

1996

# Fiscal and Political Decentralizations in China - A Critique of the Current Fiscal Reform Efforts

Yasheng Huang

Follow this and additional works at: [https://ir.lib.uwo.ca/economicsperg\\_ppe](https://ir.lib.uwo.ca/economicsperg_ppe)

 Part of the [Economics Commons](#)

---

## Citation of this paper:

Huang, Yasheng. "Fiscal and Political Decentralizations in China - A Critique of the Current Fiscal Reform Efforts." Political Economy Research Group. Papers in Political Economy, 70. London, ON: Department of Economics, University of Western Ontario (1996).

POLITICAL  
ECONOMY  
RESEARCH  
GROUP

# PAPERS IN POLITICAL ECONOMY

**Paper No. 70**

**“Fiscal and Political  
Decentralizations in China--A  
Critique of the Current Fiscal  
Reform Efforts”**

**Yasheng Huang**

ECONOMICS REFERENCE CENTRE

JAN 24 1996

UNIVERSITY OF WESTERN ONTARIO

The Political Economy Research Group was established in the faculty of Social Science at the University of Western Ontario in 1988. Its purpose is to foster scholarship, teaching and interdisciplinary research in political economy, with a focus on:

1. the application of economic models and methods to the study of political processes and institutions,
2. the economic impact of political processes and institutions,
3. the influence of economic factors on the formation of public policy and on institutional change,
4. the politics of economic policy making,
5. the political, social, and economic effects of public policy.

*Co-directors:*

Ronald Wintrobe (Economics)  
Robert Young (Political Science)

*Board of Directors:*

Peter Howitt (Economics)  
B.B. Kymlicka (Political Science)  
John N. McDougall (Political Science)  
Peter Neary (History)  
John Whalley (Economics)

*Staff:*

Jayne Dewar

*For further information:*

Political Economy Research Group,  
Department of Economics,  
Social Science Centre,  
London, Ontario, Canada N6A 5C2  
phone: (519) 661-3877  
fax: (519) 661-3292

07/25/95

Fiscal and Political Decentralizations in China  
—A Critique of the Current Fiscal Reform Efforts

ISSN: 1181-7151  
ISBN: 0-7714-1852-3

43291

Yasheng Huang  
Assistant Professor  
Political Science  
University of Michigan

For the 1994-95 academic year:  
SSRC-MacArthur Fellow, CFIA  
Harvard University, 1737 Cambridge St.  
Cambridge, MA 02138  
(O) 617-495-1828  
(F) 617-495-8292  
huang8@husc4.harvard.edu

After August 1, 1995:  
CCS, 104 Lane Hall, University of Michigan,  
Ann Arbor, MI 48109-1290  
(O) 313-764-6308  
(F) 313-936-2948  
yasheng.huang@um.cc.umich.edu

Abstract:

One of the important objectives in the current fiscal reform effort is to re-impose some degree of fiscal recentralization. According to press reports, the Center hopes to increase its share from currently 30 percent of the consolidated revenue to about 60 percent. This is done by establishing a form of tax federalism and by a re-definition of tax categories. These measures have enjoyed widespread support from both foreign and Chinese economists and China specialists, who argue that China's tax system is overly decentralized.

In this paper, I offer a defense of the principle of fiscal decentralization and in particular the fiscal decentralization as institutionalized in the tax contract system that the current reform seeks to abolish. My argument is both empirical and normative. I argue that the current reform effort aiming to achieve a more centralized tax structure is arguably unnecessary on economic grounds and definitely undesirable on political grounds. As an empirical issue, I show that China's tax system is not as decentralized as commonly believed by examining the structure of China's budget and of the effect of China's unitary political system.

The single-minded focus of the current reform on raising revenue is particularly unfortunate when the more important causes for fiscal decline have to do with the chronic inefficiency of the state owned enterprises, compulsory bank lendings, and the continued bureaucratic provisions of private goods. In addition, the central leadership has not shown much interest in strengthening rule of law protecting property rights so that cross-border investments and movement of goods and services can be encouraged. Fiscal recentralization is definitely "anti-reform" if it is carried out in the absence of the more important microeconomic reforms and without concurrent development of rule of law protecting property rights.

My more severe criticism of the current fiscal reforms rests on normative and *political* grounds. I argue that a fundamental political challenge in contemporary China is to devise means to constrain the discretion and the power of the central government. History has shown Chinese central government to be reckless and irresponsible; there are also institutional differences between the central and local governments that give more discretion to the central government. From this perspective, any constraints on central discretion—be it formal or informal—are welcome and it is necessary to devise fiscal reforms in ways that *de facto* constraints can evolve into institutional constraints.

The vision for a democratic future for China put forward in this paper is one of gradual evolution, from a "hard" authoritarian regime characterized by absolute rule to a "soft" authoritarian regime characterized by a degree of intra-elite separation and divisions of power. I argue that local governments, as compared with any other non-central governing institutions, are the best candidate to supply intra-elite democracy and a check-and-balance mechanism. I further argue that fiscal decentralization can play a critical role in this transition and it is this larger political benefit of fiscal decentralization with which we need to be concerned.

This paper is at the very beginning of its writing and only sketches some of the ideas that will be more fully developed later on. Any suggestions are welcome. Please do not quote or cite without author's permission.

## Fiscal and political decentralizations in China

There is a prevailing view that China's fiscal system is excessively decentralized. According to this view, China lacks a fiscal system that gives an appropriate balance between central/local shares of revenue. Local governments have increasingly claimed a larger share of the tax revenue and this development has hampered the ability of the central government to project macroeconomic stability and has even threatened the political unity of the country. The Chinese central government concurred with this view and has undertaken measures aimed at increasing governmental revenue in general and increasing the central share of governmental revenue specifically.<sup>1</sup>

There are two kinds of criticism of this view. One is an empirical criticism, i.e., the criticism disputes the facts used to reach their conclusions or the interpretations of these facts. The other criticism is more normative in nature and it centers on the argument that the characteristics of China's tax system should be not evaluated in terms of their economic functions alone but they should be evaluated more broadly. Specifically, we should take into account the *political* benefits associated with fiscal decentralization.

