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Fiscal decentralization, revenue and expenditure assignments, and growth in China

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Abstract

Theory suggests that a close match between revenue and expenditure assignments at sub-national levels benefits allocative efficiency, and hence economic growth. That is, a convergence of revenue and expenditure assignments at sub-national levels of government should, according to the theory, be positively associated with a higher growth rate. In the case of China, this paper shows, divergence, rather than convergence, in revenue and expenditures at the sub-national level of government is associated with higher rates of growth. A panel dataset for 30 provinces in China is used to examine the relationship between fiscal decentralization and economic growth over two phases of fiscal decentralization in China: (1) 1979–1993 under the fiscal contract system, and (2) 1994–1999 under the tax assignment system. The seeming contradiction between the theory and evidence in the China case is reconciled by taking into account the institutional arrangements that prevailed during the two phases of fiscal decentralization, in particular the inconsistency between the assumptions of the theory of fiscal decentralization and the institutional reality of China.

JEL classification: H2; H7; O1

Keywords: Fiscal decentralization; Economic growth; Revenue; Expenditure

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1. Introduction

Since initiating economic reforms in 1978, fiscal decentralization has been a central component of China's economic policy at a time when China has experienced unprecedented economic growth. Although China remains a unitary political system, where sub-national government elections are virtually not exist, its fiscal system is nevertheless a decentralized one featured by a fiscal contract system (1980–1993)[1] and revenue assignment system (1994–present). Regardless of China's non-democratic institutions, the benefits of fiscal decentralization seem still applicable, according to Oates (1972, p. xvi), because ‘‘for an economist, however, constitutional and political structures are of less importance: What is crucial for him is simply that different levels of decision-making do exist, each of which determines levels of provision of particular public services in response largely to the interests of its geographical constituency. By this definition, practically any fiscal system is federal or at least possesses federal elements’’.

The question of whether fiscal decentralization has contributed to China's economic success over the past 20 years is, however, open to debate. Some argue that fiscal decentralization has been fundamental to China's economic success (Oi, 1992; Qian, 1999; Qian & Weingast, 1997). It has been asserted that the fiscal contract system (1980–1993) provided material incentives that encouraged and rewarded sub-national governments to promote local economies (Oi, 1992; Qian, 1999). Secondly, Qian (1999) assumes that sub-national governments had less control over banks and therefore could not bail out their state-owned enterprises (SOEs) by extending credit to them as the central government did. Fiscal decentralization, they argue, hardened the budget constraints of sub-national governments' SOEs, and thus made these SOEs more efficient (Qian, 1999). The fiscal contract system, it is also asserted, allowed sub-national governments to conceal information about their financial position and enabled them to avoid revenue predation from the Center (Qian & Weingast, 1997), thus allowing them to retain the financial resources they needed for investments that promoted economic development.

Some studies have, however, offered evidence suggesting that fiscal decentralization fragmented the national market, and hence negatively affected economic growth. Instead of inducing jurisdictional competition that would have potentially enhanced allocative efficiency, decentralization, it is argued, created revenue incentives that encouraged sub-national governments to engage in protectionist behavior (Yang, 1997). Enterprise ownership by local governments provided an incentive to local governments to duplicate enterprises under their jurisdiction so as to capture the revenues that would have otherwise gone to the central coffers, leading to ‘‘backward specialization’’,[2] as evidenced by the convergence of regional relative outputs and a divergence of regional relative factor allocations and labor productivities during the reform era (Young, 2000). As a result, the centrally controlled planned economy devolved, according to this argument, into one of many regional planned economies controlled by sub-national governments (Young, 2000). In addition, such ownership structure of SOEs enabled sub-national governments increasingly to mandate these firms to provide public goods—such as housing, healthcare, childcare, schooling and pension. Thus, it is argued that budget constraint on sub-national governments was effectively

[1] Under fiscal contract system, each subnational government level contracted with the next level up to meet certain revenue remittance targets, which could be either a nominal amount or a percentage share. The retention was at the sole discretion of subnational governments. For details, see Bahl and Wallich (1992), World Bank (1989, 1993).

[2] The term is used by Yang (1997).