but by the various departments of State Council and their subsidiary companies. Therefore, to strengthen the center's power and enforce its "macro-economic control", the central government believed it needed to re-centralize the fiscal system at some point. The explicitly claimed intention of the center was to strengthen the macro-economic control, however, this target is ambiguous in the sense that it might mean that the center wants to pay for the transition costs in SOE and state-owned bank restructuring, or it wants to re-strengthen its control on the economy, i.e., in our words, re-strengthen its regulation so that the economy develops to realize the center's intention. This was achieved by a series of reforms in mid-1990s, especially the 1993 central banking reform and the 1994 fiscal reform. These reforms significantly enhanced the center's power over the fiscal resource allocation.⁴²

Some remarkable changes after 1993 are the increases of TCI⁴³ indicators for the west provinces, which means the process of deregulation in these provinces has been reversed to some extent. It is interesting to ask why the local governments in relatively backward wanted to go back to the distorting development strategy that led to low-efficiency. (Also see Figure 5.2 shows that on average, the TCI index for all provinces has increased since mid-1990s).

⁴² The financial centralization is somewhat different. The reform reduced significantly the local governments' impacts on the volume of banking credit. However, The Central Bank's law promulgated in 1993 also prevented the central government's scope to finance deficit by printing money. The higher ratio of non-performing loans in state-owned banks and its possible risks for financial crisis also significantly limited the central government's intention to directly intervene the banking system.

⁴³ TCI is measured as the ratio of capital density of manufacturing sectors to that of the whole economy, therefore, it can measure, to some extent, the deviation of an economy from its endowment structure and comparative advantages. Refer to more details by Lin (2001) and Lin and Liu (2001).

Figure 5.2: Average Value of TCI across Chinese Provinces



As we see, the implementation of catching up development strategy can be described along two dimensions: one is the available instrument set of enforcing the development strategy; another is the differentiated impact of strategy implementation across regions. It is critical for us to understand the changes of fiscal system in these two dimensions.

We believe that the capacity of the government and its available instruments significantly affect the role of fiscal system at different stages of transition. The deregulation in the 1980s induced the central government to give up much of its control over the economy, and at the same time decentralized the fiscal system, as we argued in previous parts (since in a more and more liberalized economy, the traditional centralized fiscal arrangement could only lead to increasing costs in tax collection and expenditure assignment). However, the deregulation process since late 1970s significantly limited the available instruments for the center to control the economy. When the time came that the central government wanted to re-strengthen macro-control over the whole economy, the only way out is to re-centralize the fiscal and financial system

Two lines of evidence after the 1994 reform can be provided to support the argument above: First, the higher share of the central fiscal revenue since the 1994 reform has significantly enhanced its power and control relative to local governments.

Specially, for the relatively poor regions whose expenditures are highly dependent on the central transfers, the local governments have been more vulnerable to the central policy intentions. Second, with the fiscal centralization, the central government has, strangely, kept ignoring the huge problems in local fiscal imbalances. This has been shown very clearly in the serious local deficits in many local governments. Put another way, there has been strong imbalance between the fiscal revenue distribution and expenditure assignment since the 1994 fiscal reform. The question is why the central ignored this problem for so long.

In figure 5.3, 5.4 and 5.5 we plot the relationship between TCI and the ratio of fiscal expenditure to GDP, the ratio of local fiscal deficit to GDP, and the ratio of local fiscal expenditure to fiscal revenue in 1980, 1990, 1995, and 1999.

Here we take the ratio of local fiscal deficit to GDP as the measurement of the impacts of central net transfer on local economy. Roughly speaking, the higher local fiscal deficit, the heavier the fiscal dependence of local government on the central government, and, the higher ratio of local fiscal deficit to GDP, and the heavier the control or impacts of the central policy on local economy. The figures for the other two variables also showed some similar patterns. As TCI increased, the ratio of local fiscal expenditure to GDP and the ratio of local fiscal expenditure to revenue also become bigger and bigger. In addition, the linear relationship between these three variables and TCI became more and more apparent in late 1990s. To some extent, the changes of the relationships from the 1980s to the 1990s show that the available instrument set for enforcing central control has been shrinking as marketization reform deepened, and the central government had to be more dependent on the fiscal system to exert its control in the 1990s than in the 1980s. Obviously, in the 1990s, the central government could not control the economy with the traditional instruments employed in the planned period, or even in 1990s (such as mandatory investment and resource allocation), while the bad loan in the state-owned banking system and the worsening performance of SOEs in stock market that increased the financial risk also restricted the scope of central intervention into the financial system. Facing limited choices, the central government strengthened its fiscal power from time to time, and the tax-sharing arrangements have been changed by the central government several times after the 1994 reform. For example, in 1998, the securities trading tax was shifted from being a purely local tax to a shared tax, with 88 percent going to the Central Government and 12 percent for the local government. In 2002, the center also began to share the income tax with the local governments.

