

**SUBNATIONAL PUBLIC FINANCE IN CHINA:  
THE NATURE, CAUSES, AND CONSEQUENCES OF THE 1994 FISCAL  
REFORMS**

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## ABSTRACT

This dissertation aims to explain the nature, cause, and consequence of *informal* fiscal decentralization in China since 1994. The 1994 tax reforms intended to strengthen the central government taxing power by increasing tax revenue through the tax assignment system. China also prohibited local government debt taking, while increasing intergovernmental transfers between the central government and local government. These series of China's centralization reforms in 1994 have realized uneven success. Central government tax revenue was improved significantly. However, local government still takes debt through the financial platform companies. The increased intergovernmental transfers did not decrease regional disparity, which is one of the goals of the central government. These are the unintended consequence of the centralization reform that this study tries to account for.

This study shows that revenue centralization unintentionally aggravates problems of local public finance. While maintaining the budget balance according to budget law, local government has carried out competitive economic growth and expenditure management. The ability to manage expenditure and attract investment is the criteria employed to evaluate the accomplishment of local leaders.

This study finds that prohibition of local government debt in China is constrained by their social network. This norm influences the strategy of local governments to increase their debt taking beyond the realm of formal rules under the competitive environment. This study also demonstrates that centralization of revenue made local governments increasingly resort to intergovernmental transfers, which in turn fail to reduce inequality across jurisdictions.

This study argues that an *informally* decentralized state reduces the merits of the decentralization. The *informal* consequence of the political and fiscal systems in China result in local leaders that acquire the medium level of change in power, while pursuing fiscal decentralization and maintaining political centralization. However, the unintended consequence is the retreat of the fiscal system, such as the increased fiscal instability and large gaps across jurisdictions.

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## **LIST OF ABBREBRIATIONS**

CBRC: China Banking Regulatory Commission

CCP: Chinese Communist Party

CPRs: Conflict Prevention and Resolution

EBR: Extra-budgetary revenue

Exim: Export-Import Bank

GDP: Gross Domestic Product

HI: Historical Institutionalism

LGFPs: Local Government Financing Platforms

MOF: Ministry of Finance

NPLs: Non-Performing Loan

NTB: National Tax Bureau

PBOC: People's Bank of China

PRC: People's Republic of China

RCI: Rational Choice Institutionalism

SOE: State Owned Enterprises

SRF Self Raised Funds

TRS: Targeted Responsibility System

TSS: Tax Sharing System

VAT: Value Added Tax

VTBs: Village and Township Banks



## **Chapter 1**

### **Introduction**

#### **I. Purpose of Study**

The purpose of my research is to explore the nature of the Chinese tax reforms in 1994, discuss the causes of the tension between the central and subnational governments after 1994, and demonstrate its consequence as an informal decentralization. This dissertation mainly argues that although the Chinese central government strengthened its formal fiscal centralization through the tax reform in 1994, it paradoxically produced an informal fiscal decentralization as a consequence. The Chinese central government centralized its revenue system, while maintaining an administrative decentralization and political centralization in 1994, but fiscal centrifugal forces against the centripetal reform emerged despite their politically strong partisan arrangement. To establish this, I will examine the subnational governments' behavior as they provided public goods in their jurisdictions with a wide range of budgetary and extra-budgetary revenue. The study of the subnational governments' behavior with regard to public finance is the most effective way of understanding these political and fiscal institutions, as well as the nature and pace of economic reform in China.

After opening its economy toward the world in 1978, China has reformed fiscal system several times. The most radical tax and fee reform were launched in 1994 and in 1996 respectively. Their intention was to improve the state taxing capability, particularly the central government's, and to control the subnational governments' extra-budget collection. The tax reform in 1994 as a centralized concept was also expected to regulate subnational governments, while the reform did not reduce the subnational governments' expenditure responsibilities. (OECD 2006; World Bank 2002), it reduced their tax ratio vis-à-vis the central government and

limited subnational government debt financing (Budget Law, 1994).

Nonetheless, the consequence of the reform turned out to be that the central government actually could not accomplish its goal. The central government compelled the subnational governments' compliance to the new fiscal policy by increasing the central government's revenue capabilities and decreasing the local governments' fiscal autonomy. However, this paradoxically increased several undesirable effects. The Subnational governments' resistance to this revenue reduction undermined the reform.—(1) by increasing revenue base on extra-budgetary system , and (2) by failing to reduce the regional disparity in distributing fiscal transfers, which has become a new goal.

First, although fiscal centralization has decreased the local governments' budgetary autonomy, it also has created incentives for local officials to seek their own unrestricted fiscal sources. These include means such as; fee revenues, real estate-based revenue, and indirect debt taking, as long as they comply within the law. As for the unregulated revenue sources, the subnational governments have begun to utilize financing vehicle companies, which have taken on huge amounts of indirect debt on behalf of local governments. The local governments' financing vehicles have invested in infrastructure development which resulted in the housing market bubble after 1994.

This centralization and the centrifugal forces comprise an institution called the “paradox of the fiscal centralization.” Although previous literature has indicated that the subnational government deficits resulted in an increase of central government expenditures and debt (Fornisari et al., 1998 in Rodden, 2005, p. 4), or inflation (Treisman 2000 in Rodden, op. cit., 2005, p. 4), optimists argue that the Chinese government is able to recapitalize the debt (Reuters, Jun 27, 2011). The problem is that the central government failed to collect accurate data on the

debt. The central government could not penetrate into the subnational level to uncover information under the informal decentralization. Government ministries, government bodies such as the central bank and the bank regulator, and scholars each provide different estimates for the amount of outstanding debt. (Ibid.).

Secondly, even after the tax reform in 1994 when the central government could increase its revenue and, hence, intergovernmental transfers from the central sources increased, the central government has not been able to reduce the regional disparity. This is largely because local governments fail to equalize their public good distribution while allocating transfers according to their purpose.<sup>1</sup> This is one of the major reasons why the second generation of economic reformers, Hu Jintao, and Wen Jiabao, have failed to reduce the disparity across regions, despite employing substantial rhetoric for such a decrease in economic disparity among regions.

Actually, the central planners sought to regulate subnational officials' behavior in several aspects. In order to reduce extra budget, the central government has gradually incorporated some types of extra budget into their budget revenue throughout the reforms. For example, the profits of state-owned enterprises (SOEs) became an enterprise income tax. The central government has also reduced the real-estate bubble with the subnational governments through mutual cooperation. The central government did not bailout the subnational governments' financing vehicle companies, either—for example, some asset management companies in Guangdong areas (Jin et al. 2003).

Recent studies consider federalism and decentralization as a substantial form of fiscal

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<sup>1</sup> Another reason is that local governments have different strategies between rich and poor areas, given different endowments. While the poor have waited for help from the center, the rich have tended to pursue fiscal autonomy. A government officials I met call this the discrepancies between fiscal right and tax right (财权, 税收不统一) (An Interview with a official at Shandong, July, 2011).

discipline against any fiscal imprudence (Treisman 2000 in Rodden, op. cit., 2005, p. 4). On the other hand, federalism and fiscal decentralization also play the role of fiscal indiscipline and creating the as the possibility for fiscal imprudence depends on the fiscal sovereignty (Ibid.).

The puzzles are, in the hierarchical Chinese Communist Party (CCP) where party discipline is very strong, why did local officials undermine their fiscal centralization in 1994? What factors facilitate some subnational governments balancing budget, while others perform deficit spending? What factors facilitate some subnational governments taking care of socially dependents, while others' priority is administration? How does the central government regulate local officials and units of government? How is it possible for local officials to challenge the central government's tax reform scheme and continuously employ favorable regional policies? What are the consequences of the local officials' fiscal behavior? As consequences, what accounts for the cross-regional variation in the fiscal behavior of the subnational governments, and what are the implications for the public sector in China? To seeking the answer for these questions, I will develop (1) why the central governments implemented the 1994 reform, (2) what changes were made through the 1994 tax reform, (3) why the local government tried to change the institution, and (4) what institutions have developed since the reform, and what extent can the reforms after 1994 can be regarded as consequences of the 1994 reforms.

In seeking these answers, this study discusses the disruptive changes brought on by the 1994 tax reform and the impacts on the local government strategies by examining two issue areas: central government grants, and debt-taking. In addition, this study will figure out how norms, politics, Chinese styles, and institutions influenced local officials' fiscal behavior and built the fiscal institutions in China. This dissertation develops a set of analyses about the informal decentralization in China that go together with trends of recent studies that focus on how

institutions influence the forms of fiscal decentralization across countries, and as a conclusion, contains some policy suggestions.

This dissertation delves into the local government loan policy and also local government's expenditure as it was affected by decentralization. This dissertation establishes that the Chinese local governments do not have tax autonomy; they have increased their local government loans by creating an informal decentralization. In addition, an important cultural factor in China, the so called *guanxi* (关系) (network), compounds the relationship between decentralization and local government loans. It establishes that *guanxi* positively increases local governmental loans in specific fiscally independent regions. Second, it also posits that that after receiving intergovernmental transfers, the fiscally independent regions invest in public welfare and regional economic growth, while dependent regions spend more for public administration.

## **II. Literature**

The literature on decentralization and federalism generally has focused on such questions as whether the decentralization improves political and economic well-being. It also describes what kinds of constraints might increase the fiscal and political incentives within the decentralization. They seek to understand how this relates to successes or failures in people's welfare in the various contexts. Like general literature, the abundant literature on decentralization in China examines whether decentralization contributes to China's economic growth and improves public good provision; it identifies what kinds of the fiscal and political incentives in Chinese decentralization increase efficiency related to taxing, spending, and economic growth. It often investigates how the multi-tiered government shares information in Chinese decentralization; and how old informal institutions reduce the efficiency of formal institutions.

This section reviews major literature on institutional development of federalism, centralization and decentralization, explores the applied studies of these theories, and suggests further development in decentralization and federalism and in particular study for China. In detail, it develops questions about how informal institutions reverse the central government reform effort in the context of highly political centralization and how informal institution influence on information revelation.

Historically, literature on decentralization and federalism unfolds its focus from normative to positive ground. Since the middle of the 16<sup>th</sup> century, literature has discussed whether the power and authority should be devolved among multi-level governments and between the state and society over a long time period. Following the normative literature, the empirical research in the 20<sup>th</sup> century finds that decentralization has diverse effects on numerous and diverse areas: devolved political and fiscal power also causes political and economic side effects.<sup>2</sup> Facing multiple problems across countries, recent literature after the 2000s seeks to describe the political and fiscal conditions and constraints which have led to failures or successes with decentralization in different countries. Those conditions, constraints and consequences include impacts of both formal and informal institutions. Following this new trend, my paper builds upon Kathryn Stoner-Weiss (1998), and figures out the subnational governments' preferences have been developed in the context of formal centralized countries. One of the findings of this dissertation is that a problem may be caused by a factor in some jurisdictions but not be so in others. It also looks at the role of informal institutions in the decentralization context.

The normative claims concerns whether devolving power to various parties can result in

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<sup>2</sup> Decentralization was introduced into developing countries during the 20<sup>th</sup> century.

political justice and/or economic efficiency.<sup>3</sup> The advocates of decentralization argue for self-determination and economic growth. Political scientists' views are that federalism diminishes the despotic force of "a sovereign, centralized state" by constructing self-determination of local interests (Ferguson (1767), Paine (1791-2), and Tocqueville (1835) in Keane, 1988, p.40-55)<sup>4</sup> Economists viewpoint are that decentralization increases efficiencies (Tiebout, 1956; Oates, 1999; Hirschman, 1970; Weingast and his students). The scholars studying China also argue about the benefits of decentralization, which has been the driving force for economic growth in China in the 1980s, while still maintaining a significant degree of political centralization (Oi, 1992; Jin et al., 2005).

Skepticism about decentralization has been highlighted since the 1990s when decentralization was seen as favored and was adopted by many places in the world (Hegel, 1821; Prud'home, 1995). In particular, the devolution of power to subnational governments has not been seen to be beneficial to jurisdictions in developing countries. Subnational governments in some countries failed to be accountable to their citizens, promote markets, and provide public goods corresponding to the voters' demand. Empirical studies highlight that the local officials and politicians behaved in their own self-interest and many failed to stabilize the economy.

Both the central government and civil societies are incapable of checking the local cronyism and corruption. Without any incentives, there still exists an information asymmetry for the regional public goods between regional governments and the voters, and between the regional governments and the upper level governments. The multi-tiered governments lost their capability to reduce the regional disparity between and within regions. Local oligarchies have

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<sup>3</sup> Basic concepts are defined and discussed in the "Glossary."

<sup>4</sup> These theorists are confused in that federalism is equal to decentralization.

been found to be unjust, and their mutual competition is detrimental by repressing each other. In addition, subnational governments easily engage in this “destructive competition” (Ibid.). Ironically enough, most of the empirical research in developing countries shares the underlying thought with Tocqueville, who advocated for federalism, contending that citizens do not or, furthermore, cannot act on their interests due to political and institutional constraints.

Observing the multiplicity of situations among different regions, recent literature postulates both particular ways and reasons, which determine the unique patterns of political and fiscal consequences of decentralization. From the literature, it is determined that the danger of decentralization appears under the two different conditions. First, when the central politicians fail to discipline local politicians through partisan arrangements and to support regional electoral competition, the central government becomes politically and/or fiscally incapable of monitoring the danger of decentralization (Stoner-Weiss, 1998; Wibbels, 2005). Regional coalitions in national policy making also limit central politicians and create a pork barrel funding stream.

Second, when the central government fails to distribute the proper intergovernmental grants, it might create a fiscally harmful effect. When the grants are too small, the local governments struggle to provide social services within its own limited budget (Stoner-Weiss, op. cit., 1998). On the other hand, when they are highly dependent on grants rather than revenue collection autonomy, the subnational governments lose their autonomy (Rodden, op. cit., 2002), as the grants become a signal for the central government’s commitments on a bailout (Rodden, op. cit., 2005). When the subnational governments’ fiscal sovereignty is challenged with high level of grants, borrowing restrictions, low local tax autonomy and undisciplined partisanship, the possibility of subnational governments’ enormous fiscal debt crisis in the decentralized federation is increased (Rodden, op. cit., 2002; Ibid., 2005). This has happened in Argentina and



Brazil in Latin America during the 1990s (Ibid., 2005).<sup>5</sup> Although the literature does not have a consensus on when the danger of decentralization emerges, and/or when national interests are at a loss, it implicitly agrees that the danger of decentralization is enhanced if incentive structures encourage division leaders to manipulate information advantages, and if decentralization protects the local officials in their prevalent opportunism (Ibid., p. 7).

On the other hand, the benefit of decentralization is increased by including crucial factors. First, both intergovernmental party discipline and electoral competition in regional politics facilitate providing proper public goods provision and marketization (Wibbels, op. cit., 2005). The voters reveal the information for their preferences for public goods, and the local governments compete to increase welfare. Decentralization also gives local officials an incentive for information revelation with relation to the central government. Vivienne Shue (1994) explains that under a policy of decentralization, the central government is able to penetrate into the subnational governments' bureaucracies which strengthen the state in the state-society framework.<sup>6</sup> This trade-off facilitates marketization in China. Second, the revenue collection autonomy of the subnational governments, rather than a high dependence on grants, promotes economic growth in the regions (Rodden, op. cit., 2002).

While previous literature is overwhelmingly focused on the expected benefits and problems in a number of countries, Tulia G. Falleti (2005) focuses a consequence of the decentralization based on a sequential theory of decentralization. She begins to question the

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<sup>5</sup> On the other hand, Grodzin (1966) and most public finance theorists emphasize that intergovernmental grant decreases inequalities of basic services and improves the quality of state activities in "cooperative federalism" (382).

<sup>6</sup> Since the information collection has been costly for the central government due to the subnational governments' opportunism in China, previous studies focus on how the central government penetrates into subnational governments to collect information and to motivate them to develop economy and provide public goods. According to Shu (1994), the central government did not need to suffer from directly collecting information under the decentralization.

assumption that decentralization increases the power of subnational governments.

Table 1.1 Sequences of Decentralization in Falleti (2005)

Prevailing Interest in First Move	First type of Decentralization	Type of feedback mechanisms	Second type of Decentralization	Third type of Decentralization	Degree of Change in the intergovernmental power
Subnational	Political	Self-reinforcing	Fiscal	Administrative	High
National	Administrative	Self-reinforcing	Fiscal	Political	Low
Subnational	Political	Reactive	Administrative	Fiscal	Medium /Low
National	Administrative	Reactive	Political	Fiscal	Medium
Tie	Fiscal	Reactive	Administrative	Political	Medium /Low
Tie	Fiscal	Self-reinforcing	Political	Administrative	High

*Sources:* Falleti, 2005, p. 332.

