

# Decentralization and macroeconomic performance in China: regional autonomy has its costs

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## Abstract

We give an empirical examination of the impact of fiscal and economic decentralization in China on the country's economic growth and inflation, using a vector autoregressive (VAR) model with latent variables. Our econometric investigation offers strong evidence that there is a connection between decentralization and macroeconomic performance in China. Economic decentralization appears to be positively related to growth in real output for the entire postwar period in China. Fiscal decentralization seems to have adverse implications for the rate of inflation, especially after the late 1970s. Decentralization would therefore seem to be good for growth and bad for price stability.

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## 1. Introduction

This paper investigates empirically whether decentralization in China has been beneficial for growth and inflation. Decentralization, whether in the form of fiscal

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federalism, or in the form of reduced government interference in the private sector, is generally thought to help an emerging economy. Although the devolution of economic power has been a central element in the reform process of many transition economies, there is relatively little empirical work examining the relationship between such decentralization and changes in the macroeconomy.

Decentralization may improve allocative efficiency, but it may also make stabilization policies more difficult to carry out. See, e.g., Prudhomme (1994) and Tanzi (1995). China has instituted rapid economic decentralization, and has simultaneously experienced both growth and instability. There is a growing consensus in the academic literature about the mechanisms that create the links between decentralization and economic growth and inflation in post-reform China (Brandt and Zhu, 2000; Jin et al., 1999; Lardy, 1998; Naughton, 1995; Yusuf, 1994). A simplified version of such a mechanism may be described as follows.

Although the aggregate effective tax burden may not have changed, fiscal decentralization has caused tax revenues to shift from the central government to regional governments. The regional governments, infused with new revenue, begin to build local infrastructure. This infrastructure encourages investment, both of the non-state as well as the state-owned enterprises (SOEs). The non-state firms tend to respond to the increased local infrastructure with higher rates of investment than the SOEs, given their greater efficiency. As the SOEs attempt to keep up with the rates of investment of non-state firms, a further adjustment occurs. The SOEs, observing the increased rate of capital formation of the non-state sector, increase their own rate of investment beyond the rate that would be optimal. The SOEs are able to do so because they have access to local bank loans that are not justified on economic grounds. This access to the banking system thereby distinguishes them from the non-state firms.<sup>2</sup> The banks that passively grant these loans are themselves financed by discount lending by the People's Bank. The resulting monetary expansion leads to increased inflation, while the higher output of both the SOEs and non-state enterprises cause an increase in aggregate real income.

In this paper, we provide a formal empirical examination of decentralization in Chinese economy, based on published data. We find that (i) decentralization plays indeed a fairly important role in a VAR model of growth and inflation, (ii) the pattern of the relation does not appear to be restricted to the post-reform period, but rather characterizes the entire postwar economy in China.

The next section will review China's experiences with decentralization. Section 3 will discuss our data set, including construction of measures of decentralization. Section 4 will develop our econometric models, while Section 5 reports the results of estimation and tests

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<sup>2</sup> This access to local bank loans is a facet of the "soft budget constraint" that is a key feature of many transition economies (see Maskin 1999 and Qian and Xu 1998 for recent theoretical work on the topic). One might claim that a key distinction between SOEs in China and in a country such as, e.g., Brazil is that the Brazilian banking system does not lend to the SOEs with the same degree of passivity as does the Chinese banking system.

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