

# The tradeoff between growth and equity in decentralization policy: China's experience<sup>☆</sup>

Baoyun Qiao<sup>a</sup>, Jorge Martinez-Vazquez<sup>b,\*</sup>, Yongsheng Xu<sup>b</sup>

<sup>a</sup> School of Public Finance and Public Policy, Central University of Finance and Economics, Beijing, China

<sup>b</sup> Department of Economics, Georgia State University, USA

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## Abstract

This paper investigates the potential tradeoff between economic growth and regional equity in the design of fiscal decentralization policy in the context of China's experience. We develop a theoretical model of fiscal decentralization, where overall national economic growth and equity in the regional distribution of fiscal resources are the two objectives pursued by the central government. The model is tested using panel data for 1985–98. We find that fiscal decentralization in China has led to economic growth as well as to significant increases in regional inequality.

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## 1. Introduction

The fundamental objective behind China's economic reform starting in the early 1980s was to develop the country's economy in view of the failure of the socialist planning model. A basic premise of this strategy was to decentralize decision making with the belief that local governments could allocate some of the available resources more efficiently than the central government had done until then. Close to twenty years of decentral-

ization reforms have followed during which the share of central government expenditure in the general public sector budget decreased from about half in the beginning of the 1980's to a little over one-fourth in 1998. China's economic strategy explicitly accepted that economic growth would not benefit all regions the same, but would let at least some of them have more opportunities to catch up with the global economy. As former leader Deng Xiaoping had put it: "Let part of us be richer first." The relationship between growth and equity in the distribution of income<sup>1</sup> has been widely discussed in the economics literature.<sup>2</sup> There has been

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\* Corresponding author. Department of Economics, Andrew Young School of Policy Studies, Georgia State University, PO Box 3992, Atlanta, GA 30302-3992, USA. Tel.: +1 404 651 3989; fax: +1 404 651 3996.

E-mail address: [jorgemartinez@gsu.edu](mailto:jorgemartinez@gsu.edu) (J. Martinez-Vazquez).

<sup>1</sup> Distribution of income is defined across the population as opposed to across regions.

<sup>2</sup> The growing consensus is that there is a negative relationship between inequality and growth Barro and Sala-i-Martin (1995) and that initial inequality is detrimental to long-run growth (Benabou, 1996).

much less research on the relationship between growth and inequality in the geographic distribution of resources or fiscal disparities, though there has been a recent debate in the decentralization literature as to whether fiscal decentralization accelerates or retards economic growth.<sup>3</sup> On the other hand, there seems to be a general agreement in the decentralization literature that, all else being equal, unfettered fiscal decentralization can lead to a concentration of resources in a few geographic locations.<sup>4</sup> To the best of our knowledge, no empirical analysis of the impact of decentralization on the geographical distribution of resources has been done.

The purpose of this paper is two-fold. We first develop a theoretical model of fiscal decentralization, where overall national economic growth and equity in the distribution of fiscal resources among subnational governments are the two objectives pursued by the policy maker, to examine the tradeoff between growth and equity in the context of China's fiscal decentralization policy. The theoretical model allows us to investigate the conditions under which a policy tradeoff between these two objectives arises. Second, we test the model predictions with data covering the 1985 to 1998 period of fiscal decentralization in China.

The rest of the paper is organized as follows. Section 2 briefly reviews China's decentralization policy over the last 20 years. Section 3 develops the theoretical model and presents its implications. Proofs of our formal results in Section 3 are organized in the Appendix. The empirical tests are conducted in Section 4. Section 5 concludes the paper.

## 2. Fiscal decentralization in China

Fiscal decentralization has been one of the most important policy thrusts undertaken by the Chinese government during the last two decades of economic reform from planned socialism (Qian and Weingast, 1996; Demurger et al., 2002). Although far from being highly decentralized, at least by conventional measures (Bahl, 1999), China has undergone considerable decentralization. Decentralization has been shaped by the two major fiscal reform thrusts that took place during this period. The first reform started in 1985, and became known as the "Fiscal Responsibility System" (FRS), and the second reform started in 1994, and was termed as the "Tax Sharing System" (TSS).

Historically, China had a centrally planned economy and unitary fiscal system in its "Soviet Socialism" era. After several fiscal decentralization experiments in the 1978–84 period, particularly the reforms known as "eating from separate kitchens" in 1980, fiscal reforms started in earnest in 1985 with the FRS. The essence of the FRS was a contracting system, whereby the central government allowed provincial governments to retain part of the tax revenues remaining after the remittance of a fixed sum to the central government for a certain period of time. In 1988, the central government introduced the Fiscal Contracting Reform, which established more stable schemes in the contracting system, lasting until 1993. A key aspect of the FRS was that provincial governments could get more fiscal revenue by collecting more tax.<sup>5</sup> On the other hand, the FRS created several problems for the central government. For example, to have a higher local economic growth, local governments could contribute fewer fiscal resources to the central government.<sup>6</sup> This could be the case if local governments tried to slow the growth of budget revenues by giving local enterprises more direct resources and incentives, such as tax exemptions frequently at the expense of central government revenues. This weakness of the FRS eventually led to the decrease of the central government share in total budgetary revenues and to a lower share of total budgetary revenue in GDP. Extra-budgetary funds provided a way to shield tax collections from the central government and also an alternative way to finance local governments' expenditure without the risk of an eventual claw-back by the central government (Bahl, 1999; Wong, 2000). Extra-budgetary funds actually were used to finance all types of local government expenditure needs.<sup>7</sup>

Realizing these shortcomings of the FRS, the central government adopted the TSS in 1994. Major goals of the

<sup>3</sup> See for example Devarajan et al. (1996) and Qian and Weingast (1996).

<sup>4</sup> See for example Prud'homme (1995) and Murphy et al. (1995).

<sup>5</sup> Jin et al. (1999) note the strong fiscal incentives provided by this reform leading to "market preserving federalism." In contrast Knight and Shi (1999) argue that the high marginal rates effectively levied by the central government on the revenues collected by the province had a significant negative impact on subnational tax effort.

<sup>6</sup> Actually, the lack of strict tax laws and influence on the tax administration gave provincial governments power over their effective tax rates and actual tax bases, even if local governments did not have legal authority over either.

<sup>7</sup> Wong (2000) argues that the piecemeal intergovernmental reform in China led to a mismatch between expenditure responsibilities and revenue sources at the local level. In this context, extra-budgetary funds have worked as a safety valve allowing subnational governments to provide basic service levels, which would not have been affordable from regular budgetary financing.

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