In this paper, I present both kinds of criticisms but the emphasis will be on the normative side of the criticism both because empirical criticism has been offered elsewhere<sup>2</sup> and because normative criticism is a more fundamental criticism of the prevailing view. My basic argument is that fiscal centralization in the current Chinese political context is arguably unnecessary on economic grounds and definitely undesirable on political grounds. On the empirical side, I argue that Chinese tax system is not as weak as some of the critics have claimed; on the normative side, I argue that there are enormous political benefits associated with fiscal decentralization. These benefits include reduction of political volatility, development of a check-and-balance mechanism, and an increase in demand for political participation from the Chinese citizenry. However, my argument in this paper should not be viewed as a defense of the specific features of China's current tax system; rather it is a defense of the *principle* of fiscal decentralization in the presence of political centralization.

### 1. Empirical argument

My empirical argument consists of two parts. First, the Chinese tax system is not weak if evaluated in terms of consolidated governmental revenues. Second, although it is true that the central share of the governmental revenue is small, it is more appropriate to evaluate the strength of the Chinese tax system in terms of the consolidated revenue because of the *political* characteristics of the Chinese system.

### 1.1. Features of the tax system

My point of departure with the prevailing view concerns the role of extra-budgetary revenue in the Chinese tax system. Many critics of the system view the expansion of the extra-budgetary revenue with alarm and believe that it is a source of disruption to the overall fiscal health of the country. Although I share the view that it is more efficient to have a unified budget, there are a number of extraneous considerations. First, it is wrong to believe that the budgetary unification, with the existing capabilities of the Ministry of Finance and with enormous incentive effects, will be likely to produce a level of revenue roughly equivalent to the sum of two sources. Unification of the two sources will entail definite losses of operational autonomy on the part of governmental agencies and thus attenuate incentives to produce and surrender revenues. It is also important to recognize that extra-budgetary revenue is non-redistributive as compared with the budgetary sources of revenues and thus unification of the two sources would amount to a shift from non-distributive to distributive form of taxation, with attendant negative incentive implications for tax effort.

It follows from the above discussion that it is arguable that since traditionally government agencies carry out many functions that are provided privately in market economies, unification of budgetary and extra-budgetary sources of revenue, in principle, is wrong-headed. The correct strategy is to privatize those functions that are currently funded by extra-budgetary revenues (such as depreciation investments and production) and to shift the budgetary revenues toward political and social spendings.<sup>3</sup> At least in static terms, it is also wrong not to incorporate extra-budgetary revenue as a part of fiscal resources available to government to carry out its functions. The extra-budgetary revenue consists of three components: tax supplements levied by the local tax bureaus, fees collected by the largely non-economic units of government, and retained earnings shared between firms and their supervisory agencies. Because retained earnings are not broken down between firms and supervisory agencies, the portion included in my calculation of the budget only includes the first two items, which are clearly governmental. This can cause a downward bias in estimating the actual resources available to the government by the amount that belongs to the supervisory agencies.

There are two reasons to include the governmental portion of the extra-budgetary revenue in calculating the Chinese budget. One is that it has become an important financing source for the government. The extra-budgetary revenue finances road and building maintenance, education, and scientific research, etc.--the activities that would have been financed from the government budget. In 1991 extra-budgetary expenditures for education

was about 15 percent of budgetary expenditures, as compared with 8 percent in 1979 (SSB, 1993, 224).<sup>4</sup> The other reason is that extra-budgetary expenditures have increasingly fallen into the orbit of the Ministry of Finance system. Since 1986, the State Council has centralized extra-budgetary management, by requiring the Ministry of Finance to set up special accounts for the funds and requiring the planning commissions to review the fund allocations (State Council, 1987 < 1986 >). The Guangzhou tax bureau, for example, already managed about 40 percent of the extra-budgetary revenue as of 1986 (Xu, 1988). In Figure 2, both the adjusted and unadjusted consolidated revenues are presented; the numbers refer to their GNP shares.<sup>5</sup>

Figure 2 about here.

The main difference between the adjusted and unadjusted revenues is the portion of the extra-budgetary revenue that is clearly governmental. Two observations are noteworthy. First, a clear fiscal decline apparently began in 1988 when the government extended tax contracts to provinces other than Guangdong and Fujian. The tax contracts stipulated a fixed provincial turnover quota to the central government, which would reduce tax buoyancy when fully implemented. But, from Figure 2, the tax share of the GNP experienced a one-time decline in 1988 but otherwise has managed to hold steady. Second, both definitions of consolidated revenues show the Chinese tax system to be relatively strong. For low income countries, in the mid-1980s the norm was 15 percent in terms of revenue/GNP share; for developed countries, it was 24 percent (World Bank 1988). The adjusted revenue level would put China near the norms for the developed countries.

Another issue has to do with the structure of the Chinese budget. As a number of authors have pointed out, the Chinese budget directly finances many economic activities that would have been financed privately in market economies, whereas the social welfare component is small or almost zero in the Chinese budget. This has two related implications. First, in most of the developed countries, the fastest-growing component of the budget has been transfer payments, such as social security and unemployment benefits; transfer payments are not an appropriate measure of the size of the public sector in market economies because they do not "crowd out" private consumption. In the United States, if the transfer payments are excluded from government expenditures, then the share of public expenditures as a proportion of the U.S. GDP declined from 37 percent to 29 percent.<sup>6</sup> In the Chinese budget, the transfer component is near zero and thus a larger proportion of the expenditures can be mobilized for macroeconomic and industrial policy purposes. Second, the goal of fiscal reforms consistent with market reforms should aim at changing the structure of the Chinese budget. The budget should stress social

spendings to alleviate poverty via income transfers,<sup>7</sup> to stabilize macroeconomy, and to finance the provision of public goods (such as defense with the salutary effect of reducing the financial autonomy of the military).

Financing direct economic activities, such as investments, should be reduced. The reform effort should not, as currently emphasized by the government, aim to increase the existing level of revenues. At the minimum, any increase in the current level of revenue should be accompanied by a reduction in the directly economic expenditure responsibilities.