As a historical institutionalist, Falleti (2005) argues that the order of political, administrative, and fiscal decentralization is selected based on the “prevailing interest in first move[r]” when adopting decentralization. The specific context refers to intergovernmental power arrangements and prevailing interests of participants. The order of decentralization reform establishes the particular sequence of decentralization that leads a country to undergo further directed reforms. According to the order, decentralization increases, maintains or decreases the power of subnational governments. The territorial preferences of level of governments are different. The central government prefers administrative decentralization (A) to fiscal decentralization (F), and fiscal to political decentralization (P), in other words  $A > F > P$ . The subnational governments prefers  $P > F > A$ . If the central government appoints and removes governors and mayors, and the subnational governments cannot have the fiscal resources to enforce their responsibility, decentralization decreases the power of subnational governments. On

the other hand, if the subnational governments are established through election, with an accompanying political decentralization, and have enough resources with a transfer of revenues to conduct responsibilities, the decentralization increases the power of subnational governments (Ibid., p. 330). The table 1.1 shows the degree of change in power of the levels of government (Ibid., p. 332).

Not all, but most research focusing mainly on the political and structural aspects of decentralization still overlooks informal decentralization as a consequence. This concept refers to a form of decentralization which is created outside the constitution. A wide variety of examples, each with different historical background and pre-existing conditions, have resulted in the creation of informal institutions. Informal decentralization might come about and be forced to be accepted before its effectiveness has been evaluated and before a social consensus is reached. Stoner-Weiss (1998) argues that the informal decentralization of Russia has been promoted due to a fiscally and politically incapable central government, and adaptive local governments. Above all, political institutions—legislative inertia; weak political parties; an ineffective constitutional court; weak ties between central ministries and local bureaucracies and between central and local political actors; regional representatives holding regional interest at the upper house of the Russian Parliament; and the weak political institutions such as the presidential representatives at each jurisdiction—facilitate the process (Stoner-Weiss, op. cit., 1998, pp. 7-8).<sup>7</sup>

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<sup>7</sup> Stoner-Weiss (1998) figures out the institutional factors which provoke informal decentralization in Russia as follows: democratization, the election of governors, representative government, and market economy (Stoner-Weiss, 1998, p. 5-7). Central officials in Russia are not able to discipline local officials for integration of Russian states through party system. Candidates of regional assemblies run elections without national party affiliation. As regional governors and heads of regional legislatures automatically acquire seats in the upper house of the Russian Parliament, the Federation Council, provincial politicians are strongly hold regional interests. The Constitutional Court is an ineffective body to check the rising tide of regional autonomy. The presidential representatives at each region failed to monitor all federal bureaucrats at the regional level, the fulfillment of the federal budget, and the use of federal property in the regions and to counterweight to the gubernatorial administrations in the regions. The

This dissertation follows up on recent works by examining the nature and causes in the context of a specific category of state in which institutions lie. The category refers to political democratization or authoritarianism, the election of governors or the appointment, and market or planned economy, fiscal centralization or decentralization, and so on. It also seeks to uncover the informal consequences of the political and fiscal systems in China. Building upon Falleti (op. cit., 2005), this research focuses on comprehending the consequences of both fiscal centralization, and administrative decentralization, in the context of political centralization in China. By the reform of the previous fiscal and administrative decentralization as its nature into fiscal centralization, the central government tried to increase its fiscal and political power, but unexpectedly it was faced with an informal form of fiscal decentralization in China. Norm represented political tolerance and social connection has been accepted and enforced beyond the official system in China. This research also identifies political and fiscal institutions which give local officials incentive to build informal decentralization. On the contrary to Russia, where the central government is politically weak, as cited in Stoner-Weiss, an argument is made that informal decentralization in China has been promoted with a strong partisan arrangement and with adaptive local governments. Nonetheless, as in Russia, the consequence of an informal decentralization produces a fiscally negative effect. This is partially due to a lack of incentives for transparency with the local information by the subnational officials.

### **III. Hypothesis**

This dissertation will describe the revenue centralization reform in 1994 as the “nature” of the

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leaders of federal organs in the regions would not submit the authority to the newly empowered presidential representatives.

reforms. It will hypothesize that the centralization has been succeeded, but it has also created unintended consequences which has brought harmful effect of common resources across the country.

The central government reformed revenue system to strengthen its revenue amount vis-à-vis its subunits'. China is a unitary system, where administrative division includes the central government, and its subunits, which are comprised of four levels of governments—provinces, prefectures, counties, and township. In most literature concerned on China, local government refers to all of these four levels of governments. Some literature also includes village level government, which is not legal administrative level, while functioning for village affairs. Among the four levels of local government, this dissertation focuses on four levels of government in chapter 2, city government which is comparable to prefecture or county levels in chapter 3, and county governments in chapter 4.

The actual budget of these governments consists of three components: on-budget accounting, extra-budgetary accounting—both of which refer to the formal budgets of all government levels—and off-budget accounting, which is not officially approved and recorded. OECD estimates off-budget expenditure over 8 percent (OECD, 2006, p. 2 and pp. 27-28). Thus, the statistics of official government revenue and spending actually underestimate the reality of off-budget amount.

Subnational governments are funded primarily through revenue-sharing and transfers, but also through off-budget accounting in extra system as secondary sources. The reforms in 1994 did not work as planned, due to lack of funding source facing subnational governments. It is the local officials' interest to extend extrabudgetary system. Local dependence on debt appears reasonable. Although transfers from the center to local governments are specified by purpose,

based on tax-based return or redistributive allocation, rule-based or discretionary, general or particular purpose, they are discretionary re-distributed at county level to fulfill their mandatory public good provision and satisfy its priority.

#### **IV. The Conceptual Framework: New-Institutionalism**

This dissertation adopts the framework of new-institutionalism to analyze fiscal system of local government in China. New-institutionalism (Shepsle, 1989) refers to a form of institutionalism that embraces political rational choice theory. The basic behavioral postulations of new institutionalism depart from that of traditional rational choice theory. James G. March and Johan P. Olsen, who introduced new-institutionalism in 1989, define political institutions as rules and routines which determine human behavior and appropriate actions (March and Olsen, 1989, p. 21 in Koelble, 1995). Since then, new institutionalism theory has developed, which has split into three categories: rational choice, sociological, and historical institutionalism (Hall, 1996; Koelble, op. cit., 1995, p.232). All the three categories of institutionalism embrace both formal rules, and informal rules—procedures, routines, norms and conventions—as institutions. The New-Institutionalists ask three questions on the way of actors' behave, the role of institutions, and the reasons of institutions' persistence overtime (Hall, op. cit., 1996, p. 939).

##### *Rational choice institutionalism (RCI)*

The basic behavioral postulations of rational choice institutionalism depart from that of traditional rational choice theory. In rational choice theory, a rational agent is an individual who is not determined by the social structures. RCI explores the features of social outcomes based on both the individual rational agent's preferences and the institutional features. Structural elements

and procedures combine with individual preferences produce social outcomes: the rational agents reveal their choices for alternatives by employing the specific strategy for the outcomes that are influenced in the institutions (Shepsle, 1989).

To rational choice institutionalists (RCI), an institution is created, maintains, and changes reflecting an actors' set of preferences in order to maximize their preferences (Douglas North, 1990; Koelble, op. cit., 1995; Hall, op. cit., 1996, p. 944-945 and p. 952). Institutions reduce uncertainty by providing information about the others' corresponding behavior (Hall, op. cit., 1996, p. 945). Thus, RCI considers institutions solve the collective action problems such as the 'prisoner's dilemma' and the 'tragedy of the commons' (Hall, op. cit., 1996, p. 934). Meanwhile, North (1990) perceives institutional change as "the marginal adjustments" corresponding to the price and preferences of individuals, shifting the incentives.

There are criticisms RCI faces. First, RCI cannot explain unintended consequences which are omnipresent in the world, and understate the much inefficiency that institutions present (Hall, op. cit., 1996, p. 952). Second, the RIC approach implies that institutions are to be created when Nash equilibrium is reached. In Nash equilibrium, if a player changes his/her own strategies, he/she only lose his/her interests. Thus, it is contradicted with the reason why existing institutions would be changed (Hall, op. cit., 1996, p. 953). Third, unlike RCI's argument, the consequences cannot be safely predicted from origins (Hall, op. cit., 1996, p. 952).

As one of the RCI, Oliver Hart (2001) structured the principal-agent model, pointing to the importance of securing private benefits with the patronage of human resources management, and the diversion of economic wealth as both causing potential conflicts. The model has been applied to enterprises in market economies, with a focus on the relationship between stockholders and managers. The importance of this model can be extended to a large extent to governance, with a

focus on principal-bureaucrats and/or politicians, who similarly secure private benefits as an effective incentive. However, the principal-agent model cannot be applied to China's central-subnational government relations as an analytical framework. Huang (1996) proves that the central government as principal and subnational governments as its agents play their role. Nonetheless, most importantly, the central government does not correspond completely as a principal; even governments correspond as agents often acting in ways contrary to the interests of the principal—the citizen.

Furthermore, Huang (1996) fails to explain that the nature, and unintended consequences of fiscal reform as this dissertation hypothesizes—a single political party creates in the institution of constraint of the domination, and informal decentralization. An incentive scheme designed by the center paradoxically induces conflicts between central and local governments. It is hypothesized that the principal variables for self-financing motivation in extrabudgetary system—such as debt financing and discretionary distribution of intergovernmental transfers in the regions—have significantly influenced economic growth, helped to provide public goods and increased the possibility of political promotion. Therefore, ironically, the centrifugal forces will dominate as long as there are incentives for governments to pursue subnational revenue maximization and secure private benefits for local officials. A main idea in this dissertation is to develop the idea that politics reduces economic efficiency by showing that the imperfect mechanism is full of inefficiency.

Instead, this dissertation will apply Elinor Ostrom's framework (1990) to analyzing Chinese informal decentralization. In Ostrom, the mixture of private and public institutions and relatively small scale proves successful management of scarce resource and prevents of the tragedy of commons. The reason, why some Conflict Prevention and Resolutions (CPRs) effectively govern



their resources and the others do not, depends on commitment, monitoring efforts, and information about rule compliance in the CPRs (Ibid., p.186-187). To give confidence for workability of the commitment and monitoring effort to the institutional members, additional three variables also turns out to be reliable or dependable, that is, “incremental self-transforming” (Ibid., p.190) in which small institutions can solve the problem by associating with other units as in the case of Philippine federation of zanjera (Ibid., p.189); “external political regimes” (Ibid., p.190) which could legally bother self-organization in Newfoundland; and information and transaction costs (Ibid., pp.190-191). By introducing these factors, Ostrom argues that the gap between the formal theories of collective action and the empirical cases can be filled. Nonetheless, this dissertation does not apply Ostrom as it is. Rather, it will juxtapose cases in Ostrom with China, showing how Chinese centralization reform has failed in certain extent, and created unintended consequences as historical institutionalists argue. Finally it will suggest how to redress the unintended consequences in China.

### *Sociological Institutionalists*

Sociological institutionalists focus on how existing institutions construct the idea of institutional reform (Hall, op. cit., 1996, p. 953).<sup>8</sup> They criticize rational choice institutionalism in that individuals cannot choose the institutional rules, procedures, and norms without restraint, because individuals are embedded in the institutions. Institutions identify actors’ preferences or identities that rational choice institutionalists consider taken as granted (Ibid., p. 951-952). “If rational choice theorists often posit a world of individuals or organizations seeking to maximize

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<sup>8</sup> Like other new-institutionalists, the sociological institutionalists argue that institution is an inclusive notion: “[i]nstitutions are not merely rules, procedures, organizational standards, but also conventions and customs” (Walter Powerll and Paul DiMaggio quoted in Koelble, 1995, p. 234).

their material well-being, sociologists frequently posit a world of individuals or organizations seeking to define and express their identity in socially appropriate ways (Ibid., p. 949).” Human behavior tends to stick with the established routines and is difficult to change (Powerll et al. in Koelble, op. cit., pp. 232-234). Thus, sociological institutionalism can usefully explain how the existing institution limits the range of new institutional creation. It also can explain the presence of the inefficient institutions based on cultural background and the reason why social legitimacy plays in the institutional change (Hall, op. cit., 1996, p. 953).

However, due to their over-socialized view, they faced a limitation on the explanation of institutional change (Powerll et al. in Koelble, op. cit., pp. 232-234). Sociological institutionalists also miss points to which institutional creation or change reflects power relations among actors with contending interest (Hall, op. cit., 1996, p. 953).

### *Historical Institutionalists*

Historical institutionalists share the same starting-point with sociological institutionalists in that institutions are multiple in a world (Ibid., P. 954). Thereby, they emphasize existing institutions mold processes of institutional creation and change (Ibid.). Meanwhile, similar to the rational choice theorists, the historical institutionalists do not deny that individuals pursue their own interests and acknowledge that individuals take on strategic behavior (Ibid., p. 954-955). However, historical institutionalists argue that the outcomes are produced by the interaction among the various groups based on the asymmetry of power (Ibid.; Koelble, op. cit.). As an historical institutionalist, Peter Hall (1986) says that “the organization of policy-making affects the degree of power that one set of actors has over the policy outcomes” and “the organizational position influences the actor’s definition of his own interests, by establishing his institutional

responsibilities and relationships to other actors” (Hall, 1986, p.19; Koelble, op. cit.).

Historical institutionalists seek to explain that the same operative forces will not globally generate the same results. The effect of operative forces will be intervened by contextual factors (Hall, op. cit., 1996, p. 941; Falleti, op. cit.) or contingency (Mahoney, 2000) along a set of path with the historical background. Early contingent events or contextual events create a trajectory of transform that result in an outcome and that deviates from other comparable cases. James Mahoney (2000) argues that the origin of choice or event is contingent during critical junctures, and thereby outcome does not necessarily efficient. Falleti (2005) emphasizes context in which the origin of choice or event happens.

An historical event in the trajectory is divided into continuity periods and critical juncture, which refers to the time when an institution changes and a new path develops along history (Hall, op. cit., 1996, p. 942). Path refers to the trajectory in which the past influences the present. Regardless of a new path happened by contingency or context at origin, there are two possibilities over how the trajectories develop later (Mahoney, op. cit.). First is reinforcing precedents: self-reinforcing might be locked-in by the reproduction of inefficient path as a sequence. Second is transforms of path or reverses precedents: this reactive sequence refers to both a reaction to precedent events and a cause of consequent events. Thus, sometimes, the path produced by institution might create unintended consequences and inefficiency rather than purposive and efficient (Hall, op. cit., 1996, p. 941-942).

This dissertation asks about nature, causes and consequences of the 1994 fiscal reforms. Building upon rational choice institutionalism, this research asks three questions: what the causes for fiscal reforms in 1994 are; what the facet of nature in fiscal reform after 1994 is; and to what extent revenue centralization after 1994 can be considered as the unintended consequences of in

China and the intergovernmental power. Informal institutions in China produce unintended challenges. The norm based on political connection drives China to undergo particular consequences of the decentralization. The reason for reform will explain the background when Chinese central government introduced the reform. The facet of the “nature” of the reforms will be described for the revenue, expenditure, and transfers after 1994 reform. This research also identifies political and fiscal institutions which give local officials incentive to build informal decentralization.

It hypothesizes that the 1994 reforms didn’t work as planned to the some facet. The consequences have accomplished intended result to the central government in some extend, but the extent the revenue centralization after 1994 have also created some unintended harmful consequences in China. Unintended consequences bring undesired results for the central government in China. Informal institution in China has influenced unintended consequences, which have been inefficient outcomes. Under political centralization, fiscal centralization effort has not had an impact on intergovernmental relations.

## **V. Application of New-Institutionalism In China**

### **: Institution, Informal Institution, and Unintended Consequences**

New institutionalism is the adequate theoretical frameworks to explain informal decentralization in China from its creation, to its consequences. My dissertation applies new institutionalism and points out that the sources of contrasting fiscal policy performance lie within the structure of the political and fiscal institutions, which define the incentives for revenue collection and allocation.

It focuses on how the relationship between the central government and its units has been

influenced or determined by the system and its distribution of authority throughout the formally centralized country of China. The political, fiscal, and cultural institutions and structures define the interactions between the central government and the subunits for the allocation of their authority. This also involves identifying the competing parties' interests, as it relates to the central and local governments and their interests. This is how the management of the government relationships affects the fiscal decentralization that results including the unintended consequences in Chinese fiscal system.

