Racing to the Bottom or to the Top? Decentralization, Revenue Pressures, and Governance Reform in China

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Summary. — China’s decentralization has been praised for promoting inter-jurisdictional competition that incentivizes local officials to promote economic development. The downside of decentralization is that it enables these same local authorities to slow or block implementation of centrally mandated governance reforms, especially when these may negatively affect local development goals. We suggest that China’s fiscal system and promotion system have created mismatched incentives that encourage cash-strapped local authorities to disregard central governance reforms. Specifically, we show that cities with weaker revenue bases were slower to implement new, centrally mandated environmental transparency regulations. Additional evidence points to a bifurcation in development strategies. In fiscally strong cities, increased foreign investment leads to greater compliance. In fiscally weak cities, foreign investment is associated with decreased disclosure, suggesting they aim to promote local development by becoming pollution havens. Similarly, high levels of pollution induce fiscally strong cities to increase pollution disclosures while the opposite holds in fiscally weak cities. These findings imply that mismatched decentralization policies can undermine other important governance reforms, even ones that might be expected to be complementary to decentralizing initiatives.

Key words — decentralization, governance reform, environment, China

1. INTRODUCTION

Hoping to improve governance and speed economic growth, many countries have experimented with various forms of decentralization (Manor, 1999; Martinez-Vazquez & McNab, 2003). In principle, decentralization enhances political accountability, either by increasing politicians’ dependence on their own constituents’ votes to stay in power (Faguet, 2012), or by making subnational governments more reliant on local revenue—and the consent of local actors—to fund their expenditure (Garman, Haggard, & Willis, 2001). Even authoritarian states, which by definition are averse to direct political accountability, stand to benefit from decentralizing. By granting local governments the power to autonomously raise and distribute revenue, or by allowing subnational leaders to adapt national policies to local contexts, authoritarian states can build more efficient economic institutions that cater to local strengths (Montinola, Qian, & Weingast, 1995; Heilmann & Perry, 2011; Xu, 2011). But does decentralization always lead to improved governance?

Research has shown that the effects of decentralization are far more contingent than initially hoped, often because existing power arrangements undermine attempts to redistribute authority to local levels (Bardhan, 2002; Treisman, 2007; Faguet, 2014; Weingast, 2014). In newly decentralized systems, weak local governments risk becoming captured by powerful local interests, leading to corruption and favoritism instead of greater local accountability (Bardhan & Mookherjee, 2006; Faguet, 2014, p. 6; Mattingly, 2016). Non-democratic systems are especially prone to local capture because discretionary institutional rules and limited public participation enable powerful groups to distort policies to their benefit (Faguet, 2014, p. 6; Weingast, 2014, p. 18). In China, for instance, efforts to regulate pollution under decentralized administration have been plagued by local capture. Local officials are prone to protecting polluters due to their economic importance, enforcing regulations laxly or levying only nominal fines (van Rooij, 2006; Zhang, Ortolano, & Zhongmei, 2010, p. 311–314; Lo et al., 2012). Meanwhile, authoritarian restrictions on press freedom, public participation, and an independent judiciary prevent central leaders from obtaining reliable information on corrupt officials, further frustrating Beijing’s efforts to punish collusion or clean up the environment (Birney, 2014; Stern, 2014).

Over the past thirty years, the Chinese central government has tried to break through these information barriers, experimenting with village elections and a variety of other quasi-democratic governance reforms that strengthen the ability of ordinary citizens to monitor and place pressure on the local authorities (O’Brien and Li, 2000; Wang, 1997; Wang & Yao, 2007; Distelhorst & Hou, in press; Manion, 2016). One of the most notable in recent years has been the introduction of new transparency regulations. Beijing now requires local governments to publicly disclose information on pollution, government budgets, and other policies, complementing these other reforms and potentially exposing them to even greater pressures from below. However, for this very reason, local governments may use their independence to resist implementation of these reforms.

A major source of leverage central governments have over localities is their control of fiscal resources. The threat of withdrawing subsidies or reducing transfers can grant a great deal of power to the national government even in nominally decentralized systems with bottom-up democratic political pressures (Weingast, 2014, p. 19-20). This implies that localities with fewer sources of fiscal revenue under their own control should be particularly susceptible to top-down pressures.

Our findings in this paper go against this expectation. We find that fiscally weak cities—ones lacking strong sources of
revenue—were less likely to implement Beijing’s transparency reforms, particularly in the environmental domain. We believe this is a side effect of what has been billed as one of China’s great institutional strengths, a hierarchy in which advancement is determined primarily by the ability to generate economic growth or at least fiscal revenue (Shih, Adolph, & Liu, 2012; Xu, 2011; Lü & Landry, 2014). These career pressures create a strong incentive to oppose or at least foot-drag on implementation of reforms that might adversely impact the business of a city’s major revenue-generating firms. This problem could only have been exacerbated by China’s mid-1990s re-centralization of a number of sources of tax revenue that previously had been under local control. This fiscal reform left most cities facing a significant budget shortfall, making it challenging in some cases even to provide basic social services (Wang & Herd, 2013; Man, 2011). Any policy that threatened revenues would therefore not just threaten a local official’s ability to perform and seek promotion, but also that official’s ability to do the minimum necessary to keep a city functioning. We propose that this overwhelming revenue focus has encouraged fiscally weak cities to shield polluting industries from transparency measures, for fear of losing what little revenue they have.