## 1.2. Political characteristics

Even if the level of consolidated revenue (relative to GNP) is high, there are still concerns about the levels and the shares of the revenue claimed by the central government. Figure 2 presents the shares of central and local revenues as percentage shares of GNP.<sup>8</sup> The first noteworthy aspect is that although the consolidated revenue is comparable to other developed countries, the share of central revenue in China is clearly smaller. The peak was in 1986 when the central revenue share was about 9.6 percent; in 1992, it stood at 6 percent. In contrast, in Japan, the central revenue share was about 14 percent and for India, 15 percent in the late 1980s. Another aspect is that the Chinese tax system in the early 1980s was much more decentralized than it was in the early 1990s. Over time, as shown here, the gap between the two bars has actually become smaller. This directly contradicts the widely-held opinion that the reforms have worsened the central revenue position, although the central budgetary gains have not been steady.

Figure 2 about here.

One of the arguments against fiscal decentralization is that central government is more efficient in the provision of public goods. The reason is an asymmetrical distribution of benefits and costs: Each local community only enjoys a fraction of the provision of public goods but will have to bear the full cost toward their provision. In a fiscally decentralized system, goods of this nature will be typically under-provided because the marginal benefits of supplying an extra unit of public goods would appear excessively low relative to the marginal costs.<sup>9</sup> I argue that this argument does not quite hold in China and that the aforementioned skewed distribution of fiscal resources between the Center and the localities belies the true power of the central government if the nature of the Chinese political system is not taken into account.

Economic and political analyses of fiscal federalism typically differ in their definitions of the meaning of federalism. Political scientists tend to have a legalistic approach and define federalism as a system in which



divisions of responsibilities and power are specified and protected constitutionally. Economists define federalism as a system in which allocative decisions made in a jurisdiction reflect the preferences of the residents of that jurisdiction. Indeed, in one of the most influential economic studies of federalism, Oates (1972) goes out of his way to say that political definition of federalism does not bear on an economist's concerns. He says (1972: 17):

In contrast to the conception of federalism in political science, it makes little difference to the economist whether or not decision-making at a particular level of government is based on delegated or constitutionally guaranteed authority. What matters is simply that decisions regarding levels of provision of specified public services for a particular jurisdiction (be they made by appointed or elected officials, or directly by the people themselves through some form of voting mechanism) reflect to a substantial extent the interests of the constituency of that jurisdiction.

Such a conception requires a heroic assumption that allocative decisions made by elected officials do not differ from those appointed bureaucratically. I show below that in evaluating China's fiscal system such a conception is fundamentally flawed.

China is the only large country in the world that has an unitary political system. In France, another country with a long tradition of centralization, Napoloen could proclaim: "At this very moment every pupil, in every French Lycée, is now working on the same Tacitus version!" China's system is not as comprehensively unitary; its unitary character is political. The central government has the monopoly power over the appointment and removals of local officials and it is this aspect of the unitary political system that improves the efficiency of public goods provision. It does so in two ways. First, it simply mandates the localities to pay the full (or nearly full) costs of public goods provision. Second, it sets up political and bureaucratic incentives so that local officials take into account the full benefits of public goods provision. In brief, strong political control by the center in part obviates the need to assert strong fiscal control. Thus one of the arguments against fiscal decentralization does not completely hold here because Here my analysis differs sharply from that of Wang and Hu (1994), who argue that declining central revenue is symptomatic of declining state capacity.<sup>10</sup>

Local governments are forced to pay the full costs of public goods provision in two ways. One is the Chinese version of "unfunded federal mandate;" the other is fiscal appropriation by the central government when there is an urgent need. The central government has been able to delegate significant financing responsibilities to the localities so as to reduce its own expenditure requirements and largely because of this expenditure delegation,

most of the provinces in fact incur significant deficits.<sup>11</sup> The unitary political system also confers on the central government the power simply to appropriate local revenues when there is an urgent need. This appropriation power leads to a large discrepancy between the provinces' formal and informal tax contributions. Under the formal system--i.e., the tax turnover quotas stipulated under the tax contracts--, tax contributions vary greatly across provinces, when measured in terms of tax contributions to the center as percentage shares of the provincial net material product (NMP).

In Table 1 under Column A, provincial tax contributions to the center vary widely, from a high of 7.55 percent (Liaoning) to a low of 0.20 percent (Inner Mongolia). Rather remarkably, Guangdong's tax contribution, at 1.72 percent, is lower than that of Anhui (2.02 percent). However, the effective tax contributions--the sum of the formal and informal contributions--present an entirely different picture. For Guangdong, the effective tax contributions are defined as tax contributions plus the unserviced central borrowings; for other provinces, the effective tax contributions are the tax contributions minus the central subsidies.<sup>12</sup> For rich provinces, the large discrepancy in the *ex ante* contribution rates has disappeared. Liaoning's tax contribution is about four times that of Guangdong under the formal system; the difference narrows to around 12 percent under the effective system.<sup>13</sup> Effective contributions from poor provinces are negative because they receive more central subsidies than they contribute to the central coffers (World Bank, 1985).<sup>14</sup>

Table 1 about here.

Because of the unitary nature of its political system, arguably, it is more appropriate to evaluate China's tax system in terms of consolidated revenues rather than in terms of central revenues. The center has firmer control of an *administrative nature*, as compared with central governments in other countries, and it relies on these administrative means to achieve economic objectives. But these administrative instruments would be less effective in affecting local economic conduct when local tax departments possessed less revenue. This is true because we can make a *bona fide* case that the administrative control by a higher level of bureaucracy is tighter over a lower level than the bureaucratic control over enterprises. General revenue losses, in a sense, devalue the administrative resources available to the central government.

The administrative monopoly power also allows the Center to set up incentive structures so that public goods will be adequately supplied. More frequent personnel changes and shorter tenures tend to make local officials pursue an "objective function" closer to that of the central government. Because of the centralized

appointment and promotion procedures, willingness to comply with the center plays a key role in the selection process. Longer tenure promotes localism because as years of service in one province increase, the leaders may identify themselves with or be captured by local interests. An alternative reasoning argues that frequent appointments improve information distribution for the central government. When specific information about local officials or about their conduct is costly to gather, adjusting the length of personnel tenure is a relatively efficient control method.<sup>15</sup> In separate works, I have shown that newly-appointed local officials, those with shorter tenures and with stronger bureaucratic ties with the central government, tend to curb inflation-prone investments during austerity periods more and pursue investment objectives closer to those of the central government.<sup>16</sup>

To summarize the above discussion, I question the necessity and the urgency of implementing drastic changes in the central/local fiscal relations as currently under way as a result of the reform program the Chinese government has attempted to implement since 1993. This rather single-minded and potentially harmful focus on fiscal reforms is in sharp contrast to the reluctance to implement much more necessary and urgent microeconomic reforms, which may automatically shift the structure of the budget in desirable directions.<sup>17</sup> The reform priorities are misguided.