Integration of institutional analysis together with individuals' rational choice is a powerful tool to explain how the Chinese central-local governments are related. Indeed, the change in revenue centralization occurs accompanying the political framework, which influences the individual choices between the center-local governments. The questions needed to consider how the decentralized expenditures in China is financed in respect to these intergovernmental transfers and the mobilization of "own-source" revenue given formal and informal institutions, and how the "rationality" between the center and the sub-units modified the political and *de jure* fiscally centralized institution. Despite the fact that the central government does not allow the local governments to hold debt, and the local governments are prohibited from issuing bonds or having debt, they still do so, informally. The local governments have secured debt financing through Local Government Financing Platform (LGFPs). Meanwhile, the central government's rhetoric of equalization turns out to be empty, as its transfers do not reduce the fiscal inequalities. This dissertation will address the importance of the informal institutional consequence combination with the local governments' strategy for interest maximization in China. It will show that to what extent unintended consequences of fiscal system are connected with political, fiscal, and social institutions, that refer to sub-units limited authority over their tax revenue base

and rates, the top-down regulatory framework, and a traditional cultural factor in China. Therefore, one of themes of this study will connect their limited institutional design without mechanism that would inhibit the unintended consequences of the fiscal system within the top-down regulatory framework.

*Intended Purposes: Centralization, Decreased Transaction Cost, Local Information Revelation*

In 1994, in the face of declining revenue caused by incomplete and asymmetric information for the jurisdictions, the central government designed its revenue centralization and expenditure decentralization policy in order to smooth out revenue deficiency and public goods output. Before the reform, the central-subnational government had competed for their revenues. The central and subnational governments explicitly pursued maximization of tax collection, while subnational governments also took opportunistic behavior, engaging in excessive tax competition among jurisdictions. The central government could not monitor the competition with its limited capability. Thus, a structure was introduced to reduce the transaction costs, which connected political incentives with revenue collection capability in 1994 (Choi, 2006), and later the target responsibility system (TRS). The central government induces local governments' compliance by evaluating the local governments' fiscal provision and potentially changing the distribution of their political status. The portion of revenue has been also returned to the tax base areas to maintain their incentive. Not only revenue system, subnational governments' ability to promote economic growth and provide public goods has also influenced the subnational officials' promotions and turnover (Li et al. 2005; Enikolopov et al., 2007; Whiting, 2001, p.280). The central government correlated political and fiscal factors taking into account along with opportunistic behavior with subnational officials' promotions and turnover. Thus, the central and

local governments look for a balance between growth, the provision of public goods and services, and political status.

A typology of decentralization in Table 1.2 shows the separation of the fiscal autonomy for government revenues and expenditures. Revenue decentralization is related to the budget size—the revenue rate and base for total revenue, and revenue rate for levels of government—and simple collection power (Rodden, *op. cit.*, 2005). Expenditure decentralization is related to the decision making autonomy for the size of the budget and any resource distribution, such as the expenditure items and rates given the size of the budget (*Ibid.*). Accordingly, there are four combinations of fiscal centralization and decentralization: revenue centralization, expenditure centralization (RC, EC); revenue centralization, expenditure decentralization (RC, ED); revenue decentralization, expenditure centralization (RD, EC); and revenue decentralization, expenditure decentralization (RD, ED). The central government prefers (RC, EC), while local governments prefer (RD, ED) under formal institutions. In the combination of (RC, ED), the central government is further able to weaken the local governments' fiscal autonomy by influencing the intergovernmental transfers and by limiting the ability of the local government to take on debt, while imposing an expenditure responsibility on the jurisdictions (*Ibid.*; Eyraud et al., 2011).

Table 1.2 Typology of States by the Fiscal Autonomy of Central and Local Governments

	Revenue Centralization (RC)	Revenue Decentralization (RD)
Expenditure Centralization (EC)	(RC, EC) Centralization Very Weak Fiscal Autonomy	(RD, EC) Semi-Decentralization Weak Fiscal Autonomy
Expenditure Decentralization (ED)	(RC, ED) Semi-Decentralization Weak Fiscal Autonomy Argentina China after 1979	(RD, ED) Decentralization Strong Fiscal Autonomy U.S.

RC: Revenue Centralization, RD: Revenue Decentralization, EC: Expenditure Centralization, ED: Expenditure Decentralization

As a result of the central government designed mechanism to increase revenue, formal fiscal system in China is positioned at revenue centralization and expenditure decentralization. Through this combination of (RC, ED), the central government has increased their own tax revenue and the whole tax revenue in China by reducing tax competition across jurisdictions. While holding the power to override local decisions for local fiscal autonomy, the central government cedes the expenditure responsibilities, allows the tax collection authority for local taxes, and distributes transfers. Meanwhile, the central government has not devolved political authority through a political appointment system throughout whole economic reform period since 1978.<sup>9</sup>

However, while succeeding at reducing the uncertainty of tax collections (Choi, 2006), centralization fails to increase the revelation of local information on extra-revenue sources and expenditures. While the political incentives facilitated revenue increase for the central government, decentralization of the expenditures along with the lack of funding limited the ability of the central government to acquire the information on the local governmental fiscal choices. Furthermore, sub-units have their extensive discretionary authority to set their own revenue sources through extra-system and expenditure priorities.<sup>10</sup> Thus, these sub-units utilize these resources to increase their interests as next section.

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<sup>9</sup> If applying Falleti (2005), who is a historical institutionalist, the sequence of the reform is expected to increase the central government power vis-à-vis local governments.

<sup>10</sup> Own source of revenue refers to independent revenue, user fees, and debt, rather than tax revenue, which is shared with the center and which local governments have limited authority over.



### *Local Government Strategy and Informal Institutions*

Each level of government seeks to change its current institution, when their interests change and they perceive the cost of change is lower than the cost of the *status quo*. Depending on their context of legality, local governments sometimes expand their autonomy beyond the constitutional limitations and create their informal institutions. The combinations of local government strategies and institutional types are embodied as in Table 1.2. The levels of government apply four strategies in both their formal and informal institutions to change their fiscal centralization. These strategies are coercion, struggle, bargaining, or consent, given the context of legality which administers the interaction between the central-local governments as shown in Table 1.2.<sup>11</sup> Coercion is adopted when a strong political party forces conclusion without mutual agreement between political parties. Consent is agreed when a satisfactory conclusion is reached after bargaining process. Struggle is applied when a political or monitoring vacuum exists, and/or an unsatisfactory conclusion is reached. Bargaining is a repeated negotiation processes to reach to a conclusion. These strategies are relevant to institutionalized pattern in central-local relations and thereby the payoffs. The payoffs of these strategies are formal centralization, decentralization, informal decentralization, and informal and chaotic decentralization as described in Table 1.3. Hutchcroft (2001) described post-1991 Somalia as an extreme case of the struggle under the chaos and anarchy of decentralization.

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<sup>11</sup> Yongnian Zheng (2007) considers these strategies as institutions of coercion, bargaining, and reciprocity (Zheng, 2007, p. 53-54).

Table 1.3 Typology of States by the Relationship of Central and Local Governments under Informal Institutions

		Formal Institution	Informal Institution
		Formal C or Formal DC	Informal DC
		Strategy 1 Coercion Consent	Strategy 2 Bargaining Struggle
Formal C	Strategy 1 Coercion Consent	(C,C) Suharto (Indonesia)	(C, IDC) China after 1978
Formal DC	Strategy 2 Consent	(DC, DC) U.S.	(DC, IDC) Democratic Philippines Post-1991 Somalia

C: Centralization, DC: Decentralization, IDC: Informal Decentralization

Table 1.4 describes the combinations of local government strategies and institutional types abiding with the political factors. It demonstrates that the change from formal centralization into *informal* decentralization is facilitated by adopting a bargaining or a struggle regardless of the political discipline. However, the local governments did not devote their resources to a changing of the formal institutions under the political hierarchy, because the political cost of taking such a risk might be higher than the benefits. The informal institution and centrifugal forces in China are tolerated by the central government as long as it does not challenge to the degree of threatening the central government's authority. Regardless *de facto* threatening exists, the central leaders are scared about the perceived challenge against regime (Yang, 2004). The tolerance between levels of government is the norm for intergovernmental relations in China (Zheng, 2008). Thus, the Chinese central-local relationships are defined by their political, economic, and social constraints, which range from formal rule and regulation to informal arrangements.

Table 1.4 Typology of Strategy Applied by the Local Governments

			Strategy 1	Strategy 2
			Formal Decentralization	Formal or Informal Decentralization
			Coercion Consent	Bargaining Struggle
Strategy 1	Centralization or Decentralization Under Political Discipline	Coercion Consent	US (DC, DC)	China after 1978 (C, IDC)
Strategy 2	Centralization or Decentralization Under Political Indiscipline	Struggle	Democratic Philippines (DC, IDC)	Russia (DC, IDC) Post-1991 Somalia (DC, IDC)

Attempting to maximize their particular interests within the political centralization and particular cultural background, the subnational governments in China changed the fiscal centralization relationship. Subnational governments in China expanded the informal institutions beyond the formal structure and maintained their fiscal autonomy. Rational local governments effectively use the resources—norm, in which the local governments likely have interests—to modify centralization. The cultural factors which persisted in Chinese societies contributed to this path making. The pervasiveness of their informal behavior still takes place during the institutional transformation. The pervasive use of personal networks within Chinese society and the center's tolerance in exchange for stability in the central-local relationships created the informal decentralization. The subnational officials enable to increase the size of their budgets and reduce the impact of revenue centralization by the using extrabudget system, taking on debt, and diverting any transfers. By doing so, they are able to increase their autonomy in managing their budget and smoothly carry out their responsibility without addressing the lack of funding sources. While the local officials utilize culture and custom, the central government has continuously

compensated for the institutional weakness, learning through trial and error. However, as Qian et al. (1996) showed, while the elusive notions of decentralization play such a major role in economic growth, the decentralization path cannot be reversed by the Chinese central leaders.

### *Unintended Consequences: Institutional Change, Transaction costs, and Consequences*

The evolution of an institution does not always create an environment for efficiency or equality. Once created, the institutions change, but the equilibrium of the changes is influenced by the various parties' perception for their interests (North, 1990). Regardless of their efficiency, institutions have persisted over time. Thus, the institution did not gradually converge for more efficiency.

In particular, the Chinese fiscal system is identified with an inefficient equilibrium because it is highly influenced by politics. Politics reduce efficiency, that is accepted as axioms. Informal decentralization in China shows how political factors help to create unintended problems. Indeed, any inefficient institutions have been replaced by the central government during reform period, and fiscal policy has gradually converged toward efficiency, but the fiscal centralization, which results in one of incremental transformations, creating unintended consequences of informal decentralization. The hierarchical political structure is designed to facilitate economic growth, and to assist the central government in its overall fiscal plan. However, the structure leads to informal decentralization across the country, which results in ineffective and unequal fiscal policies as unintended consequences. The reform to avoid excessive tax competition could not avoid exploiting resources across China. This is due to incompleteness of institution during the reform period—such as lack of rule of law, commitment, and monitoring system—which hardens informal decentralization.

Unintended consequences are opposite result to what was intended. The intended consequences of purposive behavior are relatively beneficial to the party, though they may be negative to an outside party (Merton, 1936, p. 895). The nature of unintended consequences does not have to be disadvantageous (Ibid.). Economists call unintended consequences externalities which are categorized into both positive and negative externalities. Positive externalities refer to unintended benefits. Negative externalities are again grouped into two types: unintended harmful consequences taking place in addition to the intended benefit of the policy, and perverse consequences differing from what was initially intended consequence of the policy.

Unintended consequence in Chinese fiscal system is narrowed into unintended harmful effect and semi-intended consequences. Several beneficial consequences are created through the reform in China. Unified tax rates across China enable the central government assess taxes without negotiation between the center and local governments and between governments and enterprises, and thereby increase transparency. Increased tax amounts for the whole country solve funding problem facing the center. However, unintended harmful consequences take place—the extending local government indebtedness and the discretionary distribution of intergovernmental transfer.

The consequences of the subnational government behavior are not intended either by the central or the subnational officials. However, a closer examination of the consequences of informal decentralization reveals that the initiation of the consequences is “intended” by the subnational governments, to side-step centralization. Furthermore, central leaders tolerate these local practices. As long as the extent to which the center tolerates these practices, the consequences become “semi-intentional” by those that did not originally “intend” them. Thus, unintended consequences in this dissertation mean “semi-intentional” consequences.

Institutional change from centralization to informal decentralization occurs with the political arena, and it involves a redistribution of fiscal resources. Although this dissertation does not evaluate the impact of the exact efficiency over economy and fairness, the consequences of the informal decentralization can be clearly seen. Informal decentralization led by local governments might face a twin problem, which could happen in both a centralized and decentralized system. Centralization is subject to incomplete information. As happened in a centralized system, politically the informal decentralization cannot reduce the central government's despotic force as the scholars have point out for a long time. Fiscally, the informal decentralization worsens the information asymmetry between the upper level and lower level governments. The local governments do not voluntarily reveal their regional revenue and expenditure; but the existence of uncertainty supports the local officials' and politicians' self-interest when neither the central government nor the civil society fails to check the local governments. As happened in decentralized system, unintended consequences refers to the exploiting subunit extra budgetary system—assessing excessive fee for extrabudget account, debt financing that is prohibited by law, and distributing intergovernmental transfer for the political priority. The limited funding sources facing subnational government drives them exploiting common resources. Under a politically destructive competitive environment, regional disparity increases between and within the regions. Nonetheless, under the rigid political hierarchy, competition is accountable to the central government. The coercive power of the state allows for opportunism in administrative rulings for the redistribution of fiscal resources to those who are politically advantaged or current officials. Therefore, the fiscal resources will not be non-politically distributed.

## **VI. Building Conceptual Foundation:**

### **Federalism and Decentralization**

Until Rodden questioned it in 2005, the literature failed to distinguish decentralization and federalism. Since the time of Tocqueville, scholars have lamented the lack of the definition, but actually the definition of decentralization was not clear until 2000s. Tocqueville argues that “ ‘centralization’ is a constantly repeated word, but is one that, generally speaking, no one tries to define accurately” (Tocqueville, 1835). Daniel Treisman laments that “[s]cholarship is littered with so many different usages of these words [referring to the centralization and decentralization] that it is often unclear just what they mean, if indeed they still mean anything at all” (Treisman, 2002, p.2).

As Rodden (op. cit., 2005) points out, previous literature considers decentralization and federalism as the same. In simple binary typologies, federalism is considered to be decentralization, while unitary states are regarded to represent centralization (Norris, 2008, p. 9). Although Oates points out economists and political scientists have different notion about “federalism,” he also fails to distinguish decentralization and federalism. “For an economist, nearly all public sectors are more or less federal in the sense of having different levels of government that provide public services and have some scope for *de facto* decision-making authority (irrespective of the formal constitution)” (Oates, 1999, p.1121). On the other hand, political scientists consider federalism to be based on sovereignty rather than autonomy and power sharing between central and subnational government.

Nonetheless, the scholars also admit to the difficulty of defining federalism, centralization, and decentralization. Empirically it is still difficult to divide decentralization and federalism,

while the concept for the division is concrete. Rodden (op. cit., 2005) argues that Federalism is broad notion: it can be not only the formal constitutional stipulation but also implicitly accepted (Ibid., p. 43-49), and there is no global definition of government decentralization because decentralization varies for every country (Ibid., p.35-40). Ahmad et al. (1998) confess that “[d]ecentralization is not easily defined. It takes many forms and has several dimensions.....Thus care must be used in labeling, and labels—including those used in this paper—must be interpreted with care” (Ahmad et al. 1998, p. 4).

Thus, this section introduces literature review of these concepts and elucidates a differentiation between decentralization and federalism. It also presents a matrix of power sharing divisions between federal and unitary states and the degree of decentralization. Factors such as sovereignty, autonomy, representation at the legislature help to define its constitutions.

### *Federalism*

According to Pippa Norris (2008), the typology of federalism and decentralization is classified depending on horizontal and vertical sovereignty and power-sharing. The Oxford dictionary defines sovereignty as “supreme power or authority: the authority of a state to govern itself or another state: a self-governing state.” While decentralization refers to the vertical allocation of the authorities, federalism refers to the horizontal allocation of the authorities and their sovereignty.

Norris (2008) divides a constitution into discrete categories. In unitary constitutions, the central government holds sovereignty over all sub-national governments and is able to override all other decisions and regulations of sub-national tiers (Ibid., p. 22). Federal constitutions need to have at least two tiers of governments, national and sub-national governments, and each tier of



governments holds sovereignty (autonomous powers and functions) (Ibid., p. 22). Hybrid constitutions exist between the unitary and federal constitutions, in which sub-national tiers hold some independent powers for certain constituent territory, but the central government holds sovereignty (Ibid., p. 13 and p. 22).<sup>12</sup>

The word federalism comes from the Latin, *foedus*, meaning contract (Rodden, op.cit., p. 41). Broadly speaking, the federal contract is embodied in an explicit or implicit constitution (Ibid., p. 43-49). Because the contract for federalism between the center and subnational governments is maintained for the purpose of safeguarding against other states or the center itself, the subnational governments actively or reluctantly cede authority and powers to the central government. Thus, contracts generally include the protection of the sovereignty of the subnational governments, the power and autonomy of the subnational governments, the presence of independent constitutional courts, the requirement of majority rule for policy changes or constitution itself. It sometimes includes control over subnational government militias, and the representatives of small states in an upper house (legislature) (Ibid., p. 43-44). The autonomy of central governments is diverse in spectrum. One extreme case is the former Soviet Union, which is called centralized federalism, the other extreme is peripheralization (Riker, 1987, pp. 9-10).