Figure 5.3: Government Regulation and Fiscal Balance of Local Governments to GDP

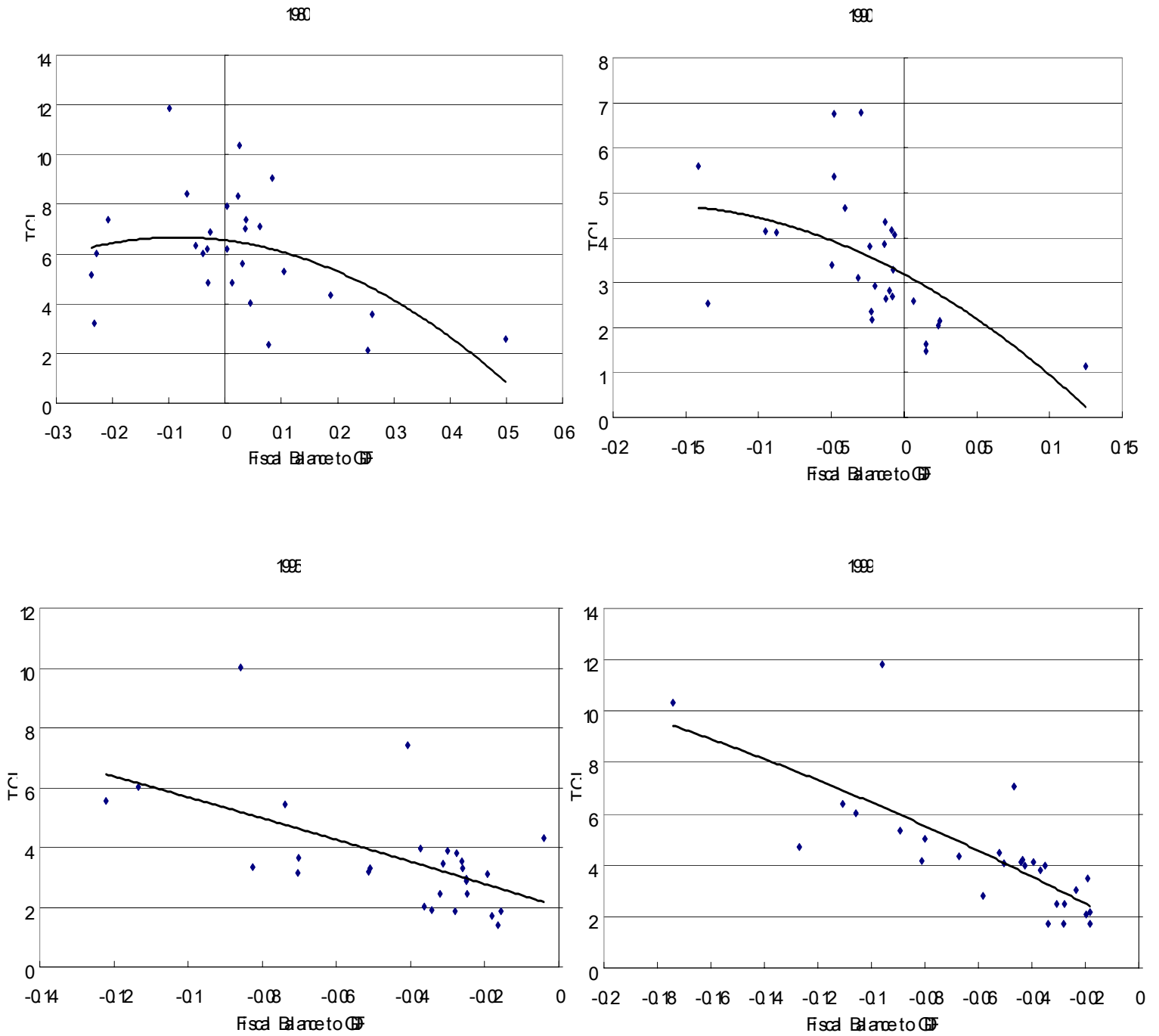


Figure 5.4: Government Regulation and Fiscal Expenditure of Local Governments to GDP

