

Decentralization with political trump: Vertical control, local accountability and regional disparities in China[☆]

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Abstract

Motivated by China's experience in the reform era, we study the fiscal relations between central and local governments embedded in a vertical control system with local officials appointed by the central government. The probability of their re-appointment depends, in part, on how well they perform in fulfilling their mandates from above. Self-interested local bureaucrats decide on the amount of predatory charges to be collected and the amount of public goods provided to increase their chances of survival, while at the same time maximizing the expected surplus accruing to their private agendas. Within the framework of this model, we explore how such issues as fiscal decentralization, local accountability and regional disparities interact with the stringency of the vertical control system. The paper also contributes to the discussion of the divergent experience of China and Russia.

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1. Introduction

The purpose of this paper is twofold. First, motivated by China's fiscal decentralization experience since the 1980s, we introduce a model that explores the impact of decentralizing taxing powers to subnational governments embedded in a vertical bureaucratic control system. With superior governments meting out rewards and punishments to local governments in accordance with the fulfillment of the mandates from above, the model explores the problem of local accountability by analysing the responses of local bureaucrats within such an institutional set-up. Second, the issues discussed in our model overlap with those in the recent literature on the interpretation of the Chinese as opposed to the Russian fiscal decentralization experience; see, e.g., Berkowitz and Li (2000), Zhuravskaya (2000).

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Our model belongs to a genre of economic research taking politics seriously, a sample of which may be found in Persson and Tabellini (2000). Central to this line of intellectual pursuit is the postulate of self-interested politicians/bureaucrats and how they navigate in response to incentives engendered by different political landscapes, be they legislative bargaining or electoral politics. Gaining currency in this new literature is the study of *decentralized* political governance, chiming in with the worldwide trend towards fiscal decentralization and local participation (World Bank, 2000, chapter 5).¹ Fiscal decentralization, through the devolution of powers to local governments, has often been hailed as a reform that brings governments closer to the people. Frequently and implicitly assumed in the new generation of models on decentralization are forms of democratic institutions that induce politicians to implement the wishes of local residents, thereby ensuring local accountability. However, some critics have pointed out that emerging economies devolving powers to local governments often lack these institutions and question whether there exists alternative institutional safeguards that handcuff the grabbing hands of local Leviathans.² Particularly striking is the Russian experience that is a reminder of what can go awry when fiscal decentralization is pushed forward without the support of those political institutions that align the incentives of local politicians and bureaucrats with a market-enhancing and pro-growth direction; see Shleifer (1997), Shleifer and Treisman (2000), Blanchard and Shleifer (2001).

Beyond the world of the median voter theorem and democratic institutions that are to a large measure the focus of the existing political economy models (Persson & Tabellini, 2000), there is still much to learn from the comparative experiences of decentralization embedded in different political institutions especially with respect to the issue of local accountability. To fill this lacuna is our model that is the end product of distilling China's decentralization experience in the reform era. *Fenzao chifan* (preparing meals from separate stoves), a Chinese metaphor for fiscal decentralization in the reform era, has conferred on local governments in China expanded taxing powers as well as responsibilities without however clearly delineated rights and duties for different tiers of governments. However, lurking behind China's intergovernmental relations is a hierarchical system of bureaucratic control with five tiers of governments. Though far from omnipotent, the central government backed up by the Party does nevertheless continue to exert considerable influence over local cadres through its stranglehold over the appointment, promotion and dismissal of local cadres, an observation that has already been eloquently elaborated by Huang Yasheng (1995, 1996, 2001).³ Through the cadre management system and, under its rubric, the increasingly institutionalised *target responsibility system* (see below), the central government steers local cadres towards its national agenda, with explicit targets ranging from economic growth to fertility control. Such a vertical control system is reminiscent of the so-called "top-down" model of Japan's central-local relations; see, e.g., Muramatsu (1988), Muramatsu and Iqbal (2001).⁴

The vertical control limits but does not totally deprive local governments of their freedoms to take initiatives. On the one hand, local officials out of career concerns endeavour to fulfill or even over-fulfill the many targets handed down from above. On the other hand, they may have their own private agendas that are not necessarily consistent with that of the central government. In dividing her resources between fulfilling the mandates from above and channeling them into her own private agendas, a local cadre has to balance the risk of damaging her career if too little resources are devoted to the mandates from above against her benefit of diverting more revenues into her private agenda.⁵ When disciplining devices such as local election and the exit option are far from perfect, vertical control seems indispensable in ensuring local accountability, a point that has been alluded to in Blanchard and Shleifer (2001).

Ironically, vertical control is a double-edged sword. While serving as a disciplining device, it also engenders perverse effects. In passing on the mandates from above, officials in each tier of government may have the incentive to impose their own targets on subordinate governments, resulting in a cascade of targets, with the burden snowballing and ultimately falling on the lowest rung of governments. Owing to the interjurisdictional and yardstick competition, local bureaucrats may also have the incentive to over-fulfill the targets from above. We also demonstrate below the perverse consequences of the target responsibility system on local cadres in poor as opposed to rich regions.

The above portrayal of China's *fenzao chifan* brings us to the second objective of this paper regarding the interpretation of China's experience. Contrasting with our description above is the increasingly influential paradigm of

¹ For a sample, see, e.g., Persson and Tabellini (2000), Lockwood (2002) and Alesina, Ignazio, and Federico (2001).

² See, e.g., Prud'homme (1995), Bardhan (1996), Bardhan and Mookherjee (2006, in press), and Cai and Treisman (2004). For a recent survey of the literature, see Mookherjee (2001).

³ See also Edin (2000), Whiting (2001) and Tsui and Wang (2004).

⁴ We thank Professor Wang Shaoguang and Professor Christine Wong for drawing our attention to the Japanese model.

⁵ Jean Oi (1999) seems to have this picture of central-local relations in mind, but she seems to put more emphasis on the freedom of local governments and the commitments of central governments not to intervene in local affairs.

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