



# Determinants of Expenditure Decentralization: Evidence from China

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**Summary.** — This study is the first attempt to examine the determinants of expenditure decentralization at sub-provincial levels in China. The Chinese central government gives detailed guidelines to local governments on public finance, but, ironically, their expenditure assignment is far from being well-regulated. Differences in fiscal decentralization on the expenditure side are enormous among local governments. Employing a panel dataset of 1995–2006, we provide empirical evidence that transfer dependency negatively affects expenditure decentralization in Chinese local governments. It suggests that intermediate governments, i.e., provincial governments, may have “grabbed” central grants for self-interests.

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## 1. INTRODUCTION

This paper aims to explore the determinants of expenditure decentralization in China, the world’s third largest country by total land area, and to examine their broad policy implications. Though China is a constitutionally unitary country, fiscal decentralization at sub-provincial levels varies tremendously across provinces, especially on the expenditure side. While there is a growing literature on the factors that explain the extent of fiscal decentralization, we still know little about what drives fiscal decentralization in different places (Bodman & Hodge, 2010). Taking advantage of the substantial variation in sub-provincial expenditure decentralization in China, this study contributes to this body of literature by testing hypotheses concerning some potential determinants of fiscal decentralization reported in the literature. Investigating the drivers of fiscal decentralization should be meaningful as most studies evaluate the effects of fiscal decentralization without looking into its complexities. Without an in-depth understanding of fiscal decentralization *per se*, it often runs the risk of overshooting when making conclusions about the benefits or perils of decentralization.

Decentralization is “often viewed as a shift of authority toward local governments and away from central governments, with total government authority over society and economy imagined as fixed” (Rodden, 2004, p. 482). Fiscal decentralization, more often than not, referring to the shift of fiscal responsibilities to lower levels of government, is fundamental to public governance in reality. Studies on fiscal decentralization have been burgeoning in the international community; however, the drivers of fiscal decentralization have remained little known thus far. Early literature on fiscal decentralization focuses on power assignment in the public sector (Tiebout, 1956; Oates, 2005). The bulk of the literature in recent decades has investigated the impact of fiscal decentralization on public governance (Prud’homme, 1995; Rodden & Wibbels, 2002; Uchimura & Jütting, 2009). The drivers of decentralization have been largely overlooked, except for some recent efforts such as Bodman and Hodge (2010) and Panizza (1999).

Compared with studies on the impacts of fiscal decentralization, untangling factors underpinning fiscal decentralization will be instrumental in generating a better understanding of the complexity and dynamics of decentralization in different politico-economic backgrounds. In many cases, fiscal decentralization *per se* is not the problem, but decentralization may have been implemented in an incompatible environment. When the drivers of decentralization/centralization are discovered, the evaluation of decentralization/centralization will be more pointed and the nuanced side of central–local relationship will be more revealing.

This study will investigate the regional variation of fiscal decentralization, *specifically on the expenditure side*, in China. Fiscal decentralization at sub-provincial levels in China is seriously under-explored in the literature. Though the literature on the impact of fiscal decentralization on economic development and public governance has burgeoned in recent years (for example Uchimura & Jütting, 2009), the investigation into the determinants of fiscal decentralization is rare. As the geographic areas of many Chinese provinces are equal to those of European countries, diversities between provinces in political, economic, and social aspects are astonishingly large. Sub-provincial decentralization in China is much more diversified than that in many other countries (Dollar & Hofman, 2008). Exploring fiscal decentralization, Chinese style, therefore, will potentially generate broad implications for other countries.

The Chinese central government does not exert a tight control over sub-provincial expenditure decentralization.

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Provincial governments in China enjoy substantial discretion in this regard. According to the Constitution of the People's Republic of China (PRC) and the China Statistical Yearbook (2009), subnational governments refer to 31 provincial governments, 333 prefectural governments, 2,859 county governments, and 40,828 township governments (sub-provincial governments include prefectural, county, and township governments). Local governments provide the bulk of public services in China wherein 70% of public money has been spent at the subnational level with more than 55% being spent by sub-provincial governments (World Bank, 2002). Due to the efforts to build a service-oriented government in recent years, local governments will take up more responsibilities for the provision of public services over time in China. Expenditure assignment for local governments is nonetheless far from being well-regulated (see also Martinez-Vazquez & Qiao, 2011). The State Council (2002), the top administrative body of the central government in China, provides regulations on local fiscal decentralization, paying most attention to the revenue side of fiscal decentralization while the regulations on the expenditure side have been nearly left blank. Variations in fiscal decentralization on the expenditure side are enormous across localities in China. For example, sub-provincial governments spent 85.32% of public money in Guangdong Province while only 53.72% was expended in Qinghai Province between 1995 and 2006 (see The Compendium of Fiscal Statistics for All Prefectures, Cities, and Counties, 1996–2007). Thus we pose our research question for this analysis: What drives the variation in sub-provincial expenditure decentralization in China? Based on the empirical results of our analysis, we attempt to draw policy implications for the improvement of the intergovernmental fiscal system in China.