## 2. Normative argument

My more fundamental criticism of the current fiscal reform efforts concerns their normative implications. The core of my argument is that given the nature of Chinese political system it is desirable to place some limitations on the discretionary power of the central government and in contemporary China local governments are the best candidate to supply such limitations. To illustrate this point, it is first necessary to spell out the basic premises of the argument; I will then present the argument itself.

### 2.1. Premises of the argument

My argument is built on two observations and to the extent that these two observations are not valid much of the following analysis should not hold. The first observation is that all the countries in the world in which there is a stable and successful federalist tax structure and in which the central governments have a large share of tax revenues are liberal democracies. These liberal democracies all have the following characteristics that are pertinent to my argument. First, there is a clearly-delineated division of power and responsibilities among top governing institutions (separation of power) and/or between central and local authorities (political federalism). Second, governmental policies and bureaucratic actions are held accountable by a system of rule of law, legislative or

public monitoring, or constraints imposed by lobbying and regular elections. Third, any changes in governments' tax policies are deliberated in an open and participatory manner. This is a result of institutional guarantee of civic rights granted to citizens (freedom of speech) and the intense monitorings by the specialized, knowledgeable, and vested interest groups. In brief, the fiscal centralization in the liberal democracies is instituted in a context of an overall political decentralization. A rough typology of different combinations of fiscal and political systems appears in Table 2.

Table 2 about here.

My second observation is that the core component of the centralization theorem--that fiscal centralization is necessary for the central government to provide an efficient level of public goods--may not hold under China's political system. In fact, there is a real possibility that the central government may use the augmented fiscal power to provide "public bads." These public bads refer to political and economic instabilities. This point can be illustrated both empirically and deductively. As an empirical matter, it should be noted that during the communist period all the major disruptions with devastating political and economic implications, such as the Great Leap Forward, the Cultural Revolution, and the Tiananmen crackdown, have been a result of the actions of the central leadership. Today, the actions of the central government can be still be a source of instability. For example, it may be engulfed in paralyzing power struggles that cause major coordination problems for economy and society; it may also commit the resources of the country to grandiose but wasteful projects such as the Three Gorges Dam and to an ambitious defense build-up that is not justified by objective international situations; it may also pursue repressive domestic practices that provoke economically costly international reactions.

An analysis of a number of characteristics of central government also suggests the importance of limiting central discretion. The central leadership tends to be less stable than local leaderships in part because it is populated by people more experienced in power struggles as the selection process of the Chinese Communist Party (CCP) requires such experience in order for any aspiring individuals to reach the top. On balance, the central government is more ignorant about many political and economic affairs than the local governments, which directly administer them. Fiscal centralization thus gives more power to a less informed level of government and it is unrealistic to expect that an increase in the central revenue will not be accompanied by an increase in the managerial responsibilities of the central government.<sup>18</sup> The centralized administration amplifies the mistakes or the negative consequences of the actions of the central government. For one thing, the policies and the actions of

the central government are national in scale and therefore their consequences are systemwide. There is also an issue of scope; the national government engages in a more diversified range of activities and policies than local governments and the shocks of their actions are more integrated cross-sectorally.

Centralized administration also requires collecting a lot of detailed information. This requirement has two implications. One is that transaction costs are high. The costs of investing in the development of efficient information collection or the costs of lobbying, engaging in influence activities and rent-seeking increase as the level of hierarchy goes up. When centralized economic administration is combined with centralized political administration, there is a multiplier effect of any bad policies because of a "bundling" of two incentives--the incentives to supply information and the political and careerist incentives. The higher the bureaucratic level at which a policy is mandated, the more integrated the two incentives. The Great Leap Forward is an example in point. The initial impact of communization movement was magnified many-fold because lower-level officials supplied false information and enforce central policies over-zealously to please their superior. The famine that resulted--the deaths between 30 to 35 million--would never have happened in a democracy where there is a freer flow of information (see Sen).

The other implication is that often the requisite demand for information is not met by supply and when there is an informational shortage, administrative convenience often requires reliance on crude proxy measures to evaluate performance. Crude proxy measures then give rise to moral hazard behavior--i.e., striving to achieve results in the measured dimensions even though the overall performance is sub-optimal. The clearest example in China is the population control policy. The one-child per family quota induces the local authorities to practice extremely repressive and exploitative policies, such as forced abortions and condoning of female infanticides, often beyond the formal stipulations laid down by the central government. The scale/scope of national government and the proxy measurement to overcome information impactedness are the root causes for the multiplier effect.

## 2.2. Constraints on the discretion of the central government

In the current political and economic contexts of China, one should not worry about "declining state capacity." The basic premise of my analysis is that an omnipotent state is still the greatest threat to economic and political developments in contemporary China. The best analogy for the Chinese state is that of the "Leviathan" in the Hobbesian sense. Its political power is absolute; its economic power, although less absolute than political power, is not only significant in scope and in scale but more importantly it is discretionary in the sense that its

exercise is not constrained by any explicit rules of conduct. The fine balance between the need to have a strong state and the need to have a disciplined state is more important than ever during economic transition. Economic transition requires a strong government to impose both economic and political discipline, to effect income transfers and to push forward politically unpopular but economically rational policies. But, as Weingast (1995) points out, "[a] government strong enough to protect property rights and enforce contracts is also strong enough to confiscate the wealth of its citizens." Given the history of the Chinese central government, this is not a question that should be taken lightly.