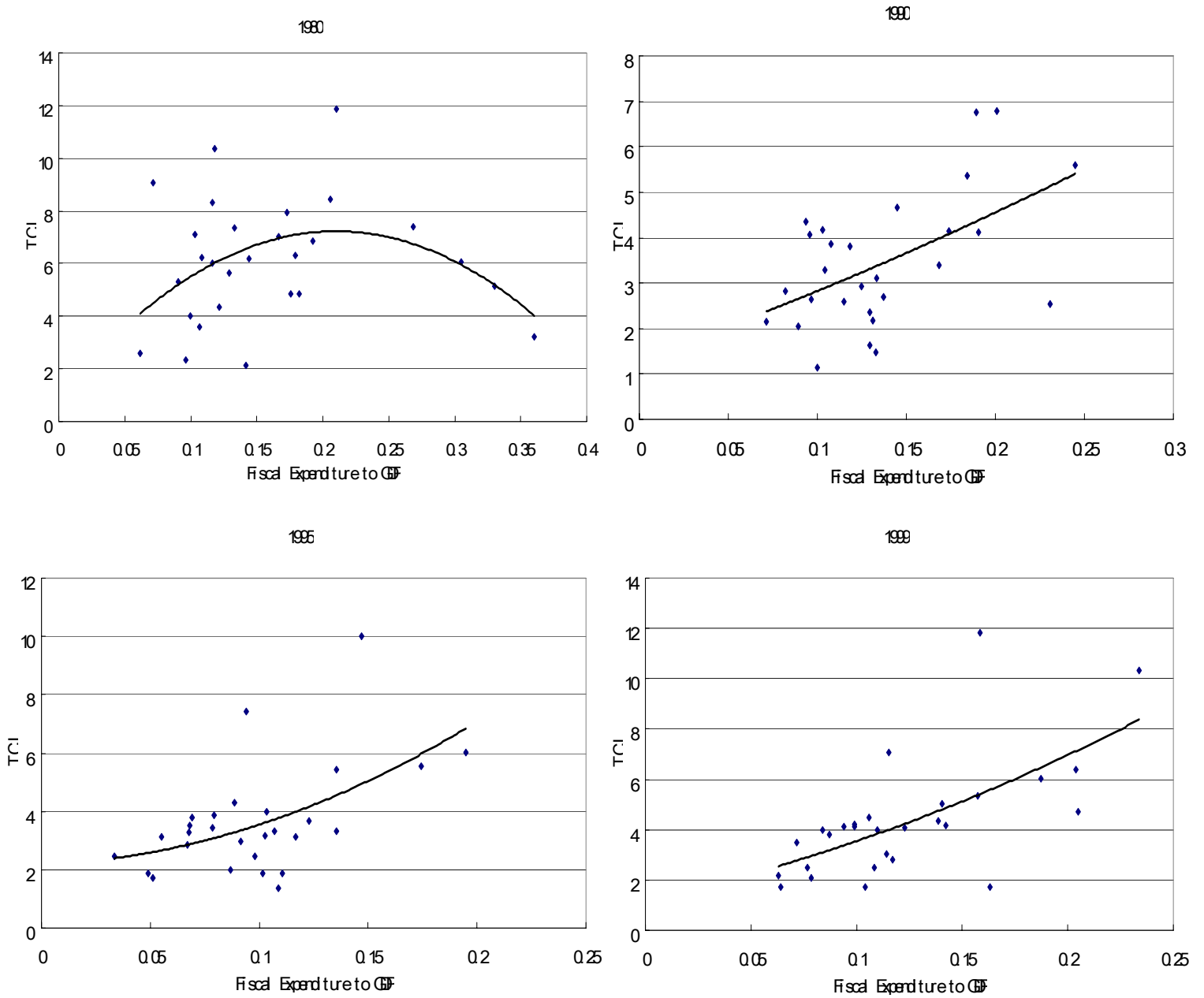
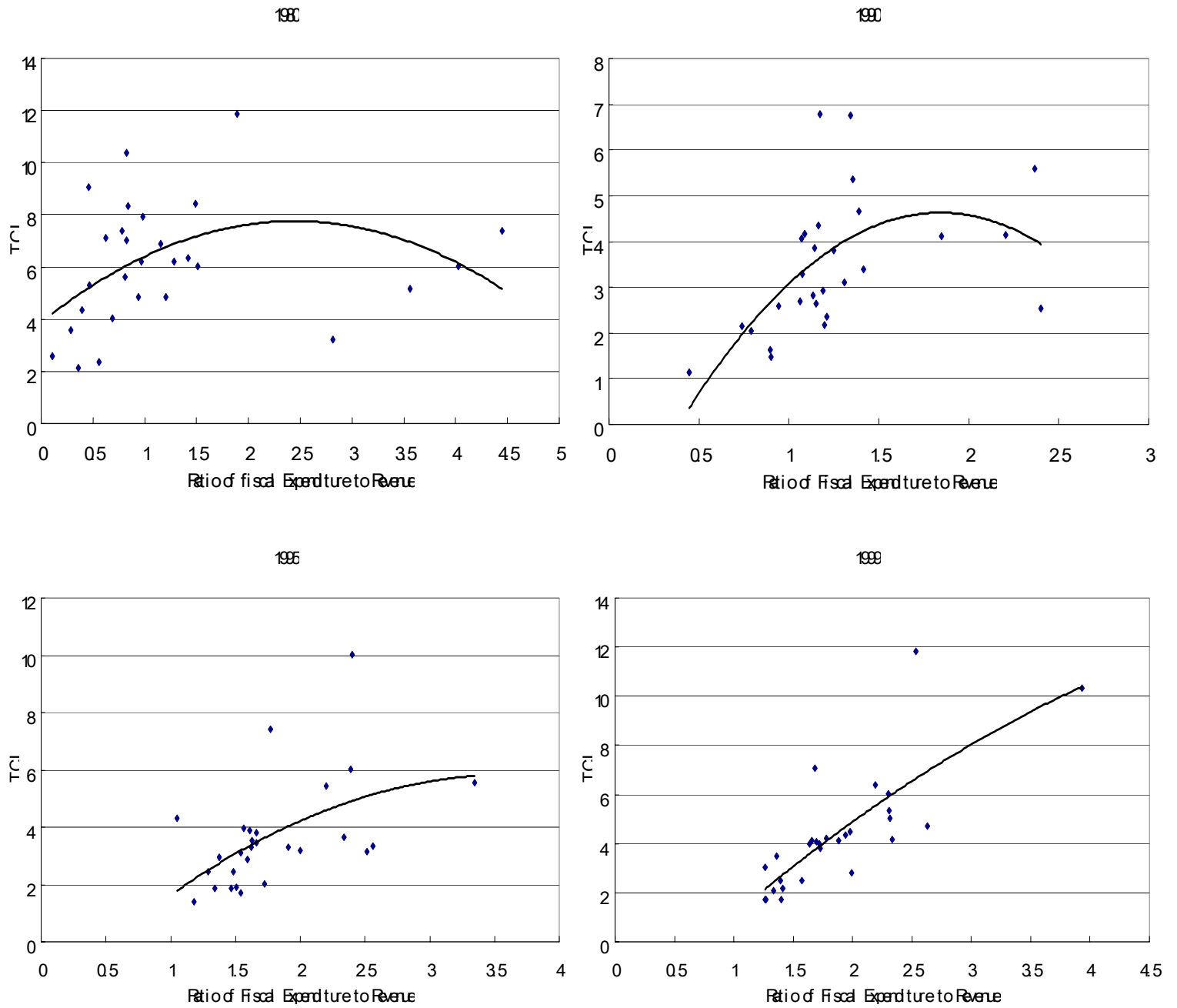