### *Decentralization*

The conventional definition of decentralization is the transfer of authority to subordinates.<sup>13</sup> In other words, decentralization is defined as when subnational governments are empowered

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<sup>12</sup> There are two contending interpretations about the incentives for the contract of federalism (Rodden, 2005, p. 42-43). While William Riker (1964) perceives the contract of federalism originates from constitutional protection against common enemies, Alfred Stepan (1999) considers the contract to be made after military conquests. Nonetheless, it is true that a federal contract is maintained for the safeguarding of its components.

<sup>13</sup> This dissertation follows the conventional meaning, but the range of subordinates is narrowed to subordinate governments.

(Rodden, 2005, p. 37-40). Generally, this authority is divided among the administrative discretion, fiscal authority, and political independence as it emerges between the levels of government. Under decentralization, the subnational government officials are elected, and acquire their own administrative decision-making authority. Fiscally, expenditures are decentralized, and/or enough resources are provided to enforce the responsibility for expenditures.<sup>14</sup> More rigorously, subnational governments are less dependent on intergovernmental grants, while having a fixed formula in revenue sharing with the central authorities, and having discrete sources of revenue through independent taxes, user fees, and borrowing. Subnational governments also have the authority to decide their own tax sharing rates vis-à-vis the central government, and to choose their own revenue rates and bases.

As defined above, the notion of decentralization and federalism is not necessarily the same thing.<sup>15</sup> Again, federalism differs from decentralization, in whether the central powers and subnational governments make a contract and thus the autonomy of the central government is efficiently limited in federalism (Rodden, op.cit, 2005, p. 7). Conversely, when the central government receives authority from the subnational units by simply acting through the administrative hierarchy, the two parties do not engage in a federalist relationship (Ibid., p. 40-41) but still maintain a decentralization of political, fiscal, and administrative resources.

Common factors belonging to both federalism and decentralization are that the public sector decision-making authority is devolved to the subnational level, and the central government is not able to override local decision. Federal constitutions and unitary constitutions are different in that

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<sup>14</sup> Falleti (2005) considers transfers equal to local resources.

<sup>15</sup> While federalism and decentralization are conceptually different, they are interconnected. Federalism refers to the process of allocating authority for constitutional protections, and decentralization refers to the constitutional allocation of authority.

an upper house represents and protects subnational government rights in a bicameral national legislature. Most importantly the subnational governments have the sovereignty (Pippa Norris, 2008, p. 9).

As Pippa Norris (2008) classifies, constitutional arrangements are divided into three major types—federal, unitary, and hybrid states.<sup>16</sup> These constitutional arrangements can be further classified into centralized and decentralized governments based upon the types of administrative, political and fiscal power-sharing between levels of governments (Ibid., pp. 3-9).<sup>17</sup> Thus, a matrix of power sharing combining both approaches, makes categories dividing federal, unitary, and hybrid states. The degree of decentralization is described as in Table 1.4 (Ibid., p. 14). Although it is divided thus for convenience, there are innumerable possible cases in the spectrum.

Table 1.5 Matrix of power sharing between the central and local governments

	Federal constitutions (F)	Hybrid Constitutions	Unitary constitutions (U)
Decentralization (D)	FD	HD	UD
Centralization (C)	FC	HC	UC

*Source: Norris, 2008, p.14*

Although the conceptual foundation is different, it is true that empirically decentralization and federalism are highly correlated (Rodden, 2005, p. 50). Decentralized federal constitutions and decentralized unitary constitutions have a weak central government and quite autonomous provinces (Ibid., p. 10-12). In other cases with centralized federal and unitary constitutions, the central government has the predominant power and authority, while the

<sup>16</sup> Here the term, constitutional, does not necessarily mean explicit constitutional stipulation.

<sup>17</sup> Political authority is distributed through election (Norris, 2008, p. 9). However, she does not clearly divide administrative and fiscal authority as referring to bureaucratic decision-making authority for the public service delivery and resource allocation (Norris, 2008, p. 8).

provinces have only limited autonomy (Norris, 2008, P. 10-11). Rodden (2005) emphasizes that, in reality, it is very rare that a single subnational government solely exerts its authority in decentralization. Rather, the authorities are more likely intertwined between the central and the subnational governments and/or between subnational governments. Policy making for decentralization thus brings about joint efforts. (Rodden, op. cit., 2005, pp. 44-45).

### *China*

The words “federalism”, Chinese style” were introduced by Gabriella Montinola and Yingyi Qian in 1996. “federalism Chinese style” follows the Chinese governmental rhetoric, “socialism with Chinese characteristics (中国特色社会主义),”<sup>18</sup> a concept which was introduced to advocate for a market economy within the socialist country of China. “Federalism, Chinese style” has been used to emphasize the condition that the Chinese Central Government has devolved large amounts of economic authority to local governments and, as a result, there was enormous economic growth in China. In particular, Montinola et al.’s (1996) research during the period of 1978-1993 and the publication of their paper in 1996 might mislead readers when considering that decentralized forces were maintained even after the tax reform in 1994. Since then, descriptions of “Federalism, Chinese style” was adopted in much of the literature without clearly defining the term. This raises questions about whether China is a *constitutionally or informally federal or decentralized state* and whether it is comprised of a federal state or decentralized states.

To make a robust diachronic and comparative analysis of the Chinese fiscal system, it is

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<sup>18</sup> Socialism with Chinese characteristics (中国特色社会主义) is introduced as the ideology to advocate the adoption of a socialist market economy in China. The Chinese government argues that it has not abandoned Marxism, but has accommodated a socialist market economy at the primary stage of socialism in order to accomplish socialism in the end.

important to review and properly label China as a decentralized state or a federal state at the beginning of the dissertation. Constitutionally, China is neither a federal state nor a decentralized state. However, the central and local relationships from “a behavioral perspective” are considered to be *de facto or informal* decentralization (Zheng, op. cit., p. 36). The Chinese constitution stipulates that upper level governments can routinely override administratively the lower-level governments’ decisions. The Standing Committee of the People’s Congress at each level of government is able to invalidate these local regulations or decisions of the next lower level (Constitution Article 67 and Article 104). The upper level governments are also able to adjust or invalidate decisions of their subordinate departments and lower-level governments (Constitution Article 108). The State Council and local governments direct the work of their subordinate departments and of lower-level governments (Constitution Article 89). Meanwhile, Budget Law, adopted by the NPC in 1994, limited local governments’ borrowing and tax autonomy: it prohibits local governments from running a deficit and from issuing bonds (Budget law, Chapter IV Budget Compilation, Article 28 and Chapter X Legal Liability, Article 73, 1994). These combined constitutional features have contributed to the unilateral centralized state.

Federalism in China might refer to the implicit concept as Rodden argues (2005). “Federalism, Chinese style,” or “*de facto*, Federalism” might imply the authority that is allocated based on player’s perception or interpretation based on the context of a specific states winning over formal constitution. However, Central Leaders within China deny that China is a federal state. Wu Bangguo confirmed that there will be no federal system in China at China's National People's Congress (NPC) in 2011 (Bristow, 2011). Chinese subnational officials politically depend on the Center. Chinese subnational governments do not perceive they have sovereignty, either, although they exert some degree of authority within their territory as long as the central

government tolerates. Thus, the term federalism is not appropriate for China even as a broad and implicit concept.

However, a large country like China faces transparency difficulties in the monitoring of local officials to reveal their local information without further incentives. As further chapters analyze, the Central Government faces limitations in their access to the local governments' debt and/or deficit financial information. In addition, it cannot properly distribute and monitor intergovernmental transfers (Interview with a journalist at the township level in Hunan province, 2011). Chinese people I met argue that the Chinese fiscal system is ruled by people, not ruled by law (Interview, 2011). Nonetheless, the subnational government does not have sovereignty *de jour* or *de facto*. In this respect, it is an exaggeration to call China's form of government as "de facto, federalism" (Zheng, op.cit.) or "federalism, Chinese style" (Montinola et al., 1996). An accurate term describing the relationship between the central government and subnational governments should be *de facto* or *informal* decentralization.

## **VII. Methodology**

To prove subnational governments are building informal behavior, a combination of quantitative analysis and interviews focusing on quantitative method are applied.

The main sources for my research included researching the Chinese statistics, field interviews, review of Chinese law, and newspapers. I developed my arguments in the contexts of city and county levels across the country.

I conducted field research in China for five months in the fall of 2008, and for two months beginning in the summer of 2011, doing interviews and collecting data. I interviewed a high level government official at the taxation and finance bureaus, two owners of private firms, a journalist,

and eight local scholars throughout China (Beijing, Shanghai, Shandong, Hubei, and Hunan). In-depth interviews are particularly precious in helping me understand the process of informal debt practices, such as local governments' interference with LGFPs' (投融资平台) debt and with the provision of intergovernmental transfers and expenditure at the local level.

Statistics published by the Ministry of Finance helped me to interpret how the fiscal system has changed over time. Fiscal statistical data is developed throughout the levels of province, city, and county government. It is published as China Statistical Yearbook, Public Finance Yearbook, and Chinese Statistical Material for Prefectures, Cities, and Counties nationwide for various years.

In examining the subnational government financing, this study applies statistical analyses to test hypotheses by utilizing cross-regional variations in debt taking. For the analyses, I have compiled two data sets. The debt data is based on the banks' annual yearbooks. The second record is local bank presidents' career background for their lifetime. For this data set, I drew on several compilations of bibliographies of bank presidents in the Chinese government websites, and bank yearbook and homepages. This is because the official local debt data does not contain the widespread practice of debt financing carried out by local vehicle companies.

In investigating the relations of transfers and spending, this study relies on official statistics. Local officials do not have much incentive to undermine the individual transfer and expenditure data in the official statistics. Details of this data will be discussed in the empirical chapter.

## **VIII. Chapter Outline**

A goal of this dissertation is to figure out some unique characteristics about the fiscal and

political characteristics of China that have shaped the forms of the local governments distinctive behavior, and to connect these distinctive characteristics to nature, cause, and consequences of fiscal institutionalization in China. The most important factor shaping informal fiscal decentralization is the basic intergovernmental fiscal and political arrangement between the central and local governments.

The dissertation is composed of five chapters as below. As already introduced, Chapter one showed the fiscal problem in China, analyzed previous literature and introduced new questions, defined federalism, decentralization, and informal decentralization, and methodology to develop further analysis.

Chapter two describes the nature of the 1994 tax reform and cause of the problems the subnational governments faced due to this reform. The *informally* decentralized fiscal system in China which came about as a consequence of the reform is motivated by the basic fiscal and/or political incentives, drawing some comparisons to the pre-fiscal reform in 1994. This historical approach attempts to explain the evolution of fiscal system since 1978 in China. Cross-time data shows that the combination of reduced local tax revenue and sustained high responsibility, together with a balanced budget requirement and borrowing restrictions is associated with the creation of informal institution of subnational governments.

Basically, the fiscal institution in China exists in the form of a top-down fiscal discipline, where the center virtually dominates taxation, borrowing, and expenditure. When a government in fiscally difficulty faces delivering welfare, officials' wage, and building infrastructure that are considered as required by the regional government mandate, the local governments quickly look to the way of informal institutions for a solution. Thus, local debt is maintained even with the legal prohibition in 1994, because the expenditures exceed the revenues. Additionally, the



intergovernmental transfers and loans from the central government to the subnational governments tend to be highly distorted. Intergovernmental transfers from the center to the subnational governments appear to be highly politicized. The subnational governments strategically allocate transfers, thus attempting to shift resources to maintain administration tied to political importance.

China does not typify the dangerous combination, which Rodden (2005, op. cit., p. 14) predicts—“the combination of politically powerful regional government, borrowing autonomy, and limited tax autonomy is a dangerous.... In these countries, is revealed the problem of federalism: the central government is capable of solving the states’ fiscal difficulties, but politically weak to ask the subnational governments to be accountable.” On the other hand, Chinese subnational governments are politically weak with limited tax autonomy and *de jour* have limited borrowing autonomy. Yet in a large country with a limited monitoring system like China, it finds it difficult to prohibit their local governments from financing debt and distorting transfers without additional incentives. From this, some important questions are raised regarding the nature of subnational governments’ finances, their incentives regarding their finances, and the consequences of their behavior.

The emergence of the informal decentralization is ultimately driven by politics. The central government’s ability shapes the local official behavior for the way local officials fulfill their responsibilities, when pressed for fiscal sources, rather than having them represent the interests of their jurisdictions. If the central government severely controls the local bureaucrats based on a targeted responsibility system (TRS) and the local government has hard time avoiding deficits, and/or firmly complying with regulation of the fiscal discipline, then the local governments create informal fiscal resources to fulfill the TRS.

Chapter three and four shows that debt at the city level and transfer distribution at the county level provides the outline for the *informal* decentralized fiscal system in China. Chapters three and four describe an obstinate type of political equilibrium in which governments having strong political connection with local banks more likely borrow, and/or having strong dependency on the transfers more likely spend to maintain their bureaucracy, with results that are bad for the whole country. Each local government differs from the others in almost every aspect—levels of economic growth, in fiscal inequality, and interpersonal relations between governments and credit companies. However, these local governments commonly conceive their roles as involving pronounced, informal decentralization, and the central government tolerates the informal decentralization as long as it does not threaten the central government itself. In chapter three and four I apply these abstract arguments and empirically analyze them with disaggregated cross-regional data, examining the consequences of the tax reform in 1994 under the condition that the subnational governments' responsibility and political environment were not changed. The case studies prove that informal decentralization has played a significant role in explaining the fiscal dilemma between centralization and decentralization in China.

Chapter three analyzes the informal decentralization as one of the consequences of the tax reforms in 1994 in China, which is associated with local government debt financing ability, based on political connections between local governments and local commercial banks at the city level. As one of its centralization policies, the Chinese budget law prohibits local governments from taking on debt; the central government also removed the expectation of a bailout by intentionally not bailing out the Trust and Investment Corporation in Guangdong province at the end of the 1990s. However, the central government has subsequently failed to prevent the subnational governments from building up their debt. Banks are still favorably inclined toward

local governments, and they allow credit to the LGFPs. Subnational governments have often taken on debt through these LGFPs (Jin et al., 2003). This occurs despite the central government's prohibition of debt taking and rejection of bailouts. My paper proves that banks and the credit market are still willing to give loans to subnational governments which have sufficient collateral with their rights to real estate, and also strong social networks connection through the bank chairmen, who exert a powerful influence over their banks' decision making process.

Data is used to test arguments about LGFPs' debt at city level and the personal connections, called *Guanxi* (关系) (network). One way to measure the local governmental borrowing capability is to examine this major custom within Chinese society, how they use *Guanxi* to perform a favor or service, for political and/or economic ties. Based on the Chinese cultural context, *Guanxi* reasons that if the creditors have strong ties to local governments, then local companies, on behalf of local governments, will easily be allowed to access the credit markets. The local government provides an implicit guarantee of their responsibility. Local debt is largest when subnational governments have these strong ties with the local creditors. Banks also consider local governments' collateral. As Chinese literature points out, debt-taking increases the regional disparity, as the usage of local governmental debt differs, depending on local economic conditions (Fan et al., 2008; Fu, Kaili, 2011; Zhu et al., 2011; Su et al., 2011; Chen et al, 2006; Sun, 2010; Cao 2005). Thus, the predicted risk would be different, depending on the region. The social networks also add a predicted risk, which would also be different depending on the region.

Chapter four presents the relationships between the intergovernmental transfers and the structure of their expenditures. It tests how intergovernmental transfers fail to reduce regional

disparity. The transfers influence the type of expenditure in different ways for different regions. The focus of this chapter is on how individual transfers influence three types of expenditures: administrative, educational, and agricultural, in both the fiscally dependent and independent counties across the whole country. This chapter provides information about the designated purpose of the intergovernmental transfers, and briefly explores the extent to which the central government intends to reduce these inequalities through these transfers. One conclusion highlights whether an individual transfer does equalize public welfare linked to various social segments, such as the fiscally supported public welfare population like the peasants, and primary and secondary school students. This chapter suggests that future research should focus on the reasons why the intergovernmental transfer fails to equalize the fiscal situation across the regions. This might involve several tiers of government, including central government, provincial governments, the prefectures, and finally the counties, all of which have together diluted the effectiveness of these transfers. Alternatively, it may be that poorly crafted transfers have allowed distortion of the transfer allocation by the subnational governments (Tsui, 2005; Shen, 2012).

