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Regional decentralization and fiscal incentives: Federalism, Chinese style

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Abstract

Aligning the interests of local governments with market development is an important issue for developing and transition economies. Using a panel data set from China, we investigate the relationship between provincial government's fiscal incentives and provincial market development. We report three empirical findings. First, we find that during the period of "fiscal contracting system" the discrepancy between ex ante contracts and ex post implementation was relatively small, suggesting that the fiscal contracts were credible. Second, we find a much higher correlation, about four times, between the provincial government's budgetary revenue and its expenditure during 1980s and 1990s as compared to 1970s, demonstrating that provincial governments faced much stronger ex post fiscal incentives after reform. Third, we find that stronger ex ante fiscal incentives, measured by the contractual marginal retention rate of the provincial government in its budgetary revenue, are associated with faster development of the non-state sector as well as more reforms in the state sector in the provincial economy. This holds even when we control for the conventional measure of fiscal decentralization. Finally, we compare federalism, Chinese style, to federalism, Russian style.

JEL classification: P35; P51; H77
Keywords: federalism; local government; fiscal incentives; economic development; transition

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1. Introduction

Reforming the government is a crucial component of both the transition from a planned to a market economy and economic development. Creating thriving markets in these economies typically requires transforming a highly centralized and interventionist government into one that supports the market and fosters decentralized economic activities. Democracy, separation of powers, and the rule of law are among the important institutions that allow citizens to hold the government accountable for its economic actions and to secure markets from arbitrary state intrusion. By devolving power from the central to local levels, federalism is another institution that helps implement a limited yet effective government conducive to market development.

Economic theories of federalism have traditionally emphasized allocative benefits of decentralization in the provision of public goods and services, such as education and health care. There are two related ideas. First, Hayek, (1945) discussed the use of knowledge in society, emphasizing that local governments have better access to local information, which allows them to provide public goods and services that better match local preferences than the national government. Second, Tiebout (1956) introduced the inter-jurisdictional competition dimension and argued that such a competition provides a sorting mechanism to better match public goods and services with consumers' preferences. Drawing on these ideas, Musgrave (1959) and Oates et al. (1972) built a theory of fiscal federalism, stressing among other things the appropriate assignment of taxes and expenditures to the various levels of government to improve welfare.

Our main concern in this paper is the relationship between fiscal incentives facing local governments and local government promotion of market development in the local economy. Recent experiences of transition and developing economies have shown that a central barrier to economic development in these countries is from the governments, especially local governments, as their policies are often hostile to local business development. Local government policies, such as business regulation and levies, may have either favorable or adverse effects on the entry and expansion of local business enterprises. This leads to two types of government role that have been identified in the literature (Shleifer and Vishny, 1998): The government either plays the role of the "grabbing hand" by restricting and preying on productive enterprises and protecting unproductive ones, or it plays the role of the "helping hand" by supporting productive enterprises and disciplining unproductive enterprises.

Our study of federalism centers around the question of how the central–local governmental relationship affects the local government's behavior toward business enterprises and market development. A crucial issue is what kind of federalism better aligns local government incentives with promoting markets and productive enterprises.[1] Inter-jurisdictional competition can serve as an important incentive device, as emphasized by Tiebout and Brennan and Buchanan (1980): competition rewards local governments friendly to markets as factors of production move to their regions, while it punishes

[1] The recent theory of "market-preserving federalism" studies the general question of how federalism can be structured to promote market development (e.g., McKinnon, 1997; Qian and Roland, 1998; Qian and Weingast, 1996; Weingast, 1995; Wildasin, 1997; Zhuravskaya, 2000).