Figure 5.5: Government Regulation and Fiscal Autonomy of Local Governments to GDP



At the same time, the impacts of central control have been heterogeneous across regions, which is consistent with the inter-regional heterogeneity in the fiscal relationship between the center and the local governments. When the government re-strengthened its control on certain strategic sectors (which, as we argued before, is a typical residual of the traditional development strategy), the region with high concentration of the sectors suffered more. According to the figures, the more under-developed the economy, more dependence of local fiscal revenue on the central transfer, more regulation the economy suffers.

Let's take the example of the manufacturing development. The conditions in the central and western regions are unfavorable to the development of non-state sector relative to those in the Eastern and coastal regions. In the western regions, the central government-sponsored projects have been mostly of overtaking nature, with the regional development highly dependent on the center's fiscal support. When the local governments adopted the catching-up strategy and supported the capital-intensive heavy industrial development that deviates from the local endowment structure, the central and western regions inevitably suffered more from the catching-up development strategy than the Eastern and coastal regions, which not only led to increasing inter-regional disparity between the east and the west, but also led to larger urban-rural divide within the west than in the east..

5.1.4 Revenue Control

The outcome of the 1994 reform has been fiscal centralization both at the national and sub-national levels, which shifted revenues upward to the central and provincial levels. In recent years, the Central Government has been collecting 50-55 percent of total revenues, but accounting for only about 30 percent of the expenditures; the rest is transferred to local governments. Transfers finance more than 40 percent of the consolidated local expenditures. Similar stories can be told at the sub-national levels: In 1999, transfers financed fully one-third of aggregate expenditures at the county level, ranging upward to 61 percent for the nationally designated "poor" counties. Even though a large portion of central revenues are committed as tax rebates, the increase in central government control in fiscal allocation has been obvious after 1994. First, tax receipts accrue to the Ministry of Finance (MOF) before rebates are made—that MOF controls the purse confers power over local governments—it allows MOF to withhold funds if local governments fail to comply with the central policies. Second, MOF's allocation flexibility increased over time as the share of tax rebates fell in total transfer, which increased the discretionary part and reduced the formula-driven part of the central transfer.

As reported by the World Bank (2002), two broad trends can be seen regarding the sub-national public finance. First, there appears to be a centralizing trend, with a growing concentration of fiscal resources at the provincial level. For example, in the four provinces surveyed(Hebei, Gansu, Hunan, and Jiangsu), the provincial level's share of expenditures grew by 6-7 percentage points over the past five years except in Gansu. Second, the rural sector seemed to be net loser in the process, since the growing provincial-level fiscal share came directly at the expense of the local (rural) fiscal share, with resources shifting from the county and township levels.

The World Bank (2002) reported that the regional disparities in fiscal expenditure and service provision are extremely large by international standards, and have been growing at rapid rates,⁴⁴ while the current system has redistributed the fiscal revenues in favor of rich localities⁴⁵. On the one hand, all of these exacerbated the long existing inter-regional disparities. On the other hand, as our arguments go, if the central government does not give up its development strategy and the associated control and regulation on the economy, the increase of fiscal transfer may not improve the economic growth in poor region, but only increase the fiscal dependence of local governments with no efficiency gain..