In general, our empirical analysis confirms a negative relationship between transfer dependency (central transfer as a share of local expenditure) and fiscal decentralization in the Chinese context. Regions with a greater transfer-dependency tend to have a higher centralization of expenditure within provinces, *ceteris paribus*. As observers have long suspected that local governments play fiscal games with national governments in order to gain more grants in some countries (Gimpelson & Treisman, 2002), the results of our analysis also suggest a predatory role played by local governments in China. In addition, our study provides suggestive evidence that both population density and foreign direct investment (FDI) have negative influences over expenditure decentralization while economic development adds almost nothing to the explanatory power of our models for expenditure decentralization.

The remainder of the article is organized as follows: Section 2 discusses the theories and empirical evidence of the potential determinants of fiscal decentralization with an emphasis on the relationship between transfer dependency and expenditure decentralization. Section 3 presents data, model specification, and estimation methodology. Section 4 provides the empirical results of our analysis while Section 5 offers a discussion of them. Section 6 concludes.

## 2. POTENTIAL CAUSES OF FISCAL DECENTRALIZATION

Here we summarize the factors that have been used to explain fiscal decentralization in the literature, much of which is drawn from cross-national evidence. These potential determinants of fiscal decentralization identified in the literature are employed as the basis of our theoretical framework for this study.

### (a) Explaining the tie between transfer dependency and fiscal decentralization

The effects of fiscal transfers from the federal government (or the central government in countries like China) to local governments on local spending have been investigated extensively (for example the flypaper effect; see Bailey and Connolly (1998)). Nevertheless, the majority of the literature is linked with the theories and hypotheses (such as the median voter hypothesis) developed against a context of electoral politics. The impact of transfers from higher authorities on fiscal decentralization remains largely underexplored.

In some countries, the national government cannot channel grants to grassroots governments but have to go through intermediate governments according to the Constitutions (Hernández-Trillo & Jarillo-Rabling, 2008). Though it is not the case in China institutionally, the Chinese government has adopted a *de facto* system in practice. That is, central grants have to go through provincial governments before reaching prefectural and county governments. There is a risk that provincial governments may retain the intergovernmental transfers for their self-interests. Thus, the relationship between transfer dependency and expenditure decentralization could be either negative or positive, depending on the role and function of intermediate governments who are responsible for transmitting central grants to local governments.

Provincial governments in China, according to the State Council (2002), should hold back their own spending and augment central transfers to sub-provincial governments. It means that provincial governments are obligated to not only pass on central transfers to sub-provincial governments but also relinquish some parts of their own financial resources to lower levels of government as the latter provides the bulk of public services to citizens. In reality, no evidence suggests that provincial governments channel much of their own resources (in addition to transfers from the central government) to sub-provincial governments. The World Bank (2007) aptly points out that it “appears to be that a typical province makes little, if any, contribution to intergovernmental transfers to lower levels that are designed to equalize fiscal capacities” (p. 53). Worse still, evidence here and elsewhere suggests that provincial governments may capture some central transfers, which are supposed to be used to fund local projects and the provision of public services. Therefore, we should pay great attention to the role of provincial governments in the intergovernmental transfer system.

The hypothesis about a negative relationship between transfer dependency and fiscal decentralization has been confirmed in a study using the case of Russia. Freinkman and Plekhanov (2009) find that those transfer-dependent regions tend to have greater fiscal centralization, other things being equal. As central grants flow through regional governments, it would be possible for them to spend the transfers rather than distribute them to lower-level governments.<sup>1</sup> When controlling for all other regional characteristics, higher transfer dependency is found to be associated with lower fiscal decentralization.

Cross-national evidence, however, suggests that a greater amount of fiscal transfers tend to encourage more local expenditure as soft budget constraints arise (Bodman & Hodge, 2010; Letelier, 2005).<sup>2</sup> Higher transfer dependency thus is associated with greater fiscal decentralization. Another line of inference also supports the positive relationship between transfer dependency and fiscal decentralization. As intergovernmental transfers partially serve to compensate local governments for their implementation of central mandates, swelling transfers to local governments mean that local

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