The final chapter is a conclusion which summarizes the whole dissertation, and develops further questions. It predicts that the institutional flaws will ultimately be improved. However, it describes the phenomenon that the subnational governments' public financing against fiscal centralization in China results in the central government's *ex post* management as usual.

## **Chapter 2**

### **Nature, Causes, and Consequences: The Informal Decentralization in China**

#### **I. Introduction**

The central government has centralized their budget system since 1994. After the economic reform in 1978, the Third Plenum of the 14<sup>th</sup> Central Committee of the Chinese Communist Party (CCPCC) in November 1993 adopted a tax reform.<sup>19</sup> Since then, a series of reforms favoring the centralization was initiated. The reason for the recentralization of the fiscal system in 1994 was to overcome problems seen from the central government's viewpoint by raising both the revenue to GDP, and the central government revenue to total revenue (Wong, 2000, p. 9).<sup>20</sup>

The central government was under a budget deficit after 1979, which pressured the central government to facilitate the reform process (Tsang et al., 1994, p. 775-776). The previous fiscal contractual responsibility system was changed into the current tax assignment system in 1994. The 1994 tax reform featured: (1) revenue assignments to address the vertical imbalance of the fiscal system, (2) unfunded expenditure mandates, and (3) evaluation of cadres based on target accomplishments.

As described in chapter 1, the definition of fiscal decentralization includes a wide range of factors: (1) the tax sharing is guaranteed in the system; (2) subnational governments collect and use the higher amount of budget; (3) subnational governments have decision-making authority of tax rate and base, and budget priorities, and (4) subnational governments have borrowing

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<sup>19</sup> The "Decision on Issues Concerning the Establishment of a Socialist Market Economy" emphasizes the priority for "the establishment of a modern enterprise system and.... reforms in banking, taxation, planning, investment, foreign trade and other major fields." (Beijing Review, 2008)

<sup>20</sup> Wong (2000) and Bahl (1999) argue that the tax reform in 1994 accomplished centralization, while Chao does not.

autonomy.

This chapter will clarify the nature of the Chinese fiscal system as a formal system, the causes of fiscal reform in 1994, plus the causes of the problem, and its consequences. The consequences refer to both the subnational governments' behavior opposing to the tax reform in 1994, and its effects on the overall Chinese fiscal system.

## **II. The Causes of Tax Reform in 1994: Fiscal Centralization in China and the Problem**

Economic reform reduced the central governments capability for taxing and spending. Before the reform in 1978, the socialist economic structure was intertwined with the government. The central government owned, planned, and supervised its productive forces in three dimensions: fixed prices, state ownership, and procurement and trade (Wong 2000, pp. 3-4). The states revenues depended on these sources. During the economic reform beginning in 1978, the central government ceded some fiscal authority to subnational governments. Until the taxation system was fully established, the central government was not able to tax them over the privatization (Ibid.). The privatization of the productive forces led to the under-provision of public goods due to the resulting fiscal decline.

Beijing's most prominent goal was to stop the fiscal decline. The central government revenue was low: it declined because of the greatly reduced remittances and lower revenues from SOEs (Ibid., p.6). During 1980s, the SOEs were inefficient (Tsang et al., op. cit., p. 774-775; Wong, 1997, p.28; Wong, op. cit., 2009, p. 939). Subnational governments were competing with each other by duplicating investments, regionally blockading markets, and practicing preferential tax policy to increase their own financial revenues (Tsang et al., op. cit, 1994, p. 776). On the

other hand, this privatization empowered the subnational government with the ability to tax the constituents that were privatized (Wong, op.cit., 2000, p.9).

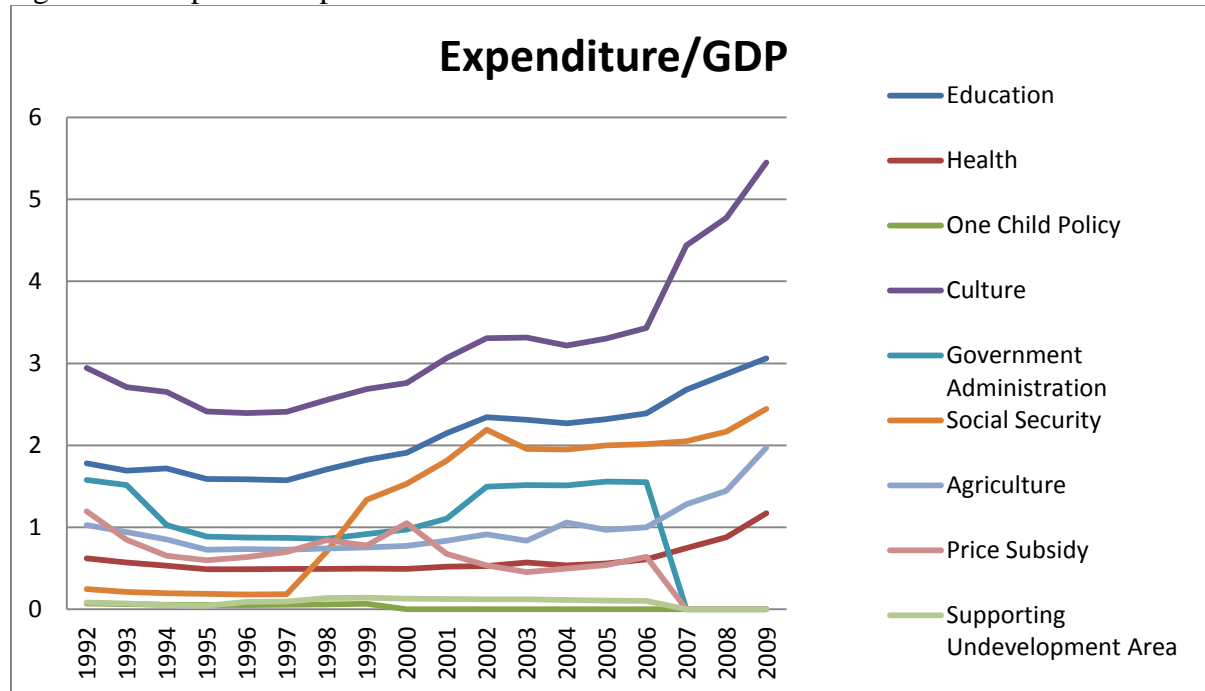
In the process of economic reform, the tax structure needed to be improved (Wong, op. cit, 1997, p. 37). In the 1980s, the enterprise income tax (利改税, tax for profit on enterprises ) was subject to negotiation between the central government, the local governments, and the enterprises (Tsang et al., op. cit., pp. 773-774). In extreme cases, one tax rate was imposed for one enterprise (一户一率) (Ibid.). The differential rates of indirect taxes were also applied across many products and sectors (Wong, op. cit, 1997, p. 37).

Furthermore, the central government had difficulties monitoring the tax obligations due to the arrival of new taxpayers, such as foreign investors, exporters, and service and property enterprises (Wong, op. cit, 2000, p.6). Foreign direct investments and international trades paralyzed the central authorities in respect to the proper rules for the forms of taxation and their monitoring system (Ibid. p.9).

The decreased fiscal revenue has reduced the corresponding expenditures as well (Wong, 2009, pp. 939). In the initial years of the economic reform, the government designated priorities on social services, such as education, health, social insurance, poverty alleviation, and environmental protection. Although Figure 2.1 does not illustrate whole years of spending in reform era, it demonstrates that the downward trend of spending per GDP did increase after the reform. Education spending was raised from 1.8 percent of GDP in 1978 to 2.2 percent in 1982, but fell to 1.5 percent in 1995 (Ibid., pp. 939-940). It fell short of the legal stipulation in the Education Law (1986), which stipulates 4 percent spending of GDP by 2000. Health spending likewise was raised from 1 percent to 1.3 percent from 1978 to 1982, but declined to 0.64 percent

of GDP in 1995 (Ibid.). Although environmental protection spending has been increased from 0.4 percent of GDP in 1980 to 0.67 percent in 1992, this was far below the need and inadequate considering their rapid industrialization (Ibid.). Due to the funding problems, China provided a low level of social services compared with other countries (Ibid.).

Figure 2.1: Expenditure per GDP from 1992 to 2009



Sources: *China Financial Statistical Yearbook*, various years

The central government needed to revamp its intergovernmental revenue-sharing arrangements. This objective is accomplished by seeking uniformity to enhance competition at a level playing field for the various parties, across enterprises and with regards to the subnational governments (Tsang et al., op. cit, p.786).

### III. Nature: Fiscal System in China

The Chinese revenue system was recentralized in 1994, but the expenditure assignment was not



changed during the tax reform. The devolution of high degree of expenditure responsibility and revenue sharing to the subnational governments would mislead one to consider the fiscal system in China to be highly decentralized. The reform has many problems. The recentralization of revenues under the Tax Assignment System worsens the disparity between revenue and expenditure assignments (OECD, 2006, p. 28; Wong, 2009, p. 942-943). Subnational governments do not have the adequate financial resources to carry out their responsibilities. Chinese decentralization exists as a default through uncoordinated revenue and expenditure assignments (Wong, *Ibid.*, p. 939).<sup>21</sup>

Figure 2.2 sketches the trend for the revenue and expenditure sharing rate between the center and its subunits in China over time. Using time series data available from Chinese Statistical Yearbook, Figure 2.2 presents the shares of government revenue and expenditure undertaken by both the central and local governments since 1990. It demonstrates that the subnational government's need to carry out an extraordinarily high share of total government spending. The Figure also displays an upward trend in the local governments' expenditures. The remarkable aspect of Figure 2.2, however, is the reverse trend of the ratio of revenue between the center and local governments against their expenditure. Although important taxes are shared between the central and subnational governments, the subnational governments received a lower

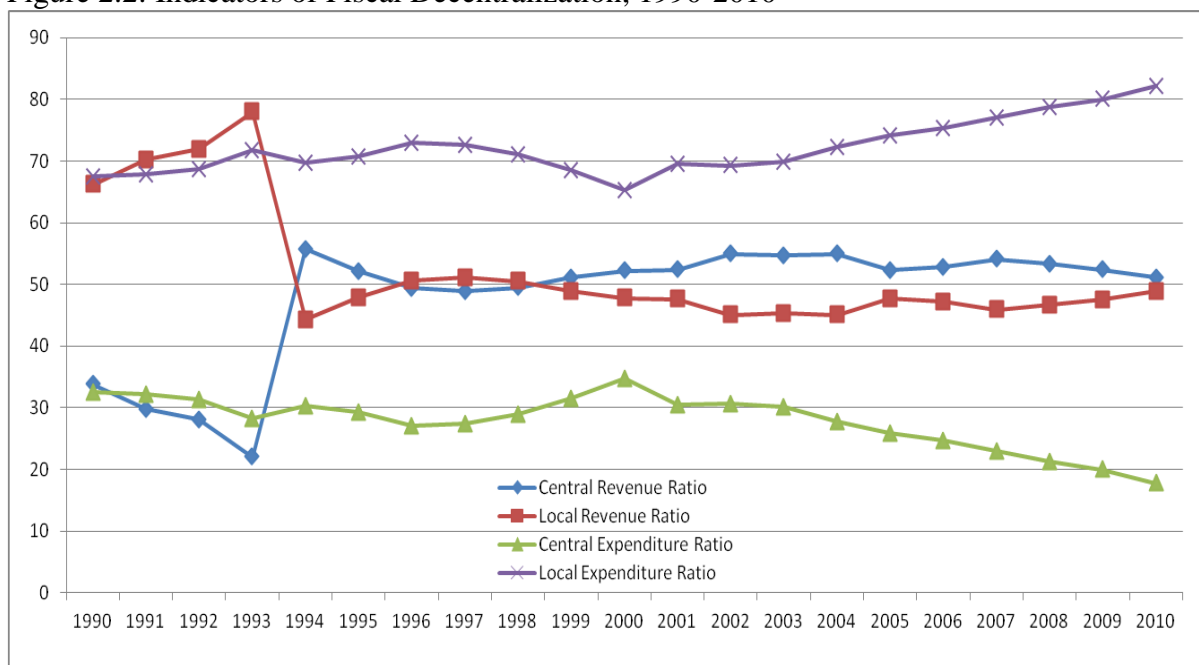
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<sup>21</sup> The division of fiscal responsibilities between the central and the subnational governments is articulated in the Constitution (Wang et al. 2013, p. 10). Article 89 of Constitution stipulates that "[t]he State Council exercises the following functions and powers:....(6) To direct and administer economic work and urban and rural development; (7) To direct and administer the work concerning education, science, culture, public health, physical culture and family planning; (8) To direct and administer the work concerning civil affairs, public security, judicial administration, supervision and other related matters; (9) To conduct foreign affairs and conclude treaties and agreements with foreign states; (10) To direct and administer the building of national defence; (11) To direct and administer affairs concerning the nationalities and to safeguard the equal rights of minority nationalities and the right of autonomy of the national autonomous areas." Article 107 of Constitution stipulates that "[l]ocal people's governments at and above the county level, within the limits of their authority as prescribed by law, conduct the administrative work concerning the economy, education, science, culture, public health, physical culture, urban and rural development, finance, civil affairs, public security, nationalities affairs, judicial administration, supervision and family planning in their respective administrative areas."

share of total government revenues. On-budget expenditure of China's sub-national governments accounts for 72 percent in average of the total expenditure assignment between 1994 and 2009 (World Bank, 2013; China Statistical Yearbook, various years). After tax sharing between the central and subnational governments, the rate the subnational governments acquired shifted from 72 percent during the early of 1990s to 47 percent as an average from 1994 to 2009 under the 1994 tax reform. The revenue is obviously lower than the expenditure for sub-national governments.

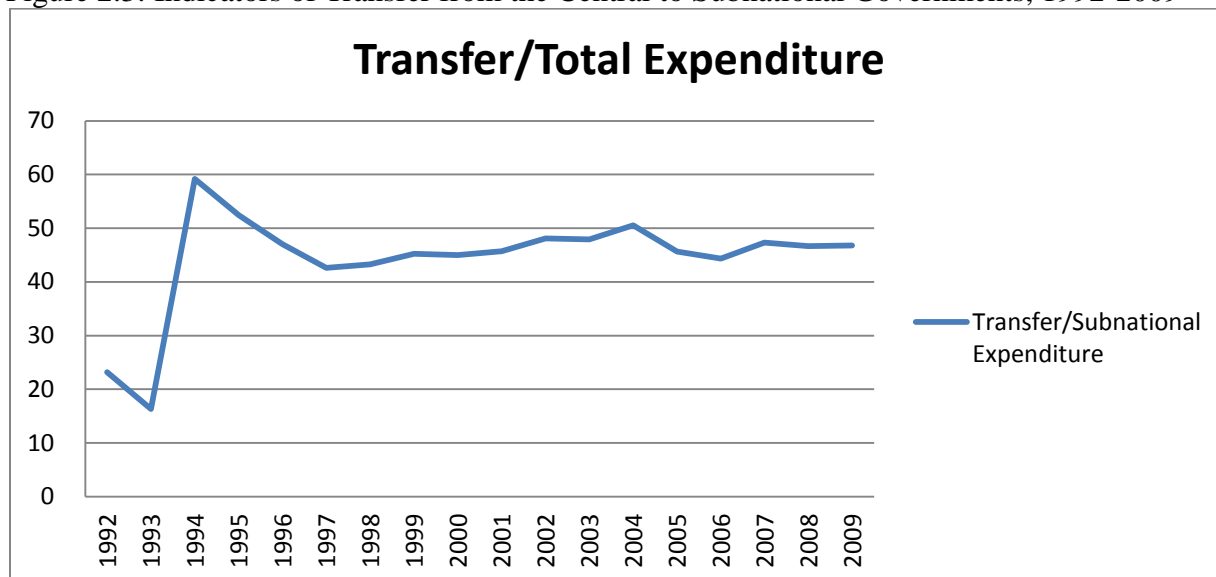
The difference between this revenue and expenditure required a large scale of transfers from the central government to province, and from the province to county and township government levels as Figure 2.3. Transfers from the central to subnational governments accounted for 47 percent of its total on-budget expenditure between 1994 and 2009 (China Financial Statistical Yearbook, various years).