5.1.5 Expenditure Assignment

The current fiscal expenditure assignment in China is inherited from the planned system, under which local public services were delivered by local governments with the latter agents of the center. The financing of these expenditures was provided through the revenue sharing system. However, since the late 1980s, expenditure assignments have been de-linked from revenue sharing considerations, and in most cases, local governments are solely responsible for financing these services. The 1994 fiscal reform specified the revenue assignments between the central government and local governments, but it did not address the issue of expenditure responsibilities between different levels of local governments. In practice, the upper-level governments (especially the central and

⁴⁴ Among provincial level units, the ratio of the highest to lowest in per capita budgetary expenditures (net of all transfers) has risen from 6.1 in 1990 to 19.1 in 1999. The coefficient of variation has grown from 0.55 to 0.86 (indicating growing dispersion among the provinces). Even excluding the three municipalities of Shanghai, Beijing, and Tianjin, the ratio of maximum to minimum has risen from 3.9 to 6.0 during this period. At the sub-provincial levels the disparities are often much larger, and vary greatly across localities.

⁴⁵ Since 1994, tax rebates dominate transfers, but they are origin-based and favor rich regions. The equalization transfers introduced to offset the effects of tax rebates have been inadequate. In the past three years, as earmarked transfers have grown, tax rebates have fallen rapidly as a share of total transfer.

provincial governments) always tried to put as much revenue as possible into their own pockets, and at the same time transfer as much responsibilities as possible to lower level governments. Subsequently, the sub-provincial levels (prefecture, county, and township) have very heavy expenditure responsibilities that are out of line with international practice. This is true especially at the county and township levels, which together provide the bulk of vital public services, including 70 percent of budgetary expenditures for education, and 55-60 percent of those for health. Cities at the prefecture and county levels account for all expenditures on unemployment insurance, social security, and welfare (World Bank, 2002). In most other countries social security and welfare are almost always provided by the Central Government, except in some transition economies. Education and health are often shared responsibilities with the provincial and central governments⁴⁶.

Despite the overall decentralization of consolidated expenditures during the past two decades, the divisions of key responsibilities have remained quite similar to what they were in the 1970s. **Table 5.2** presents the breakdown of expenditures for the consolidated budget of all levels of government, which shows that the share of capital expenditures declined from 26 percent in 1985 to 17 percent in 1996 and 1997, before increasing again in recent years under the fiscal stimulus program. In 1999 the central and all sub-national governments combined spent approximately the same level of resources in capital construction. In the important area of social services (education, health, culture and science) local governments account for nearly 90 percent of expenditures, and this share has remained stable throughout the years. Similarly, the role of sub-national governments in the area of social assistance and welfare has remained completely dominant through the decades. In 1999, local governments financed 99 percent of all welfare expenditures, a figure practically unchanged since 1978. The Central Government is practically responsible for the entirety of defense expenditures, debt service¹⁷, and geological prospecting. Areas of change in the central-local shares include the financing of price subsidies, which was mostly a sub-national government responsibility a decade ago, but in 1999 this responsibility was almost equally divided between the central and sub-national governments. Sub-national

⁴⁶ Since the late 1990s improving public expenditure management has moved to the top of China's reform agenda. Over the past three years the Government has embarked on a wide-ranging set of fiscal reforms that include introduction of new procedures for budget preparation and approval, a new budget classification scheme, and improved monitoring and audit. Beginning in the mid-1990s the Government had already made a number of promising reforms in budgetary management: passing the Budget Law and experimenting with new budgeting techniques. Reform of extra-budgetary funds had begun in 1996 and intensified in 1998 and 1999. In 1999 the MOF began to formulate organizational budgets that show all budgetary, extra-budgetary and other resources and spending for each ministry. However, all the reform didn't change the fundamental characteristics of fiscal expenditure assignment.

governments have also played an increasing role over time in the areas of industry, commerce, and agriculture.

The changes over time in the composition of central government expenditures (as percent of central government expenditures) and of sub-national government expenditures are also quite telling. Back to 1978, 44.5 percent of all central expenditures were in capital construction . The two other major items at that time were defense expenditures (30 percent) and SOE losses (8 percent). In 1999 the most important expenditure at the central level was debt service (38 percent), followed by defense and capital construction (21 percent each). In the case of sub-national governments, the most important expenditures back in 1978 were capital construction (30 percent), expenditures on social services (15 percent), and agriculture (11 percent). In 1999 these were 12 percent, 24 percent, and 7 percent, respectively⁴⁷.

From the description above, we find that the central government has not taken the responsibility to pay transitional costs but pushed them to local governments. Therefore, the budgetary pressures on local governments have been more and more intensified since the 1994 fiscal reform that recentralized revenues without adjusting expenditure assignments. A parallel centralizing trend appears to be occurring at the sub-national levels, with increasing expenditure shares at the provincial and city level, at the expense of county and township shares. These expenditure assignments are excessive and unsustainable given current revenue assignments. More fundamentally, we want to argue that the centralization of revenue without redefining clearly the duties may just mean that the center does not want to give up, or may even want to strengthen its control and regulation over the economy.

