



Fiscal decentralization and political centralization in China: Implications for growth and inequality

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Received 8 August 2006

Available online 20 September 2006

Zhang, Xiaobo—Fiscal decentralization and political centralization in China: Implications for growth and inequality

China's current fiscal system is largely decentralized while its governance structure is rather centralized with strong top-down mandates and a homogeneous governance structure. Due to large differences in initial economic structures and revenue bases, the implicit tax rate and fiscal burdens to support the functioning of local government vary significantly across jurisdictions. Regions initially endowed with a broader non-farm tax base do not need to rely heavily on preexisting or new firms to finance public goods provision, thereby creating a healthy investment environment for the nonfarm sector to grow. In contrast, regions with agriculture as the major economic activity have little resources left for public investment after paying the expenses of bureaucracy. Consequently, differences in economic structures and fiscal burdens may translate into a widening regional gap. *Journal of Comparative Economics* **34** (4) (2006) 713–726. International Food Policy Research Institute (IFPRI), 2033 K Street, NW, Washington, DC 20006, USA.

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JEL classification: E62; H20; O40; P20

Keywords: Chinese economy; Growth; Fiscal decentralization; Regional inequality

1. Introduction

Transferring authority to lower levels of government, which have better knowledge of the local conditions and preferences and are under closer scrutiny by their constituencies, is expected to improve the provision of local public goods and services (Dethier, 1999; Bardhan, 2002).

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Tiebout (1956) argues that under fiscal decentralization and interjurisdictional competition, citizens can vote with their feet to allocate themselves according to their preference to a package of local public goods and taxes. In other words, fiscal decentralization can prompt more efficient provisions of local public goods if individuals can freely move across localities. In addition to the sorting and matching role, Qian and Roland (1998, QR for short hereafter) emphasize that fiscal decentralization can also serve as a disciplinary device to preserve market incentives. These theories highlight the positive role of fiscal decentralization and interjurisdictional competition on the efficiency of public goods provision. In the past two decades, decentralization has become a global trend. However, empirical evaluation on the impact of decentralization on growth and distribution in developing countries is still in its infancy (Bardhan, 2002).

China, like many developing countries, has undergone a process of fiscal decentralization.¹ The sheer size of China provides a good ground to test the predictions of the theories in the context of development. Using provincial data up to 1993, Lin and Liu (2000) provide empirical evidence that decentralization is conducive to growth. Zhang and Zou (1998), however, have found a negative relationship between growth and decentralization. Jin et al. (2005) reach a more optimistic finding that decentralization is not only good for growth but also for equity based on data up to 1992. Using data at a more microlevel, a few other studies (West and Wong, 1995; Park et al., 1996; Knight and Li, 1999) show that decentralization has a negative distributional effect. These studies are all based on data up to the early 1990s. Since then, more in-depth fiscal reforms have taken place and more comprehensive data have become publicly available. Therefore, it is important to extend the work to cover a longer period and more spatial units so as to reconcile the differences.

Compared to the decentralized fiscal system, China's political system is rather centralized and can be described as a multidivisional-form hierarchy structure (M-structure) (Maskin et al., 2000). Under this structure, the government can create a yardstick competition among local officials by rewarding or punishing them on the basis of economic performance. By examining the turnover data of top provincial leaders in China, Li and Zhou (2005) show that the internal political market also serves as a disciplinary mechanism for local officials to promote economic growth. Their finding suggests that the governance structure matters to economic growth in China.

In this study, we use a nationwide panel data set at the county level to more systematically investigate the distributional impact of decentralization by taking into account both the fiscal and governance structures. To our knowledge, this study is one of the first attempts made with panel data at the county level.² The panel data set at the county level covering a more recent period provides a vehicle to reconcile the differences of empirical research on China's fiscal decentralization. The work is also a contribution to the literature. As Bardhan (2002) points out, few studies have empirically examined the performance of fiscal decentralization at the microlevel in developing countries.

The next section provides descriptive statistics of the data set used. Section 3 discusses the major theoretical arguments on decentralization. Section 4 presents empirical analysis and shows why the results are seemingly in contrary to the theoretical predictions. The last section ends with conclusion and policy implications.

¹ For detailed description on China's fiscal decentralization, see Tong (1998), Zhang (1999), and World Bank (2002).

² Using the same data set Shih and Zhang (2004) examine the issue of transfers and subsidies and Tsui (2005) looks at the regional fiscal disparity.

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