Thus there is a fundamental need to constrain the power and the discretion of the state, but the problem is that China's political system itself possesses no inherent constraints. Although there is a need to constrain the consolidated Chinese state, I argue that there is a greater need to constrain the discretion of the Chinese central state and that the power of the local state can be relied on for such a purpose. A key characteristic of authoritarian regimes is the absence of formal constraints on the operations of the government. But there are informal and *de facto* constraints and there are more such constraints on the discretion of the local governments than there are on that of the central government. The most binding constraint for the local governments is the geographic and jurisdictional boundary and the actions of other local governments; for a large continental country such as China, geographic constraints and the actions of foreign governments are much less binding. Local governments are constrained by the central institutions and policies; because they do operate "closer to the people" than the central government they are subject to more populist constraints.<sup>19</sup> It follows from this logic that in situations in which there are *de facto* constraints on the discretion of the national government these constraints should be preserved or even strengthened. Fiscal decentralization is one of the most important such constraints; furthermore, I argue that fiscal decentralization may even be conducive to democratic development by leading to some degree of political decentralization.

My argument proceeds in two steps. First, I argue that local governments, compared with other non-central political institutions in China, are the best candidate as a constraining force for the central government. Second, I argue that fiscal decentralization, institutionalized as the tax contract system that the current fiscal reforms seek to abolish, creates conditions for the truly binding *de facto* constraints on the central discretion and for the evolution of the *de facto* constraints into explicit, formal constraints.

Local governments possess a number of characteristics that set them apart from other governing institutions. Their operations are, like those of the central government, diversified<sup>20</sup>, ranging from economic to social and political affairs. The diversified operations impart to the local governments encompassing interests in the actions of the central government; by contrast, other non-central institutions, such as the military or the Federation of the Chinese Labor Union, are specialized agencies and therefore pursue narrow interests. Central policy on defense spending, while concerning the interests of the military intensely, is of only marginal interest to the Federation of the Chinese Labor Union. However, central policies on defense or on labor concern the interests of local governments either because of their budgetary implications or because these policies directly affect them. It follows from this analysis that local governments are more *motivated* than other institutions to be involved in the policies of the central government.

The other characteristic is that there is a formal and specific delineation of their power, as compared with other institutions, because the power of the local governments is defined territorially. Territorial divisions are both clear and non-controversial, in contrast to divisions that are defined functionally. Functions change over time as technology and economy change; functions also change more easily because at any given time there is often disagreement about how the functions are defined. It is thus no coincidence that the current territorial divisions have been in place for hundreds of years whereas China's central ministries--especially those in charge of economy--have been organized and re-organized a number of times just during the communist period.

Permanence and unambiguity have three virtues over permeability and ambiguity. First, permanent divisions of power give rise to permanent interests and permanent interests are more solid than non-permanent ones. Second, if the divisions of power are unambiguous, violations of the divisions are also unambiguous and are easily shown. Clarity of the violations can attenuate incentives to engage in them because the reputation of the violator is more at stake when performance is clearly monitored. The deterrent effect arising from reputation is one of the principal justifications for explicit codifications even if it is known *ex ante* that not all the codifications are going to be adhered to. Third, unambiguous divisions of power have the best chance of institutionalizing these divisions because it is easier for all the participants to agree to more unambiguous divisions of power than they can to ambiguous divisions of power.

Constraining the power of the central government requires a degree of collusion among the non-central institutions or groups. The Chinese political system discourages and severely punishes coalition-building among

interest groups; factions cannot be explicitly organized and coordinated.<sup>21</sup> In this respect, the local governments again have comparative advantages over other institutions. There are existing forums in which local officials consult with each other extensively mainly over economic issues and it is plausible that these forums may provide opportunities for more political and policy collusions. These forums include recent economic cooperation on a regional basis (such as provinces around the Yangtze Delta and the Southwest regions)<sup>22</sup> and the long-standing the National People's Congress meetings and annual planning conferences. In contrast, collusions among different functional institutions, e.g., between the military and the civilian groups, lack legitimacy and are more difficult to coordinate.

Fiscal decentralization constrains the power of the central government in two ways. First, more fiscal resources in the hands of the local governments make local governments more powerful vis-a-vis central government and more powerful local governments reduce the effect of "public bads" supplied by the central government. Public bads are systemwide and inter-jurisdictional in nature and a bad central economic or political policy reduces the welfare of the society as a whole more than a bad local economic or political policy. But if a bad central policy is enforced only in certain jurisdictions but not in others, then a bad central policy is equivalent to a bad local policy in terms of the external effects that they produce. If local governments can refuse to enforce central policies *in toto*, then the effect of a "public bad" is equivalent to the effect of a quasi public bad, i.e., the effect will be less external. Here the enforcement of the political and economic repercussions from the Tiananmen crackdown is an example; many observers have noted that the degree of repression has varied significantly across different provinces because of different enforcements of the conservative policies of the Li Peng regime.

Many analysts tend to emphasize the limiting effect of the provision of a truly public good arising fiscal decentralization (such as stabilization and income distribution). This emphasis is myopic, considering the fact that the Chinese history is full of havocs of central irresponsibility, but it is true that fiscal decentralization constrains provision of public goods. The net benefits associated with fiscal decentralization are positive if one of the two conditions holds. The first condition is that the Chinese central government provides more public bads than public goods; the second condition is that the public bads provided by the central government tend to have a catastrophic external effect. At least the second condition is still quite true in contemporary China.

Second, fiscal decentralization itself is a constraining force, because central fiscal dependency reduces the ability of the center to undertake more costly bad projects/policies. If there is no broad consensus about the merit



of these projects/policies in question, the tax contribution effort declines. In anticipation of this effect, the central government either refrains from undertaking them or strives to achieve more consensus, which makes the system more participatory and democratic. At the very least, local governments have an incentive to be involved in national policies, which they finance heavily. This is already happening in China. The "tax revolt" of the Chinese provinces in 1990 and 1991 in effect prevented a largely conservative central leadership from implementing rollback of economic reforms.<sup>23</sup>

In the event that the central government launches these projects/policies by fiat in the absence of societal consensus, it will incur an explicit cost in the form of high inflation. This is based on the premise that the central government controls money issue and that it can finance its projects/policies via seignorage tax. The past history, however, has shown that the central government is relatively inflation-averse and that local governments are in fact inflation-prone. Inflation has negative externalities, i.e., the economic and political costs of inflation cannot be internalized at the level of provinces but they can be internalized at the national level.<sup>24</sup> Thus separation of fiscal and financial power is a good arrangement in the sense that the monetary authority to inflate is in the hands of a level of government that suffers the most from inflation, which helps ensure a judicious exercise of central bank authority. Furthermore, to the extent that inflation averse and prone preferences offset each other, there is an incentive to develop institutions that ensure regular consultations and feedback so that policy making does not become paralyzed.