Table 5.2: The Assignment of Fiscal Expenditure Between the Central-Local Governments

	1978		1988		1995		1998		1999	
	Central	Local	Central	Local	Central	Local	Central	Local	Central	Local
Central and Local Shares per Expenditure Category, 1978-1999										
Total	46.13	53.87	38.60	61.40	33.65	66.35	38.92	61.08	35.96	64.04
Capital Construction	55.75	44.25	76.73	23.27	47.93	52.07	43.92	56.08	49.84	50.16
Working Capital	29.31	70.69	70.00	30.00	80.66	19.34	50.66	49.34	56.13	43.87
Technological	33.33	66.67	31.79	68.21	27.25	72.75	23.15	76.85	29.25	70.75

⁴⁷ At the same time, new expenditures have emerged that are not captured by the categories in the table .this is reflected in the growth of the residual item “others”, which grew from 6 percent of total local expenditures in 1978 to more than 35 percent in 1999. Included in this residual are expenditures on urban maintenance and construction (6 percent), tax administration (5 percent), and civil service pensions (3.5 percent).

Upgrading and R&D										
Geological Prospecting	30.00	70.00	100.00	0.00	98.73	1.27	98.76	1.24	90.42	9.58
Industry, Transport & Commerce	55.56	44.44	33.33	66.67	33.37	66.63	38.15	61.85	31.24	68.76
Agriculture	2.60	97.40	9.43	90.57	16.46	83.54	10.99	89.01	10.13	89.87
Culture, Education, Science & Health	11.50	88.50	12.55	87.45	10.02	89.98	11.23	88.77	10.70	89.30
Social Relief & Welfare	0.00	100.00	0.00	100.00	0.69	99.31	3.70	96.30	1.11	98.89
Defense	95.83	4.17	99.08	0.92	99.37	0.63	99.36	0.64	99.27	0.73
Government Administration	8.16	91.84	16.32	83.68	2.43	97.57	2.56	97.44	3.18	96.82
Government Debt Service			100.00	0.00	100.00	0.00	100.00	0.00	100.00	0.00
SOE Losses	38.79	61.21								
Price Subsidies			11.36	88.64	27.75	72.25	51.10	48.90	45.00	55.00
Other	47.30	52.70	12.50	87.50						

Central and Local Shares per Expenditure Category, 1978-1999

Total	100	100	100	100	100	100	100	100	100	100
Capital Construction	44.55	30.26	39.40	7.52	15.4	8.5	12.5	10.1	20.8	11.8
Working Capital	3.01	6.20	0.58	0.16	1.1	0.1	0.4	0.3	0.6	0.3
Technological Upgrading and R&D	3.71	6.35	3.96	5.34	5.5	7.5	3.0	6.4	4.4	6.0
Geological Prospecting	1.06	2.12	2.64	0.00	2.7	0.0	1.7	0.0	1.5	0.1
Industry, Transport & Commerce	1.77	1.21	1.07	1.35	1.4	1.4	0.9	1.0	0.8	1.0
Agriculture	0.35	11.35	1.24	7.46	1.4	3.6	1.4	7.3	1.4	6.7
Culture, Education, Science & Health	2.30	15.13	5.03	22.03	6.0	27.3	4.9	24.9	5.1	23.8
Social Relief & Welfare	0.00	2.87	0.00	2.13	0.0	2.4	0.1	2.1	0.0	2.0
Defense	28.45	1.06	17.81	0.10	25.8	0.1	19.0	0.1	21.1	0.1
Government Administration	0.71	6.81	3.21	10.37	0.5	10.9	0.4	9.2	0.5	8.8
Government Debt	0.00	0.00	6.35	0.00	35.9		48.1		37.7	

Service										
SOE Losses	7.90									
Price Subsidies	0.00	0.00	2.97	14.56	4.1	5.5	7.4	4.5	6.2	4.2
Other	6.20	5.90	3.13	13.79		32.70		33.99		35.26

Note: The Breakdown of central and local figures for SOE Loss in 1978 are estimated from the average of the same data from 1988-1991. Government debt service included the payment of principal and interest of domestic and foreign debts through about 1998.

Beginning in the 1999 budget interest payments are reported as a separate item. 1/Central and local share in Part II= 100% for each expenditure category. 2/ Distribution of Expenditure by category: vertical sum = 100%

Source: World Bank (2002).

5.2 The Problem of Local Governance

Now we come to the aspect of decentralization that is more local and more close to the decentralization literature, i.e., the problems related to local public finance system, the inter-governmental fiscal relationship, and more broadly, that related to the problem of local governance.

5.2.1 The Problem of Rural Taxation

In recent years, the problem of rural taxation in China, especially of increasing local informal charges on peasants, has become more acute. The central government has been aware of the problem for a decade, and has been taking various steps to alleviate the problem. Yet to date, these actions have met with limited success. In 2002, after a difficult decision-making process, the central government decided to implement the rural taxation reform in 20 provinces accompanied by a central transfer of RMB 25 billion and provincial transfers of about the same size. The nature of the reform can be summarized as “fee-tax-swap”, which removes all local informal fees but increases the rates of formal state agricultural taxes and aims to prevent arbitrary charges by the local governments and the “quasi-governmental” community organizations. Soon after the reform starts, it is found that great pressure is placed on the budgets of local governments. In some regions, a rebound of informal fees seems very possible.