Figure 2.2: Indicators of Fiscal Decentralization, 1990-2010



Source: China Statistical Yearbook (various years)

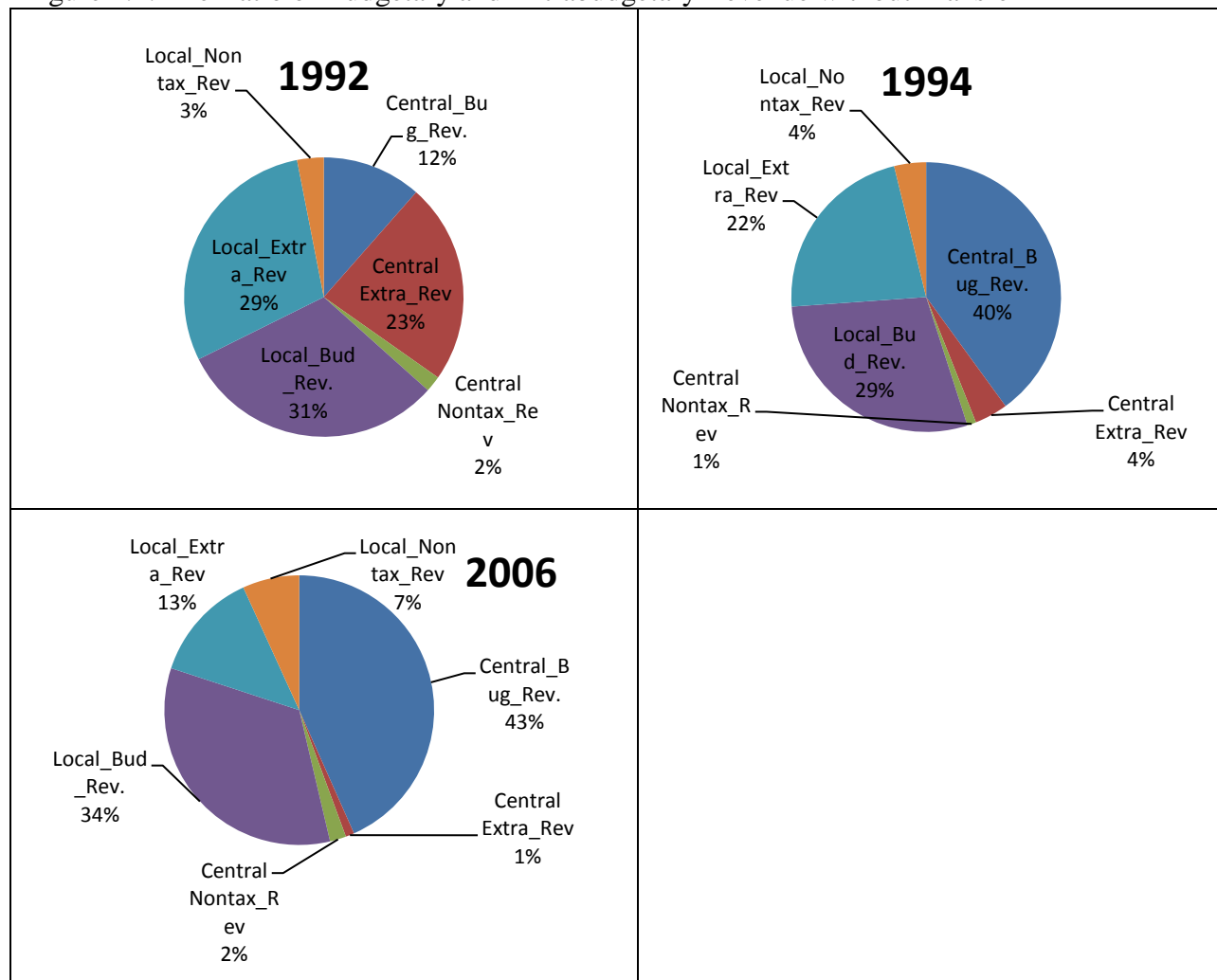
Figure 2.3: Indicators of Transfer from the Central to Subnational Governments, 1992-2009



Source: *China Financial Statistical Yearbook* (various years)

Figure 2.4 describes major changes in revenue without considering transfers before and after the tax reform in 1994. Considering whole budgetary and extrabudgetary revenue, local government revenue has decreased from 1992 to 2006. Local budget revenue has decreased from 31 percent in 1992 to 29 percent in 1994, but increased to 34 percent in 2006. Local extrabudget revenue largely decreased from 29 percent in 1992 to 22 percent in 1994, and finally to 13 percent in 2006, but it is still higher than the central government's extrabudget revenue, which decreased from 23 percent in 1992 to 1 percent in 2006. Central extrabudget has been gradually disappearing. Local nontax revenue has increased from 3 percent in 1992 to 4 percent and 7 percent in 2006. The nontax revenue of the central government has not changed during 1992 to 2006, occupying small portion of 1-2 percent level among whole revenue. Central budget revenue greatly increased in 1994 from 12 percent in 1992 to 40 percent in 1994, and maintained about 40 percent level in 2006.

Figure 2.4: The Ratio of Budgetary and Extrabudgetary Revenue without Transfer

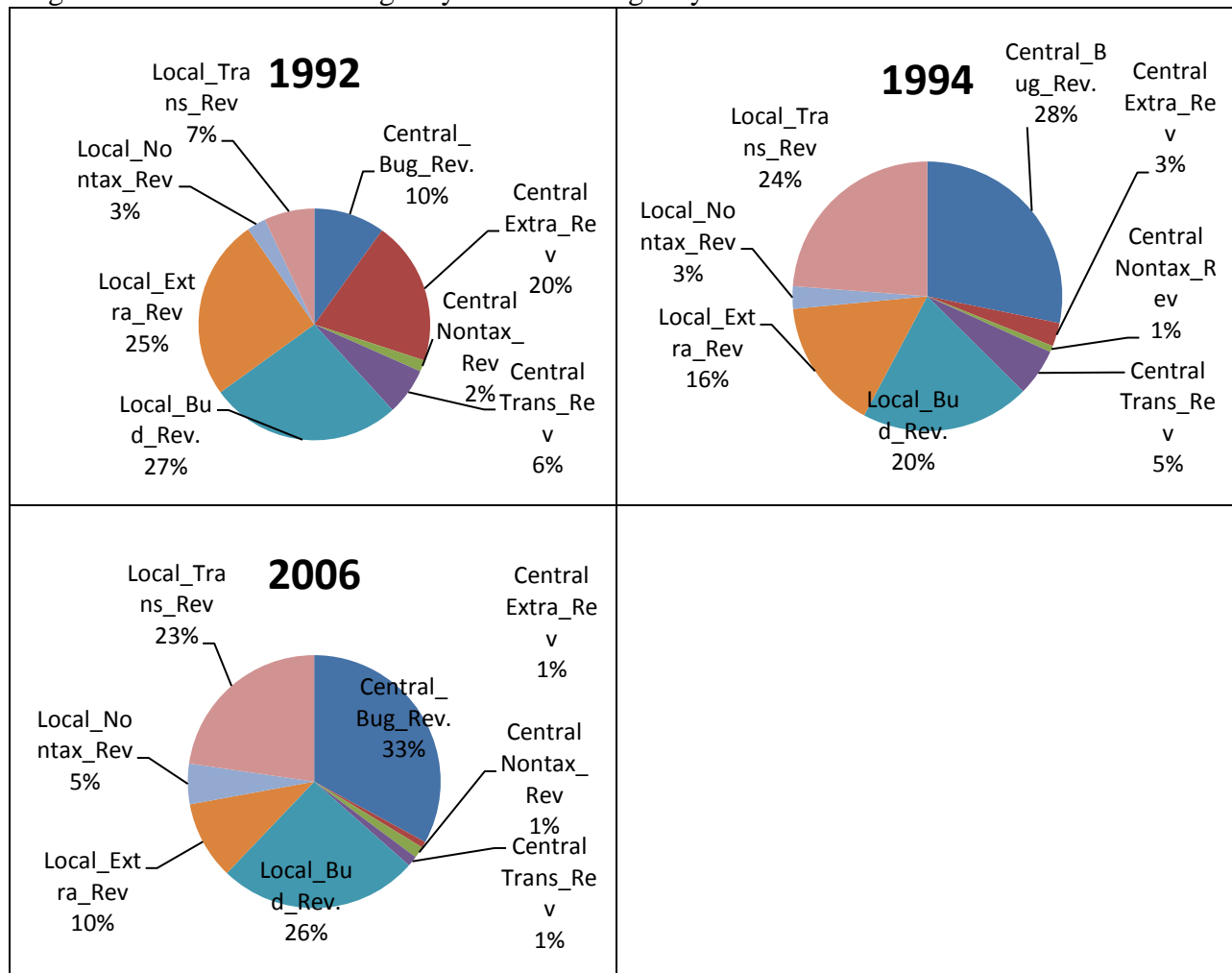


Source: China Statistical Yearbook (various years)

Major changes in revenue including transfers before and after the tax reform are described in Figure 2.5. Local budget revenue has been decreased from 27 percent in 1992 to 20 percent in 1994, but increased to 26 percent in 2006. The local government dependency on transfers highly increased after tax reform in 1994, increasing from 7 percent in 1992 to 24 percent in 1994. Total local budget revenue (budget revenue plus transfers) has gradually increased from 34 percent in 1992 to 44 percent in 1994 and 47 percent 2006, but still far behind its expenditure. Even after

including extrabudget and nontax revenue, local revenue does not enough to meet budget balance in 2006.

Figure 2.5: The Ratio of Budgetary and Extrabudgetary Revenue with Transfer

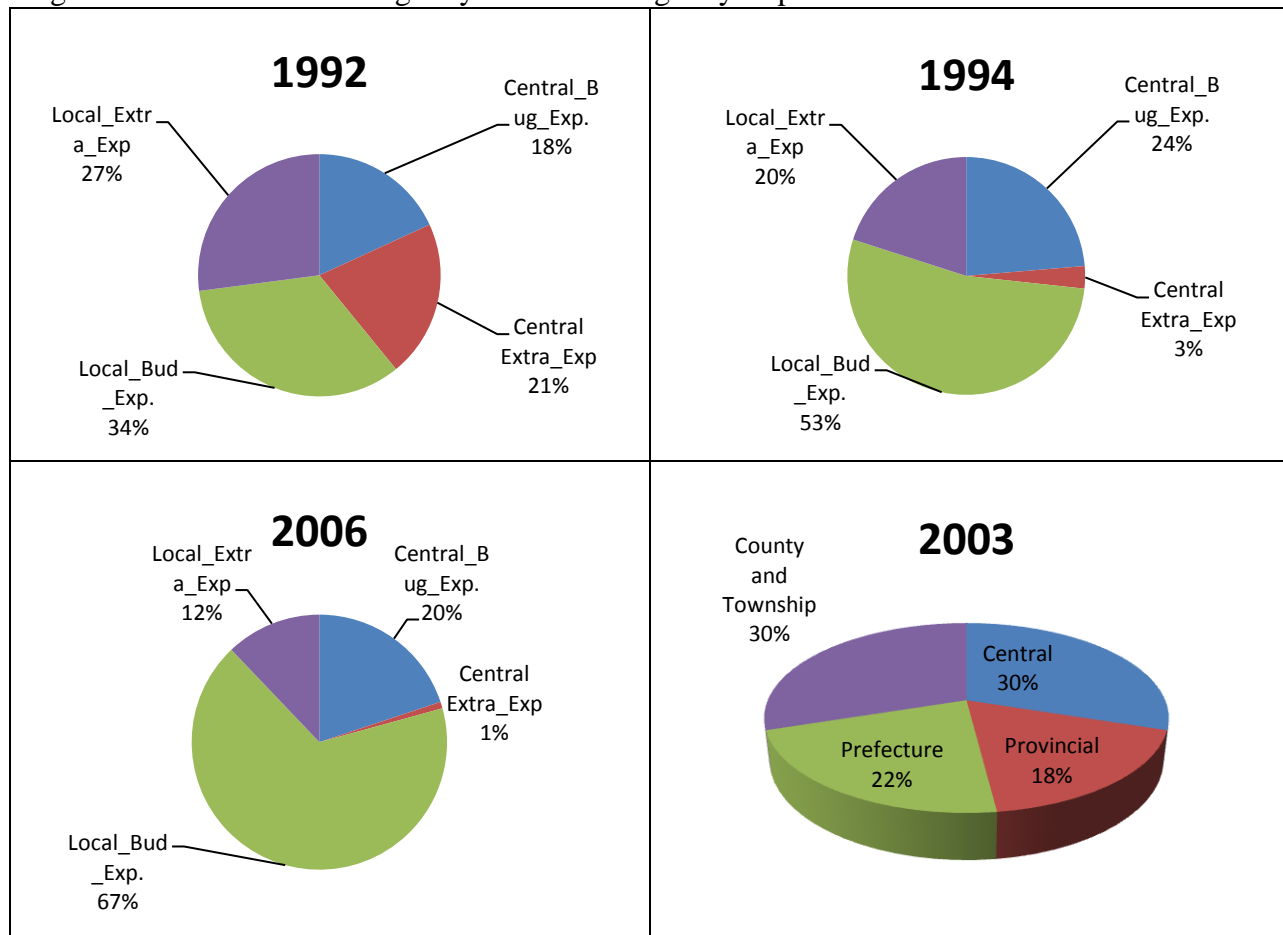


Source: China Statistical Yearbook (various years)

Figure 2.6 illustrates that major change of expenditure between the center and subnational after the tax reform. Subnational government expenditure increased vis-à-vis the center. Local budget expenditure has increased from 34 percent in 1992 to 53 percent in 1994 and finally to 67 percent in 2006. Local extra budget expenditure has decreased from 27 percent in 1992 to 20 percent in 1994, and 12 percent in 2006, but it is still higher than the central government's

extrabudget expenditure. The extra budget expenditure of the central government is 1 percent while subnational one is 12 percent in 2006. Central budget expenditure increased in 1994, but decreased in 2006. Central Extra Budget has been gradually disappearing.

Figure 2.6: The Ratio of Budgetary and Extrabudgetary Expenditure



Source: China Statistical Yearbook (various years); China Statistic Yearbook 2004 and MOF in Martinez, (2014, p. 322)

Decision making in the fiscal system is highly centralized: subnational governments have a low degree of autonomy over the decision making regarding expenditure and revenue (OECD, op. cit., p. 32). Generally, most of policy decisions in China are made by the Politburo standing committee members and the Politburo, who have the supreme power level at the CCP

and of whom, the majority are the central officials (Sheng, 2007). Provincial bargaining power within the CCP is not significant because the provincial officials occupy a minority in the Politburo and their ratio is declining in the full Central Committee (CC) membership from 1978 to 2002.<sup>22</sup>

One of the objectives of the 1994 reform was the recentralization of decision-making of the tax system. The budget is planned by the Ministry of Finance (MOF) and National Development and Reform Commission (NDRC) in the central government (OECD, op. cit., p. 38; a personal interview, July 2011).<sup>23</sup> The subnational governments cannot participate the negotiation for tax attainment rate with the central government, and cannot decide the tax rate and tax base under their jurisdiction. The expenditure responsibility is accountable to the higher level of government. Subnational governments are only able to implement the laws and policies sensitive to their local conditions with limited autonomy (Wang et al., op. cit., p. 10). Even in these decisions, in which central governments is not engaged, under the constitution of Article 89

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<sup>22</sup> The hierarchical order within CCP is Politburo standing committee members, Politburo, the full Central Committee (CC), and National Party Congress from upper to down level. They are composed of the representative of the central and provincial officials, and the military (Sheng, 2007, p. 340). To co-opt provinces, the center concedes the alternate CC membership to the provincial officials, who do not have voting power for CCP agenda (Ibid., pp. 339-340).

<sup>23</sup> The interview was conducted with a reporter in a city of Hunan province during July, 2011; Constitution stipulates follows for the decision making at the central and subnational level. “Article 67. The Standing Committee of the National People's Congress exercises the following functions and powers:..... (8) To annul those local regulations or decisions of the organs of state power of provinces, autonomous regions and municipalities directly under the Central Government that contravene the Constitution, the statutes or the administrative rules and regulations.....” “;Article 89. The State Council exercises the following functions and powers: .....(4) To exercise unified leadership over the work of local organs of state administration at different levels throughout the country, and to lay down the detailed division of functions and powers between the Central Government and the organs of state administration of provinces, autonomous regions and municipalities directly under the Central Government; ....(5) To draw up and implement the plan for national economic and social development and the state budget; (14) To alter or annul inappropriate decisions and orders issued by local organs of state administration at different levels....”; “Article 104. The standing committee of a local people's congress at and above the county level discusses and decides on major issues in all fields of work in its administrative area;.....; annuls inappropriate decisions and orders of the people's government at the corresponding level; annuls inappropriate resolutions of the people's congress at the next lower level.....”; “Article 108. Local people's governments at and above the county level direct the work of their subordinate departments and of people's governments at lower levels, and have the power to alter or annul inappropriate decisions of their subordinate departments and people's governments at lower levels.”

and 108, the central government and/or higher level of governments can legally override the subordinate government and/or subordinate department decisions, showing that local governments cannot exert extensive autonomy. This hierarchical structure limits the diverse policies for which decentralization leads across the country (Ibid.). Thus, centralized decision making and high level of subnational spending are not reconciled each other.