The specific form of fiscal decentralization—tax contract system—enhances incentives to be involved in national policy making. The tax contract system establishes a clear target to which the Center is committed. During the reform era, the Center has not adhered to the letter of these contracts and often engages in *ex post* appropriations. Some analysts have identified this as a defect with the contract system, but this is a rather trivial criticism because it is simply unrealistic to expect a one-party, overly centralized state not to behave opportunistically. A more fundamental point has to do with the costs of the central opportunistic behavior: Contraventions of the tax contracts *make central appropriations illegitimate*; the clearer these contraventions are, the more illegitimate. As is often the case, illegitimacy entails bilateral bargainings to create legitimacy<sup>25</sup> and the process of bargainings gives to the local governments a say about either fiscal or other national policies.<sup>26</sup> In this respect, my analysis departs sharply from the conventional view that deplores fiscal bargainings between the Center and localities. Bargainings are a give-and-take process and in the long run bargainings may raise demand

for political participation. In the best of the scenarios, the central government may agree to give up part of its power in exchange for an agreement from the localities to contribute more revenues<sup>27</sup> and such an exchange is easier to execute when there is an explicit contract binding the two sides.<sup>28</sup>

### 3. Conclusion

My criticism of the current fiscal reform effort is both empirical and normative. China's budget structure and the absence of a unified budget mask the strength of its tax system. Although fiscal and political centralizations are not exactly equivalent, the three economic arguments for fiscal centralization do not quite apply to China given the nature of the unitary political system.

Inflation control is a public good and China's macroeconomic performance does not suggest that provision of inflation control is excessively suboptimal. Compared with other developing and transitional economies, China has a modest and manageable inflation and its austerity programs have been, by and large, successful in containing inflation. The single-minded focus of the current fiscal reforms to raise the level of central revenue is especially unfortunate, considering the following facts. First, the Center only makes slow progress in protecting cross-border movements of goods, services and capital. Second, the Center is not pushing forward the much needed microeconomic reforms, some of which, in and of themselves, have many salutary budgetary effects by changing the structure of the budget. The reform priorities are simply misaligned.

My more severe criticisms are normative in nature. For those of us who are not only concerned about the economic but also about the political health of China, designing fiscal institutions should not be motivated by economic issues unduly at the expense of the potential benefits associated with fiscal decentralization. I argue against fiscal centralization here not because I believe that fiscal decentralization, *ipso facto*, is intrinsically superior. My argument is that fiscal decentralization, in the short run, is the best bulwark currently available against the ambition, power and caprice of the central government in a political system that allows no other forms of constraints. In the long run, the fiscal dependency of the Center may lead to an increase in political participation and policy involvement from local governments either because local revenue control may institutionalize a process of securing local consent over broader policy and political issues or, as happened in Tudor England, the sovereign may voluntarily give up some of its political power to make more credible its commitment to a stable tax base.<sup>29</sup> "No representation, no taxation" can be as true today in China as it was true in America 220 years ago.

## Tables and Figures

Table 1 Provincial tax contributions as shares of provincial NMP, 1988

	(A) Formal contributions (%)	(B) Effective contributions (%)
Guangdong	1.72	3.72
Jiangsu	6.43	3.68
Liaoning	7.55	4.15
Inner Mongolia	0.20	-14.40
Anhui	2.02	-1.42

Note: Formal tax contributions refer to revenues the provinces turn over to the Center under the central/provincial tax sharing arrangements; effective contributions refer to tax payments minus central subsidies or, in the case of Guangdong, tax payment plus unserviced central borrowings.

Sources: Guangdong's tax figures are from Maruya (1992); figures for all other provinces are from Ma Hong and Fang (1991); provincial NMP figures are from SSB (1990).

Table 2 A topology of fiscal and political systems in the world

	<u>Characteristics</u>		<u>Country examples</u>
	Fiscal system	Political system	
1)	Centralized	Decentralized	Most liberal democracies.
2)	Decentralized	Centralized	China.
3)	Centralized	Centralized	Non-democratic developing countries and unreformed CPEs.
4)	Decentralized	Decentralized	Yugoslavia

Note: Centralization here implies both the nature of the political system, i.e., authoritarian vis-a-vis democratic systems, and the nature of relations between the national and local governments.

**Fig. 1. Adjusted and unadjusted consolidated revenues as shares of GNP**

---

**Sources: Based on figures published in SSB (1993 and 1994).**

**Fig. 2. Adjusted central and local revenues as shares of GNP**

---

**Sources: Based on figures published in SSB (1993 and 1994).**

## Notes

<sup>1</sup> Probably, the most detailed and the most influential study expounding this view is by two US-educated social scientists, Hu Angang at the Chinese Academy of Natural Sciences and Wang Shaoguang at Yale University. See Wang and Hu (1993). According to press reports, Chinese central leadership and the Ministry of Finance strongly concur with the broad concerns raised in their study and have designed fiscal reform measures upon some of the recommendations in the study.

<sup>2</sup> See Hofman (1993). Hofman shows that there is no evidence that Chinese tax system is overly decentralized when taking into account the size of the country and of the population. Tian (1995) argues that fiscal decentralization is compatible with economic incentives and makes a case for fiscal decentralization on economic grounds.

<sup>3</sup> To some extent, this is already happening in China, although only very partially. Many companies in China were carved off governmental agencies; the problem is that these companies still retain many umbilical cords with their supervisory agencies, including strong financial ties.

<sup>4</sup> Thus it is at least arguable that the existence of a quasi-budgetary revenue source in part obviates the need for a higher tax rate. A World Bank calculation shows, using data from the mid-1980s, that the quasi-budgetary revenues were equivalent to an increase in the enterprise income tax burden from about 49 percent to 67 percent (World Bank, 1989, 24).

<sup>5</sup> The budget figures as given in the Chinese statistical sources need to be adjusted by making the Chinese budget conform with international definitions. The Chinese budget counts government debts as a revenue item, whereas it is a part of the deficit under the international definition. The adjustment, therefore, subtracts both domestic and foreign loans from the reported revenue and adds them to the central bank financing to derive the government deficit. The central bank financing is calculated as the difference between consolidated revenue and consolidated expenditure according to the *Chinese definition* of budget.