A unique characteristic of rural taxation in China is that besides formal government taxes, the Chinese peasants also need to pay various informal fees to local government (mainly township government) and village community organizations (Tao 2002, Lin etc, 2002a, 2002b). Based on a large panel data set covering over 6000 thousand households

and 120 villages in 10 provinces across China from 1986 to 1999,⁴⁸ we are able to describe the stylized facts of rural taxation in more than a decade. The most interesting finding is that, on average, there has been no significant increase of rural taxation as a share of rural net income in the period. In most provinces, total tax burdens on rural households (both formal taxation and informal fee charges) increased only 1-4 percentage points as a share of rural net incomes from 1986 to 1999 and the 1990s has seen even less increase. In some more developed coastal provinces such as Guangdong and Zhejiang, there has been some reduction of taxation rates in the whole period. This is contrary to the general belief that rural taxation, and especially the excessive informal fee charges have increased very fast in the past 15 years, especially in 1990s.

Then how can we reconcile the rural taxation dynamics with the fact that problem of rural taxation became more acute after 1990s. Further investigation shows that the main reason that rural direct taxation became an acute problem is the increase of rural income disparity after the 1990s and the uneven tax and fee distribution among different income groups. For example, if we include all formal taxes and informal fees paid by rural households, the share of taxes of the lowest income group in 1986 (annual per capita income less than RMB 200 Yuan) in net income is 10.5 percent, while that of the highest income group (annual per capita income larger than RMB 4000 Yuan) is 9.5 percent. However, in 1999, the share of taxes of the lowest income group (annual per capita income less than RMB 400 Yuan) in net income is 10.5 percent, while that of the highest income group (annual per capita income larger than RMB 8000 Yuan) is 4.4 percent. Given the income level of low-income groups, the higher taxation rates reduce their income significantly and further aggravate their poverty. Therefore, it is rather the increasingly regressive nature of rural taxation and the heavier burdens on poor peasants than the increase of average rural taxation level that caused the problem of rural taxation in China.

5.2.2 Rural Tax Burden and Government Regulation

We argue that differentiated impacts of the higher-level government regulations, such as grain procurement, birth control, and many other un-funded development mandates such as the nine-year compulsory education, play an important role in the rural taxation problem, and more generally, the problem of expanding government size and rising rural income disparity. The intuition is as follows: since higher-level government needs local governments to implement regulations and mandated projects but does not provide sufficient funding, and since there is an information asymmetry in regulation enforcement

⁴⁸ The data set is from the Fixed Point Rural Survey carried out by the Fixed Point Rural Survey Office, i.e., the Survey Department of the Research Center on the Rural Economy (RCRE), at the Ministry of Agriculture in Beijing

between the two (i.e., the higher-level governments cannot perfectly monitor implementation of regulations), local governments may easily expand local bureaucracy and engage in rent-seeking in the name of implementation of the higher-level government regulations. Given that local government expansion encourages rent seeking, crowds out private investment, reduces peasant consumption, they will aggravate rural tax burdens and lower rural income growth.

An important aspect of our regulation argument is that while implemented nationally, the regulations are subject to heterogeneous enforcement, which leads them to have different impacts across regions and households. For example, the central government implemented the grain procurement policy in almost all provinces. However, the quantities of government grain procured (and the ratio of government procurement to total grain output) are very different across different provinces (counties, townships, villages, and even households). The quantity of grain procurement (and its ratio to total grain output) for every province, county, township and village is determined by upper level governments according to a set of rules which take in account the factors such as natural conditions, historical factors, and even political concerns, such as local food self-sufficiency. The fact is that there is sufficient differentiation in grain procurement regulation enforcement across regions and even across households. For the birth control regulation, the central government policy are much more homogeneous across regions. However, the difficulties in implementing the relatively homogeneous regulation also vary across regions. In poor areas where income is low, non-agricultural employment limited and female education underdeveloped, peasants usually want to have more children than their counterparts in richer regions. Therefore, the difficulties in implementing the relatively homogeneous birth control policy in poorer regions are much higher, which entails higher administrative costs and more staffing.

It naturally follows that the differentiated regulations result in differentiated bureaucratic expansions, and further lead to differentiated impact on tax burdens and income growth. Another channel that government regulations may affect rural income growth is that they may have negative impacts on rural factors (such as land, labor and capital) market developments and limit factor mobility⁴⁹. If the government regulations such as grain procurement did lower rural income growth of the heavily regulated regions and households by increasing rural tax burdens and limiting labor and land mobility, removing or relaxing the government regulations will not only reduce the rural tax burdens

⁴⁹ The empirical findings do support our hypothesis (Lin etc, 2002a, 2002b; Tao, 2002).

and channel more tax revenues toward rural public goods provision, but also promote rural factor mobility, and thus increase rural income growth and promote rural income.

The mismatch of revenue distribution and expenditure assignment in rural China leads to the problems of local governance: i.e., the local governance, especially local public service provision, is severely constrained by the preponderance of spending mandates (including a continuing stream of un-funded mandates from higher levels) and the lack of revenue (tax) autonomy. With local governments striving to meet the costs of their expenditure responsibilities, Therefore, the upper level government regulation constitutes the fundamental reason for the serious problem in local fiscal system, local public good provision, and even the emergence of local corruption and income disparity.