### *Revenue*

The system introduced in 1994 separates the central and local taxation in favor of central authority. Even after 1994, a formula for allocating taxes was slightly altered three times from 1994 to 2003 and was not changed after 2003 (Ibid., p. 17).<sup>24</sup> Under the pre-reform, central-local revenue were arranged by a fiscal contract (财政包干) system introduced in 1988. Under the tax reform in 1994, central-local revenue were arranged by a tax assignment system (分税制).

Under the fiscal contract (财政包干) system, revenues were collected by subnational governments and shared upward with the central government (Tsang et al., 1994, pp. 776-778). The system is classified into two major subsystems, the fixed quota arrangement (包干) and the proportional sharing systems (Ibid., p. 778). Under the fixed quota arrangement, the provincial governments, such as Guangdong and Fujian, remitted (received) a fixed amount of revenue (subsidy) to (from) the central government. Under a proportional sharing scheme, the central and provincial governments shared this revenue based on a pre-agreed ratio (Tsang et al., op. cit., 1994, p. 778). The system allowed an individual contract process between the center and provincial governments. For example, Shanghai changed their contract from a proportional

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<sup>24</sup> The ratio of shared tax between the central and local government is about 70 percent and 30 percent after the centralization reform in 1994. Basically business tax is assigned to the local government except for the business tax on the financial industry, which is assigned to the central government (Wang et al., 2013, p. 17).



sharing scheme to the fixed quota arrangement system after consistently arguing for this shifting in the late 1980s (Tsang et al., op. cit., 1994, p. 778).

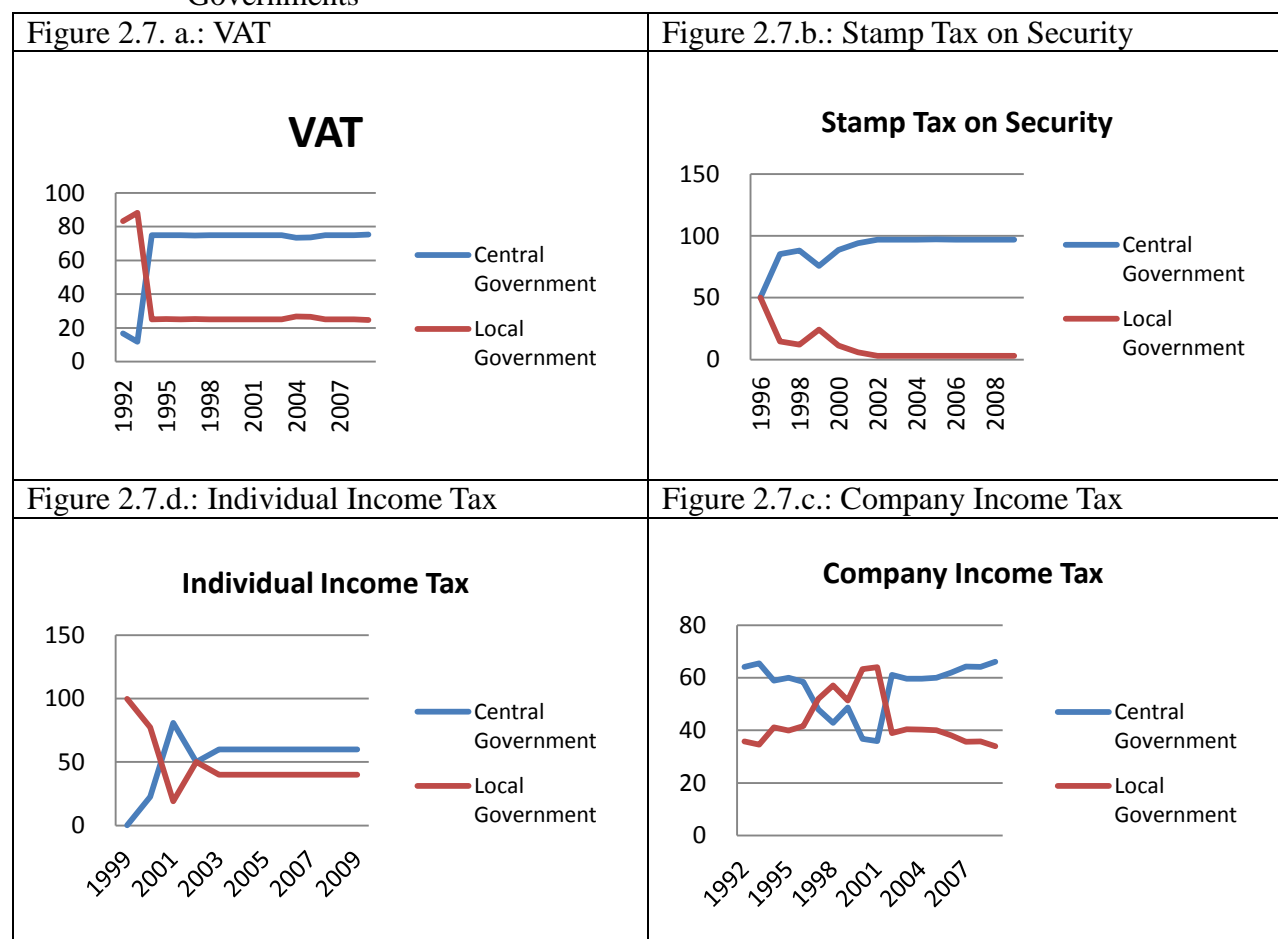
The tax assignment system (分税制) not only reduced the share of revenue for provincial governments, but also removed the chance for the negotiation of sharing rate between the central and local governments, as the sharing rate and tax bases were fixed by the central government. Table 2.1 shows that taxes are divided into three categories: central taxes, local taxes, and shared taxes between central and local governments (OECD, op. cit., 2006, p. 29). The newly established National Tax System (NTS) collects central revenues, and then transfers the shared revenue to local government, while the Local Tax System (LTS) of local governments collects local taxes (Wong, op. cit., 1997, p. 35). The shared taxes are VAT, company income tax, individual income tax, and stamp tax on security. As Figure 2.4 shows, at the initial stage the reform allocated some local taxes with significant revenue bases to the subnational governments. For example, personal income tax was wholly belonging to local government, when it was introduced in 1999. However, the high revenue generating tax such as the personal income tax was soon shared at an advantage of the central government in 2002 and 2003. The several changes of revenue system hold a declining ratio for the central government's revenue.

Table 2.1 Revenue Assignment

Central	Subnational	Shared revenues
Tariffs	Business tax (except banks, nonbank financial institutions, insurance companies and railroads)	VAT (75percent central-25percent local)
Consumption taxes	Profits from locally controlled SOEs	Stamp tax (97percent central -3percent local)
Income taxes of centrally owned SOEs	Urban land use tax	Company Income Taxes (60percent central -40percent local)
Import-related consumption taxes and value-added taxes (VATs)	Urban maintenance and development tax (except banks, nonbank financial institutions, insurance companies and railroads)	Individual Income Taxes (60percent central -40percent local)
Taxes on banks, nonbank financial institutions and insurance companies (business taxes, income taxes, and urban maintenance and development tax)	Fixed asset investment adjustment tax	Resource taxes (offshore oil belongs to central, the rest to subnational government)
Taxes on railroads	Housing property tax	
Profits from centrally controlled SOEs	Agriculture-related taxes	
Business tax (banks, Nonbank financial institutions, insurance companies and railroads)	Contract tax	
	Tax on use of arable land	
	Tax on land value increase	

Source: Ministry of Finance; OECD, 2006, p. 29

Figure 2.7: Indicators of Revenue Sharing between the Central to Subnational Governments



Sources: Fiscal Statistical Yearbook (various years)

Table 2.2: Budgetary Revenues among Levels of Government, 1994-2003

Year	Central	Provincial	Prefecture	County
1994	55.7	7.6	18.5	18.2
1995	52.2	8.7	20.2	18.9
1996	49.4	10	21.3	19.3
1997	48.9	15.4	17.3	18.5
1998	49.5	13.8	17	19.7
1999	51.1	10.4	21.2	17.3
2000	52.2	10.7	19.7	17.4
2001	52.4	11.2	18.9	17.6
2002	55	11.7	17.1	16.3
2003	54.6	11.4	17.5	16.5

*Source: China Statistic Yearbook 2004 and MOF in Martinez, (2014, p. 322)*

Table 2.2 shows the division of budgetary revenues for the different levels of government between 1994 and 2003. Although the ratio has fluctuated over the years, the province, prefecture and county government has received around 11 percent, 19 percent, and 18 percent of all revenues. However, the provincial governments increased its ratio by lowering the ratio for the prefecture and the county levels. (Martinez et al., 2014, p. 321)

### *Expenditure*

China began to decentralize the budgetary expenditures at the outset of reform in 1978 (Wong, op. cit., 2009, p. 939). The most striking aspect of fiscal system in China is the prevalence of local governments' shared amount of major public expenditure. Subnational governments account for 53 percent of the total expenditure in 1978 and 75 percent during the 1980s-2006 (Ibid.). In 2003, the county governments are responsible for 30 percent of total budgetary expenditures, prefectural governments are responsible for about 22 percent, and provincial governments are responsible for 18 percent (Martinez, 2014, op. cit., p. 309).

Basically the central government cedes almost all responsibility to the subnational governments. In particular, the subprovincial governments—municipal, county, and township governments—have been assigned high shares for the major social expenditures in this fiscal decentralization. Table 2.4 illustrates the expenditure responsibilities between the central and subnational governments, which help to explain a key feature of decentralization in China. While the central government has been in charge of economic development (including investment expenditures), defense, and diplomacy, local governments have worked for day-to-day social service provisions (Wong, op. cit., 2009, p. 939). Because the social services—basic education,

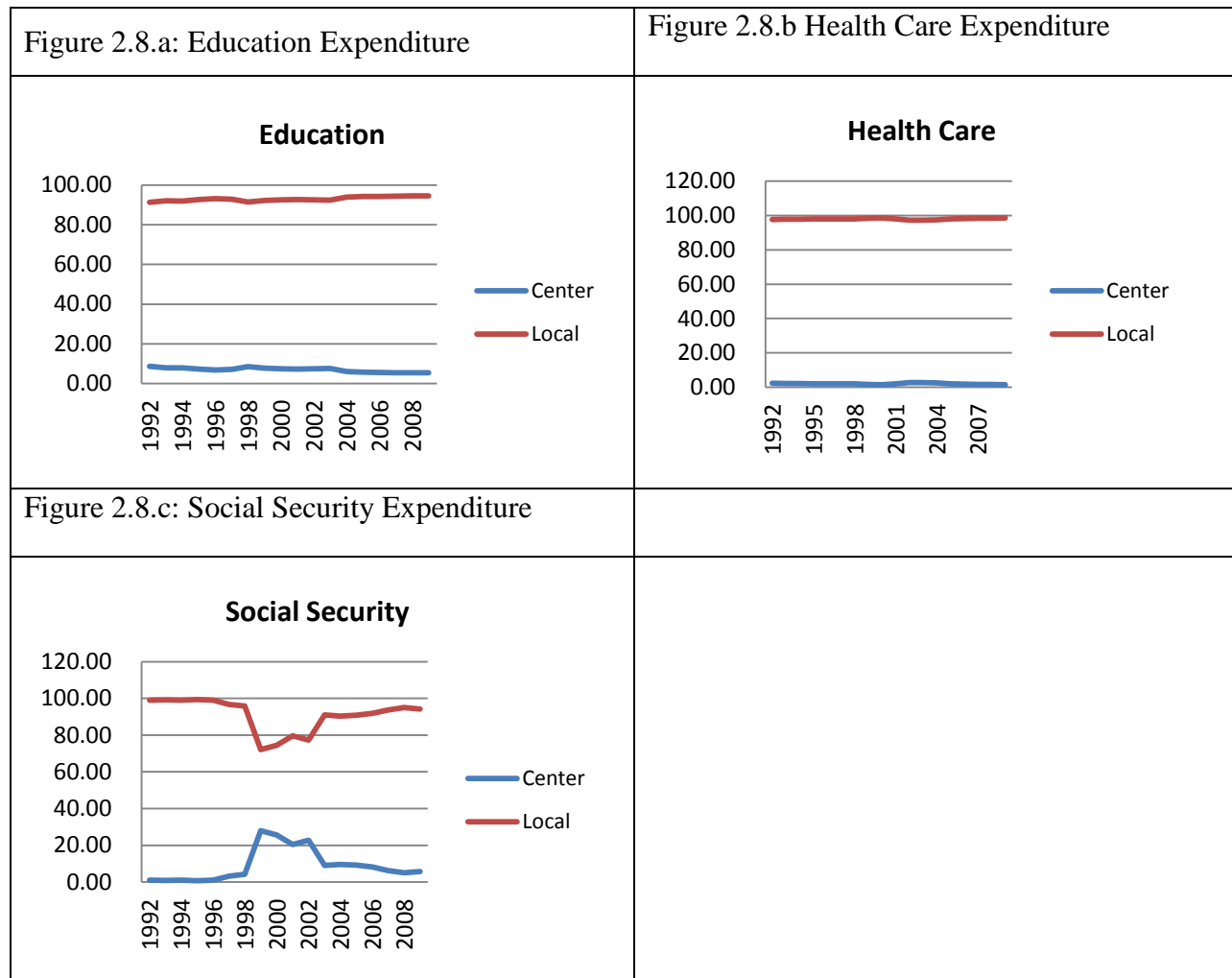
health care and social security—spend high costs, they occupies a high share of expenditure (Ibid., p. 942). This division also implies that most of the expenditure in the central government responsibility is easily cut, but expenditure responsibility in subnational governments is faced with pressure, if it tries to reduce.

Table 2.3: Expenditure Assignment among Levels of Government

Central	Subnational	Shared responsibility
National defense	Sub-national government administration	Capital construction (infrastructure projects of national and interregional nature are undertaken by the central government, local projects by sub-national governments)
Armed police troops	Innovation and science and technology promotion funds of locally controlled SOEs	Operation of agriculture and production support
Diplomacy and external assistance	Urban maintenance and construction	Culture, education, science and public health (the central government is responsible for items of national importance and higher education in general while the location principle applies for the rest)
Central government administration	Price subsidies	Social security funds (the central government makes up partly for the shortfall of PAYGO components of locally managed social security funds)
Innovation and science and technology promotion funds of centrally controlled SOEs	Public security agency, procuratorial agency and court of justice at the sub-national level	
Geological prospecting	Social security-related expenditure	
Principal and interest payment on domestic and foreign government debt		
Public security agency, procuratorial agency and court of justice at the national level		

Source: Ministry of Finance, OECD (2006, p.26)

Figure 2.8: Indicators of Expenditure Sharing between the Central to Subnational Governments



Sources: Fiscal Statistical Yearbook (various years)

Figures 2.5.a through 2.5.c illustrates the level of government responsibility in each of three policy areas: education, healthcare, and social security. The portion of the expenditure for each item between the central government and subnational governments is plotted with two lines (China Financial Yearbook). For education, the central government has funded 5-10percent, while local governments have funded 90-95percent. For healthcare, central government has had responsible for 2-3percent, and local government has had 97-98percent. For social security,

central government has charged for 1-10 percent, while local government has charged for 90-99percent, except for the period from 1999 to 2002, when central government funded 20-30 percent, and local governments funded 70-80percent. The expenditure of the subnational governments has been further accentuated due to the transfer of the responsibility from SOEs — such as educations, health care, pensions, and supporting laid off workers of these enterprises (Wong, op. cit., 2009, p. 939; OECD, op. cit., 2006, p. 26).

Table 2.4: Expenditure among Levels of Government, 2003

	Central	Provincial	Prefecture	County and Township
Total	30	18	22	30
Capital Investment	44	23	22	11
Agriculture Expenditure	12	46	11	30
Education	8	15	18	60
Scientific Research	63	23	9	5
Health Care	3	22	32	43
Social Security	11	39	32	18
Government Administration	19	11	22	48
Expenditure for Public Security Agency, Procuratorial Agency and Court of Justice	5	25	34	35
National Defense	99	1	0	0
Foreign Affair	87	13	0	0
Foreign Aid	100	0	0	0
Others	29	16	25	31

*Source: China Statistical Yearbook and MOF cited in Martinez (2014, p. 309)*

Table 2.4 illustrates the relative shares of the major expenditure components among the levels of government. The county governments are mainly responsible for basic education while the center and provincial levels have the responsibility for higher education. The central government makes the overall plan for the basic education and allocates special education funds to subsidize the basic education in poor, minority areas and for teachers' (or normal) education. The city and



county governments actually implement the education programs and finance their basic education (Martinez et al., op. cit., p. 306). For agriculture, the county governments or a higher level are responsible for “establishing special agricultural funds for agricultural development, forest cultivation, and construction of special projects such as water conservation facilities, and for the steady increase of expenditures to support agricultural science, technology, and agricultural education to promote agricultural development (Ibid., p. 308).” The central government supports agriculture development by committing and inputting an increasing rate of annual expenditures in agriculture (Ibid.).