<sup>6</sup> For OECD countries as a whole, the social welfare expenditure as percentage of GDP was about 16 percent between 1985 and 1990. It is worth noting here that in developed market economies there is a concern that excessively high welfare spendings are hampering economic growth. In East European countries, at a much lower level of income, social spendings are also very high (see Sachs 1995). The figures that Wang and Hu cited contain social spendings and therefore should not be taken as the norm for the Chinese budgetary spendings.

<sup>7</sup> Wang (1995) and Ma (1995) have shown that inter-provincial transfers have declined and argue that this

is a sign of declining fiscal capacity of the central government. This is not entirely true. It is plausible to argue that the declining income transfers are in part due to declining demand for them. There is evidence that in the first period of reforms (1978-1984) coastal and interior provinces converge at a rapid rate; the convergence continues since the mid-1980s but at a slower rate. Some of the reform measures themselves act as one-time income transfers, such as the price adjustments in the late 1980s. In the 1960s and 1970s, the large-scale income transfers were necessary in part because Chinese provinces diverged economically.

<sup>8</sup> Chinese sources on central/local budgetary breakdowns are incomplete. The central and local revenues are reconstructed by relying on the following simple assumptions. First, all the domestic debts are incurred by the central government; the breakdowns of external loans are given in SSB (1993). Second, the clearly governmental portion of the consolidated extra-budgetary revenue also holds for central and local extra-budgetary revenues as well.

<sup>9</sup> For a more detailed exposition of this view, see Oates (1972).

<sup>10</sup> This line of reasoning depends critically on the fact that the Chinese political system is an effective unitary system. This is an empirical issue and I have shown elsewhere (1995) that the central government has strengthened its administrative control over local officials as its economic control has declined during the reform era.

<sup>11</sup> See Wong (1990).

<sup>12</sup> During the reform era, the Center has not only "borrowed" from Guangdong to cover its budget shortfalls; in 1981 it borrowed 154 million *yuan* from Fujian (Tong, 1989, 19) and in 1987, it borrowed 236 million *yuan* from Tianjin (Tianjin jingji nianjian 1988, 1989, 515). In 1988, the central government returned a portion of this money to Tianjin by excluding thirteen small taxes from being counted as local revenue and by excluding loans as an expenditure item, as is customary in the Chinese tax system. In this case, the money appropriated by the Center equals the difference between Tianjin's loans and the value of these thirteen taxes. See Tianjin jingji nianjian 1989 (1989, 539-40). Usually, the Center does not appropriate this money in an outright manner; instead, it appropriates a significant portion by reducing local retention and the collection base simultaneously.

<sup>13</sup> This calculation may bias downward tax contributions from Jiangsu and Liaoning because we do not have data on central borrowings from these two provinces. It is unlikely that there were central subsidies to Guangdong because one of the reasons that Guangdong has a rather low formal tax burden is to give it nearly

complete fiscal autonomy and responsibility.

<sup>14</sup> Since the measurement used here already normalizes the differences in economic development, that poor provinces have both lower tax contribution ratios and receive substantial subsidies might be due to the central government's pricing policies. According to the World Bank, Chinese energy and raw material prices are set low relative to their economic costs. The price of heavy fuel oil is one-third that of international levels and coal is set at 60 percent of its long-run marginal production costs (World Bank, 1985, 71). Administrative pricing affects the levels of tax revenues from different provinces. Provinces with a large energy sector--many of which are located in the interior regions--have a lower level of tax revenue because their tax revenue is artificially depressed since their main products are set below their market values.

<sup>15</sup> Kaufman (1960, 155-56), in his study of the management of the American forest service, argues that personnel turnovers check policy deviations because no matter how successfully a ranger may hide his performance from his superiors, he cannot do so with his successor. There are in fact many similarities between an American forest ranger and a Chinese local official. Both have a high degree of autonomy and operate quite independently; in addition they both must also reckon with powerful local interests which, from time to time, pull them in a direction inconsistent with that of their respective superiors. Kaufman argues that there should be considerable centrifugal forces that fragment the forest service and the fact that it is not fragmented shows the success of the design of the management system.

<sup>16</sup> See Huang (forthcoming) and Huang (1994).

<sup>17</sup> For an analysis on hidden deficits as a result of non-performing bank loans, see McKinnon (1993), Chapter 13.

<sup>18</sup> In this aspect, it is worth noting that the 1994 reform stipules no restrictions on central power to adjust tax base and rates and the central government has been reluctant to commit itself to a clear division of expenditures. See Ma (1995) for an analysis.

<sup>19</sup> An empirical demonstration of this point is the difference in attitudes toward inflation/unemployment tradeoffs by the two levels of government. Local governments are consistently more concerned about unemployment than about inflation; the central government has the reverse preferences. See Huang Yunchen, Lu Jian and Fan Yu (1992).

<sup>20</sup> Local governments are less multidimensional than the central government. They are not responsible for defense and diplomacy, for example.

<sup>21</sup> There are, of course, always factions in Chinese politics, but very often they are based on lineage or shared ideological stances rather than being marriages of convenience that are characteristic of *quid pro quo* policy coalitions. On factions in Chinese politics, see Nathan (1973).

<sup>22</sup> A very interesting perspective on this regional cooperation is provided by Zheng and Wu (1994). They argue that the most successful form of regional cooperation typically occurs among poor provinces in part because poor provinces are not in an effective position to bargain with the center individually. Thus regional cooperation among poor provinces tends to be spontaneous (i.e., without much central coordination) and more institutionalized.

<sup>23</sup> See Montinola, Qian and Weingast for an analysis along this line.

<sup>24</sup> For more details along this line, see Huang (Forthcoming).

<sup>25</sup> Often this involves appeals by the Center to the localities about their sense of duty and obligations. Appropriations would appear less illegitimate to the extent that these appeals are convincing.