In cities with strong sources of revenue, however, the story is different. Officials in such cities no doubt also seek to generate revenues for promotion, but face less pressure to make this their sole focus because they have sufficient revenue to cover welfare and public services. Instead, they may seek to distinguish themselves in the promotion race by standing out in their implementation of other central initiatives, even if this has an impact on revenue collection and growth. In recent years, the Central government has signaled its strong commitment to improved environmental performance by linking bureaucratic promotion to hard pollution reduction targets, and strengthening laws to punish non-compliant firms. Officials in fiscally strong cities can therefore use strong performance on environmental measures to distinguish themselves from their revenue-focused counterparts in fiscally weak cities.

Investing in environmental transparency and cleaner industry may also be part of a broader industrial upgrading—rather than clinging to revenues from dirtier heavy industries, fiscally strong cities may try to move to the next level of development and attract cleaner investors. In short, the different revenue pressures introduced by fiscal decentralization have pushed richer cities and poorer cities toward two opposing development strategies, with one group ‘racing to the bottom’ as the other rises to the top. As evidence of this, we show that in cities with stronger revenue sources, more air pollution and more foreign direct investment were associated with more rapid adoption of environmental transparency reforms.

Our findings contribute to the literature on decentralization in two ways: First, the use of fiscal resources and central transfers to enforce obedience to central mandates is a common theme in the fiscal decentralization literature (Díaz-Cayeros, 2006; Garman et al., 2001; Rodden, 2004). However, we show a case where greater dependence on central transfers is associated with non-compliance with the Center’s policies. Our research therefore highlights how the partial decentralization of fiscal systems can undermine other important governance reforms, even ones that might be expected to be complementary to decentralizing initiatives.

Second, the paper highlights a perverse consequence of China’s system of decentralized promotion, which many scholars have lauded as a key to the country’s remarkable economic growth. The emphasis on revenue collection in determining bureaucratic promotion, we argue, has pushed officials in revenue-starved cities to protect highly polluting local industries. Yet if revenue were the only path to promotion, we should see officials from both rich and poor cities seeking to increase revenue at all cost. Instead, we see officials in revenue-rich cities complying with transparency reforms at the expense of revenue generation. We argue that fiscal decentralization generates these divergent responses by putting a greater pressure on officials in fiscally weak cities to increase revenue. In contrast, officials in relatively revenue-rich cities have more latitude to comply with central mandates and outperform their revenue-poor counterparts by responding to popular demands for more transparency and cleaner industry, which the center also promotes. In short, fiscal decentralization has led local officials to focus on different strategies for promotion, which in turn has driven rich and poor Chinese cities down different pathways of development.

Below, we first discuss China’s decentralization and transparency reforms in China. We then move on to discussing data and measurement before presenting statistical results.

2. FISCAL DECENTRALIZATION AND REVENUE PRESSURES

Fiscal decentralization is conceptualized as the balance of expenditure and revenue collection between the local and national government, providing local governments with greater power over taxing and spending (Rodden, 2004). Under highly decentralized systems, the majority of public goods and services are funded by local government revenue, and national governments have little authority over how this revenue is raised and allocated (Garman et al., 2001, p. 207). Most countries have experimented with decentralization to one degree or another, and the early wave of research on decentralization and “fiscal federalism” came to mostly optimistic conclusions. Initial studies based on aggregate cross-national data suggested that these efforts would likely increase accountability and reduce government waste (Weingast, 2009). Yet what Weingast calls “second generation fiscal federalism” has reached a more tempered view.

One key insight from the second-generation literature is that the transfer of fiscal resources does not always lead to the transfer of fiscal authority. For instance, when local politicians have access to revenue acquired from outside their local tax base (such as fiscal transfers) and enormous discretion over how this revenue is spent (fiscal authority), fiscal transfers can be likened to “windfall revenue” (Morrison, 2009, p. 110–111; Gervasoni, 2010, p. 307). These fiscal ‘rents’ promote opportunistic spending, and are used carelessly to boost electoral support (Rodden, 2002) or invested in repressive apparatuses to keep out political opponents (Gervasoni, 2010, p. 308–309). However, this scenario requires the center to transfer both fiscal revenue and authority to local level.

More often, we see cases where expenditure responsibilities are devolved to the local level, but the central government maintains such tight control over how revenue is collected and spent that “expenditure decentralization [alone] may communicate very little about the locus of authority” (Rodden, 2004, p. 484). Garman et al. (2001) show that when political authority is concentrated at national level, fiscal transfers are more likely to be earmarked and independent local spending is limited. Governance may degrade when local governments lack resources, and must pander to the national government’s policy priorities at the expense of local interests to win more of these earmarked funds. Under such cases, “own-source revenue”—that is, revenue raised and retained at the local level
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