VI. Concluding Remarks

In this paper, we argue that the successful fiscal/administrative decentralization reform in China after 1978 is endogenous to the process of deregulation, while decentralization without deregulation before 1978 did not promote economic growth but only led to economic overheating and even chaos(such as the Great Leap Forward in late 1950s). As to the marketization reform since late 1970s, it is clear that there was no formal and mature reform design at the beginning. However, the reform policies adopted by the central government were rather pushed by the market forces released by deregulation process and were consistent with the internal logic of the catching-up development strategy-led “Distorted Macro-policy Environment—Planned Resource Allocation Mechanism—Low Incentive Micro-entities ” trinity system than by the positive motivation of higher-level leaders. It must be noted that the central government did not change the development strategy at the beginning of the reform, but only wanted to improve the efficiency of the traditional system by improving the micro-incentives. However, due to the inherent logic of the trinity, once some power was delegated to the micro-agents and some de-regulation of entries into certain sectors was initiated, the reforms would naturally evolve to the resource allocation system and macro environment, resulting in a de facto change of the development strategy (.Lin et al 1995, chapter 5.5). Associated with the de-regulation process, the central government had to decentralize the fiscal system, because the deregulations of industrial entries and giving more incentives to micro-units increased the taxation and administrative costs for the central government.

In this paper, we also describe the evolution of the central-local fiscal arrangements and its impacts on China's development, special attention is paid to the problems created by the 1994 fiscal centralization reform.. The implication is that to cover the huge transitional costs and reduce the serious inter-regional disparity in economic growth and social public service delivery, certain concentration of fiscal resources might be necessary, however, the current inter-governmental (both central-provincial and sub-national) relationships need to be further adjusted, and local governance needs to be further improved. On the one hand, higher-level governments should not evade their responsibilities in supporting the delivery of local education and universal medical services. Therefore, a much more efficient transfer system that helps the poor better must be set up with stronger local voices and more local participation. On the other hand, the removal or gradual relaxation of the unreasonable government regulations such as grain market intervention and birth control in rural areas should be implemented. The problem of further promoting rural elections at village and township levels should also be on the agenda.

As we see, during the fifteen years since 1978, the contents of the Chinese reforms were mainly to loosen government control and regulatory restrictions with the goal of improving incentives. What was done is mainly to delegate powers, share benefits, and use material incentives to improve the initiatives of enterprises, localities, and workers. To achieve that, reform policies generally took the form of "particularistic contracting" between the government and subordinate units, such as agricultural contracting between the government and farming households, fiscal contracting between the central and local governments, and industrial profit contracting between the government and state enterprises. However, it failed to establish a rule-based market system incorporating international best practice institutions both at central-provincial level and at local levels. In this period, fiscal federalism with rule of law and constitutional base did not even happen, which is due to the nature of contractual relationship between central government and provincial government (subject to intensive negotiations between central and provincial government). Therefore, a further improved and institutionalized inter-governmental fiscal arrangement must be established.

Fiscal decentralization can take many forms, including the fiscal revenue sharing, expenditure duty distribution, intergovernmental transfers, authorization of municipal borrowing, and so on. As for the current fiscal system reform, to bring improvements will require reforming budgetary practice, which is being initiated at the central level.

The first aspect of this required change is to clarify the assignment of responsibilities. The policy-making function should be linked to financial responsibility. If the Central Government retains its role in making national policy on social services such as the Nine-

year compulsory education, it should set up mechanisms to implement the policy, including general or specific purpose grants. And it should consider making transfers directly to the level responsible for service provision, even if it means reaching below the provincial level. It will be necessary to stop the un-funded mandates again guaranteed by law.

The second aspect is to give local governments more real autonomy. The assignment of revenues should be revised to grant some autonomy to sub-national levels. Giving local governments some taxing powers is a prerequisite for implementing real fiscal decentralization. It is also a necessary condition for bringing extra-budgetary revenues back into the budget in exchange for giving up their autonomy over informal revenue sources, local governments have to be given some tax autonomy to allow them to respond to local expenditure needs. Assigning more revenues and giving autonomy to local governments will also increase efficiency of the inter-governmental transfers system by reducing the overall level of transfers without sacrificing equalization.

To enhance the credibility of its commitment, the central government should designate specific revenues for the equalization effort, either as a percentage of central revenues, or by earmarking specific revenue sources (such as the incremental revenue accruing to central government from VAT and excise taxes).

Coming back to the topic of the paper, we believe that in a large transitional country like China, de-regulation shall not be confused with decentralization. As a large country, decentralization in many cases is only a means to deregulate since the implementation of deregulation policies must be carried out by the hands of local governments. As a transitional country, the government is still involved in many profit-seeking sectors usually in the hands of private sectors in developed market economies. A reasonable decentralization of public functions with reasonable inter-governmental fiscal arrangements has barely started.

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