<sup>26</sup> Many China analysts view bargaining with alarm, equating it with loss of central control. My analysis shows that bargaining can be a form of political participation and is a positive outcome of fiscal decentralization. (For a similar view, see Zhang and Wu 1994). An optimistic scenario is that local governments not only retain a say over fiscal policies but also over personnel appointment at the Center. If local officials are presented with different personnel choices, representing different fiscal visions, they should have personnel preferences. Shirk (1993) argues that Chinese politics is already characterized by a "reciprocal accountability." This analysis should not imply that I "favor" those candidates that localities prefer; the point simply is there needs to be a mechanism to balance and check the central government in its personnel selection. Who eventually emerges from this process is of less interest to me than the process of consultations by which personnel are selected.

<sup>27</sup> In one area, the Center has clearly given up part of its power and this is the area of economic legislation. Provincial People's Congresses have promulgated numerous laws since 1979. According to one author (Lin 1992-3), "[provinces] are increasingly becoming partners of the center in the field of policy making."

<sup>28</sup> As Levi (1988) points out, revenue contributions are a reciprocal process. She says, "Quasi-voluntary compliance rests on reciprocity. It is a contingent strategy in which individual taxpayers are more likely to cooperate if they have reasonable expectations that both the rulers and other taxpayers will also cooperate." Levi (1988: 69).

<sup>29</sup> See Weingast



## Bibliography

- Hofman, Bert. 1993. "An Analysis of Chinese Fiscal Data Over the Reform Period." China Economic Review 4(2):213-30.
- Huang Yunchen, Lu Jian, and Fan Yu. 1992. "1991-1992 Nian Hongguan Jingji Taishide Panduan Yu Zhengce Jianyi." [Judgment on the 1991-1992 Macroeconomic Situation and Policy Suggestions]. Jingji Tizhi Gaige Neibu Cankao [Internal References on Economic System Reforms] (1):3-8.
- Huang, Yasheng. Forthcoming. Inflation and Investment Controls in China: The Political Economy of Central-local Relations During Reform Era. . New York: Cambridge University Press.
- . 1994. "The Political Economy of Inflation and Investment Controls in China During the Reform Era (1976-1992)." Unpublished Paper.
- Kaufman, Herbert. 1960. The Forest Ranger: A Study in Administrative Behavior. Baltimore: John Hopkins Press.
- Levi, Margaret. 1988. Of Rule and Revenue. Berkeley: University of California Press.
- Ma Hong, and Fang Weizhong. 1991. Zhongguo Diqu Fazhan Yu Chanye Zhengce. [China's Regional Development and Industrial Policies]. Beijing: Zhongguo Caizheng Jingji Chubanshe.
- Ma Jun. 1995. "Zhongyong Yu Difang Caizheng Guangxi de Gaige." [Reforms of Central/local Fiscal Relations]. Dangdai Zhongguo Yanjiu [Modern China Studies] (1 and 2):118-33.
- McKinnon, Ronald I. 1993. The Order of Economic Liberalization. Baltimore: The Johns Hopkins University Press.
- Maruya, Toyojiro. 1992. "Economic Relations Between Hong Kong and Guangdong Province." ed. Toyojiro Maruya. In Guangdong: "Open Door" Economic Development Strategy, 126-46. Hong Kong: Centre of Asian Studies, University of Hong Kong.
- Ministry of Finance, ed. 1987. Yusuanwai Zijin Guanli Shouce. [Handbook on Managing Extra-Budgetary Funds]. Beijing: Zhongguo Caizheng Chubanshe.
- Montinola, Gabriella, Yingyi Qian, and Barry R. Weingast. Forthcoming. "Federalism, Chinese Style: The Political Basis for Economic Success in China." World Politics.
- Nathan, Andrew J. 1973. "A Factionalism Model for CCP Politics." The China Quarterly (53) (January-March):34-66.
- Shirk, Susan L. 1993. The Political Logic of Economic Reform in China. Berkeley: University of California Press.
- State Council. 1987 <1986>. "Guanyu Jiaqiang Yusuanwai Zijin Guanli de Tongzhi." [Notice on Strengthening the Management of Extra-budgetary Funds]. Ed. Ministry of Finance. In Yusuanwai Zijin Guanli Shouce. [Handbook on Managing Extra-Budgetary Funds]., 126-29. Beijing: Zhongguo Caizheng Chubanshe.
- State Statistical Bureau. 1990. Quanguo Gesheng, Zizhiqu, Zhixiashi Lishi Tongji Ziliao Huibian [Collection of Historical Data of Chinese Provinces, Autonomous Regions, and Directly-Administered Municipalities]. Beijing: Zhongguo Tongji Chubanshe.

- , 1992. China Foreign Economic Statistics, 1979-1991. Beijing: China Statistical Information & Consultancy Service Centre.
- , 1993. Zhongguo Tongji Nianjian 1993 [China Statistical Yearbook 1993]. Beijing: Zhongguo Tongji Chubanshe.
- , 1994. Zhongguo Tongji Nianjian 1994 [China Statistical Yearbook 1994]. Beijing: Zhongguo Tongji Chubanshe.
- Tianjin Jingji Nianjian 1988 [Tianjin Economic Yearbook 1988] 1989. Tianjin: Renmin Chubanshe.
- Wang Shaoguang, and Hu Angang. 1993. "Jiaqiang Zhongyang Zhengfu Zai Shichang Jingji Zhuanxin Zhong de Zhudao Zuoyong [Strengthen the Function of the Central Government During the Market Transition]." Unpublished Paper. New Haven: Yale University.
- Wong, Christine P. W. 1990. "Central-Local Relations in an Era of Fiscal Decline: The Paradox of Fiscal Decentralization in Post-Mao China." Working Paper No. 210 . Santa Cruz: University of California.
- World Bank. 1985. China: Long-term Development Issues and Options. Baltimore: Johns Hopkins University Press.
- , 1988. World Development Report 1988. Washington, D.C.: International Bank for Reconstruction and Development.
- , 1989. China: Revenue Mobilization and Tax Policy. . Washington, D.C.: The World Bank.
- Xu Xu. 1988. "'Zhuanhu Cunchu' Shi Yusuanwai Zijin Guanli de Youxiao Tujing ['Specialized Account' is an Effective Way of Managing Extra-budgetary Funds]." Jingji Yanjiu Cankao Ziliao [Economic Research Reference Materials] 30 June, 46-52.