### *Transfers*

As introduced earlier, transfers from the central to provincial governments contribute to make up the gap between the subnational government revenue and their expenditures. The central government devised a new transfer system in 1994, which consisted of three components of transfers—general transfers, earmarked transfers, and compensation transfers between the central and subnational governments (Wang et al., op. cit., p.17). Compensation transfers refer to the tax sharing transfers. General transfers are need based transfers. Earmarked transfers are distributed to subsidize special projects. Compensation transfers were introduced to reduce the revenue loss due to the 1994 tax reform. General transfers introduced to decrease disparities in expenditure as unconditional transfers in China. Unconditional transfers offer autonomy but involve accountability (OECD, 2012). Earmarked transfers promote local projects in certain areas as matching funds for most cases in China, which raise the central government’s control in order to achieve its goals (Ibid.). The ratio of earmarked transfers among total transfers for subnational governments is about 32 percent during 1997-2007, and 42 percent in 2011 and is middle level

comparing with other OECD countries (Chinese Statistical Material for Prefectures, Cities and Counties Nationwide; Wang et al., op. cit., p. 18). Earmarked transfers are categorized into about 20 types, and general transfers are categorized into relatively fixed types of 18 categories (Ibid.).

Although there is also a discrepancy in the estimated transfers between the Chinese government and OECD, it is true that the transfers occupy a high portion of the central expenditures. According to MOF, transfers to the subnational governments account for about 65percent of central government expenditure in 2009 (Guolianwang Shuju Zhongxin (国研网数据中心), 2011). The portion has risen substantially since the 1994 tax reform: it was 30-33percent during 1992-1993 (Ibid.). According OECD reports, it accounts for 33percent of the total expenditure including the budget, extrabudget, and off-budgetary expenditure (OECD, op. cit., 2006, p. 28).

This section showed two facet of the nature of the reform in 1994: (1) the reform in 1994 has greatly reduced the subnational government revenue even after including transfers; (2) It is true that subnational governments have barely met the budget balances for whole levels of government—provincial, prefecture, county, and township. However, lower level governments, the county and township in particular, have been obviously suffered from lack of funding sources.

#### **IV. Causes: Target Responsibility System (TRS) with Inefficient Revenue Sources**

##### *Political Authority*

The central government in China maintains a strict party structure, which motivates the local officials' political incentives and their political competition, and influences the fiscal institutions in China. The party discipline is a double edged sword in China. Subnational governments are

politically accountable to the central government, they promote markets, and provide public goods corresponding to the central government requests and their own demand. At the same time, the local political pressures require the local officials to build informal fiscal institutions, borrow debt from local banks, and divert intergovernmental transfers for their own priorities. While the appointment and dismissal authority controlling bureaucrats, with limited revenue collection autonomy and their own budget, officials force to find the way to provide public goods and services regardless of their appropriateness. Qian et al. (2003) accurately predicted: decentralization drove successful marketization and reform in China, but even the central government will be incapable of reversing the decentralization forces. As predicted, the decentralization in China informally continues regardless of the central government's intention.

Previous literature shows how political party structure and discipline influences national interests. William H. Riker in the 1950s noted that vertically integrated national political parties make provincial politicians seek national interests rather than local interests with strengthened relationship between central and provincial politicians (Rodden, op. cit., 2005, p.14). Olivier Blanchard et al. (2000) develop Riker. The differences of economic growth between China and Russia are caused by their degree of political centralization: China is politically well integrated, but Russia is not. In Russia, there was little political incentive that would lead local governments to cooperate with the central government. The central government in Russia with its dysfunctional democracy has been weak to prevent local governments from having private incentives to capture or to engage in competition for rents and from protecting old firms in the competition with new private enterprises against promoting growth (Stoner-Weiss, op. cit., 1998). The private interests of local governments set an entry barrier against new private enterprises and are hostile against new enterprises (Ibid.). On the other hand, relatively strong central

government in China enables to limit local officials' capture and competition for rents through promotion and demotion of local officials, and promotes "market-preserving federalism." While political power may detract subnational officials to pursue private benefit in China, it also facilitates excessive competition, extraction from less industrialized business, and diversion for accomplishment.

The contending perspectives offer discrepancies about whether the central government bargaining power at Chinese Communist party has withered since economic reform. One perspective is that the central officials dominate the CCP and bureaucratic administration for decision making and personal control, forming majority among the top leadership level (Sheng, 2005; Sheng, 2007). The central government officials monopolize political power through the appointment system of top governors and party secretary at provincials, and Chinese Communist Party Central Committee (CCPCC) in the party-state, so called *Nomenklatura*, the *bianzhi* (编制) list in Chinese (Ibid., 2005, p. 345).<sup>25</sup> Meanwhile, both the ministries at the central level and governors at provincial government promote and demote below level of bureaucracies, and so on.<sup>26</sup> The sources of administrative authority between the central-subnational governments in China are competed under a vertical-horizontal authority system called *tiao-kuai guanxi* (条块关系). The term *tiao* (条) refers to vertical authority from the central government ministry extending down to the subnational government bureau. *Kuai* (块) refers to the horizontal authority at the same level of the government. Under the system, a local bureau is accountable both to the central government's ministry and to the CCP party secretary who is the leader at

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<sup>25</sup> CCPCC decides party policy. Although the members of the central committee are selected by nominal "elections" by congress delegates (Sheng, 2005, p. 341), the candidate lists are nominated by the Politburo and Standing Committee of Party Congress Presidium, both of which are dominated by the central officials (Ibid., p. 343).

<sup>26</sup> *Bianzhi* (编制) system refers to appointment of the number of personnel in government administrative organs, state enterprises, and service organizations (Shambaugh, 2000, pp. 173-174).

each level of government. Provincial party secretaries direct the bureaucrats of the central government at local offices through horizontal (块) authority.

Due to the double authorities, previous literature tries to identify whether the reform of vertical authority (条) system reinforces the centralization. Graeme Smith (2010) argues that vertical-horizontal authority results in power vacuums at the township. Due to double authority, if the preferences differ between the local party secretary and the central government's ministry, the policies would be less likely to accomplish anything (Smith, 2010).<sup>27</sup> A related factor is the central government's appointment power for the top leaders at the provincial level, Susan Shirk emphasizes the counter forces of "reciprocal accountability" between the central and subnational politicians. Because the supreme party leaders at the Politburo standing party organs or Politburo are selected by the full CC membership in which provincial government occupies a crucial ratio, the provincial bargaining power has been strong, in particular, during the successionist contests among the central leaders. However, Sheng's research illustrates that the central government's proportional occupation of the full CC membership increased from 31.25 percent in 1978 to 55.17 percent in 1997 (Sheng, op. cit. 2005, p. 352). Thus Shirk's arguments cannot be empirically supported. Furthermore, the central government has strengthened their information collection capability after the economic reforms through an appointment system (Huang, 1996; Tsui et al. 2004, 75-82).

Based on discrepancies over the degree of political decentralization, a hypothesis can be

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<sup>27</sup> Due to soft centralization, township government officials cannot work their real jobs and are accountable to upper level of governments. For example, the rural credit co-operatives and the finance and civil affairs agencies are accountable to province; the head of a township land management agency is accountable to township government (Smith, 2010, p.610). Meantime, due to its location in townships, township governments and staffs ask respond to their favor from these departments. As a result, they shirk their work. The cohesiveness of these agencies to the upper level or the township bureaucracy has weakened. (Ibid.)

developed to support either side. One is that central government still crucially controls the provincial party secretaries. Actually, after the Tiananmen incidents the political control reacted against the previous decentralization system during 1980s. Thus, party secretaries were forced to follow the central party's direction as their priority. The other point of view is that although the central government exerts political influence, there is scope for evasion, and lax discipline (Shambough, 2000, p. 173-175). Mertha (2005) calls the control "soft centralization" because the subprovincial bureaucracies are centralized, but the subnational bureaucracies are decentralized (Mertha, 2005, p.792). In either case, the subnational governments develop their informal fiscal decentralization to meet the demands of the central authorities, or pursue their own priorities due to this lax discipline.

#### *Enforcement of Fiscal System: TRS with Inefficient Revenue Sources*

The evaluation system for local officials' promotion is flawed. To evaluate local cadres in accordance with the fulfillment of important tasks given period of time as dictated by superior governmental levels, a top down incentive system is introduced. This is the target responsibility system (目标责任制) (TRS), (Tsui et al., op. cit., 75-81). TRS refers to a set of performance standards (Ibid., p.72-p.75). Top leaders of subnational government officials are evaluated based on the several indicators: "ideological probity, loyalty to the Party, attitude toward work, and ability to mobilize others" (Gilley et al., 2002). In recent years, the party's Organization Department emphasized the officials' performance and successes in implementing policies. The central government shapes the structure of the allocation of fiscal resources at the local level through the TRS (Tsui et al., op. cit., p.72-p.75). Thus, TRS provokes local cadres to assign their fiscal resources in ways corresponding to the preferences of the center (Ibid., p.75).

The evaluation categories of TRS have been changed, reflecting the central government's plan. While the former scheme entirely weights the local GDP growth in China (OECD, op. cit., 2006, p. 39), the recent system is designed to evaluate efficiently ability to carry out the provision of public goods and services. Choi (2006) proves the relationship between crucial policy areas, such as the tax collection capability at province level, and governors' promotions. Graeme Smith (2010) shows that the priority of township government in Anhui province has changed from revenue collection to fulfillment of expenditure in 2000s. During the 1980s and 1990s, the priorities were collecting tax, tasks assigned by higher levels of government, and family planning (Smith, 2010). During 2000s, the priorities become National Party guiding principles and policies, family planning, and attracting investment (Ibid.). Notably, the magnitude of collecting revenue has been reduced from 92 in 1980s to 0 in 2006, while the magnitude of public goods and services provision increased from about 30 to about 45 (Ibid., p. 605). In addition, the focus of valuation of public spending was shifted from ensuring their compliance with legal and regulatory provisions to the efficiency of their spending and goal achievements as benchmarks in the various spending categories. For example, the focus has changed from the amount of education expenditures to the number of students for a given amount of expenditure (OECD, op. cit., 2006, p. 39).

Nonetheless, the TRS does not necessarily build a transparent system of budget accounting. The subnational governments seek to accomplish target responsibility, which makes them to search for revenue sources regardless of the commensuration with the preference of the central authorities (Tsui et al., op. cit., 2004). There is also the absence of an effective credit rating system and monitoring system (OECD, op.cit., 2006, pp. 35-36). While the budget is limited and extrabudget is also gradually controlled by the central government, subnational

governments or other administrative units affiliated with them can freely use the off budget in the extra-system. This is the source of problems due to difficulty of monitoring and a lack of accountability to principles.<sup>28</sup> Unlike extra-budget, off-budget expenditures in the extra system are not legally authorized, and, due to its informal nature, are substantially unrecorded. Thus, the subnational governments extremely utilize these extra budgetary systems, which are nearly fully controlled by local governments. As I will prove in the following chapters, the subnational governments are able to influence the lending decisions of the local financial institutions. Their political influence on the debt process may be highly influential because the credit-rating system and bond market therefore does not accurately value the debt according to risk factors in financial market (OECD, *op. cit.*, 2006, p. 35-36). Off-budget expenditures and the subnational government debt will constitute a risk to the sustainability of China's public finances (OECD, *op. cit.*, 2006).<sup>29</sup> Subnational governments also divert intergovernmental transfers to pay for their official wages.

Contrary to Russia, central officials in China are able to discipline local officials for integration of regions through party system. Subnational officials manage the budget system to fulfill the TRS for their political advantage, but with limited fiscal resources, subordinate governments create informal funding sources to meet their responsibility standards, which was an unintended consequence of political and revenue centralization. Although it cannot be compared with Russia, this informal decentralization in China undermines the constitution and

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<sup>28</sup> Transparency is just letting people know where, how much, and how government agents obtain and disburse funds. Accountability-to-principles is not only having the information behind the budget systems known to the public, but actually subjects the government agents to accountability, in case something goes wrong more often in the way the funds were used. Accountability is more stringent in the sense that one has a monitoring, evaluation and responsibility scheme; transparency is just limited to monitoring.

<sup>29</sup> OECD estimates subnational governments' debt increased fast during the late 1980 and the middle of 1990s due to declining SOEs performance and the construction investment boom from 1993.



reduces efficiency. As long as the central government is able to dominate the politics in China with a lack of a monitoring system, its cadre management influences the political and fiscal institutions.

## **V. Consequences**

Unfunded mandates along with the TRS have had important consequences on China's informal decentralization. In general, centralization reduces the regional disparity, at the expense of efficiency with regional diversities (McKinnon et al., 1997). In China, the central government revenue increased, but expenditure assignments to the local governments remained the same, squeezing local budgets after the tax reform in 1994. Thus, the tax system resulted in instability due to the large gap between revenues and expenditures, and between the public expenditures officially recorded in the budget and the actual expenditure and debt. These are not adequately under control of the central government and thus seriously impede effective budget planning. The problems are as follows: (1) Social services are underprovided even under the TRS. (2) Recentralization in China has failed to accomplish the needed redistribution. (3) The intergovernmental transfers were mainly used according to the priorities of the subnational governments rather than for social services. (4) As a consequence of "decentralization by default," the subnational governments are forced to greatly rely on extra-system support for its public sector (Wong, op. cit., 2009, p. 935-936).

*"Decentralization by default" and underprovided social services.*

While the subnational governments are subject to the central government directions for their expenditures, central government resource control has disconnected the revenue assignments

from the expenditure responsibility. “Decentralization by default” (Ibid.) refers to the unfunded mandate that subnational governments face in China. As Graeme Smith (2010) researches, expenditure ranges are broad from budgetary to offbudgetary mandate. Among the budgetary expenditure, the share of counties and township expenditure has risen in the economic transition period in general, primarily because officials’ wages and salaries have risen fast (Wong, op. cit., 1997, p.30). The budget of many grassroots level governments are reduced to barely manage “dining finance” (吃饭财政), which means barely able to pay civil servants’ wage bill and running expenses (Jing et al., 2009; Xiong 2012, p. 4; OECD, op. cit., 2006, pp. 33-34). The subnational governments are also forced to provide unfunded mandates, such as restructuring of locally owned SOEs, supporting their laid-off workers (OECD, op. cit., 2006, p. 5). Furthermore, they also provide entertainment expenses, which are never listed in their budget (Smith, op. cit., p. 617). For example, they need to pay for hosting guests (接待) who inspect the township to fulfill the orders dictated by upper level governments (Ibid., pp. 606-608).<sup>30</sup> As a result, these levels of governments underprovide their social services, operate deficits, fail to pay bills to meet their expenditure mandate, and embezzle intergovernmental transfers.

While the gap between revenue and expenditure is large, and TRS pressures local bureaucracies, the transfers are not effectively distributed (OECD, op. cit., 2006, pp. 33-34). Upper level governments within provinces distribute tax and transfers to their lower levels, but the process is not regulated and differs across China. This process severely increases the gap between expenditure and revenue at the lowest levels of government—counties, townships and villages (Ibid., p. 29). The consequence is that the subnational governments spend at relatively

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<sup>30</sup> According to Graeme Smith (2010), the entertainment expenditure is the major and direct reason township governments’ debt.

low levels for their major social and development needs, such as education and health by international standards (Ibid., p. 18).

### *Recentralization in China and failed redistribution*

Overall public spending in China varies from region to region. Income differences across provinces have resulted in large disparities in revenue capacity and service provision. The GDP comparison between the highest province (Guangdong) and lowest province (Tibet) during 2008-2012 is about 87 to 1 (China Statistical Yearbook). Their revenue-raising capacity is varies greatly and expenditure differs as well. Per student spending for primary school between Shanghai and Guizhou differed by 7 times in 2004 (Wong, op. cit., 2009, p.943). Wang et al.(2013) shows that public services are much more diverse than civil servant numbers and their salaries within provinces and also across provinces (Wang et al. op. cit., p. 27).<sup>31</sup> In 1998, county and township governments collected 20 percent of total revenues, while spending 28 percent of total expenditure. The gap of revenue and expenditure was met by transfers (Wong, op. cit., 2009, p. 943). However, it was far from enough for the poorer jurisdictions to carry out their responsibility with their transfers (Ibid., p. 943-944). Furthermore, extrabudget, which was repealed in 2011, and off budget have exacerbated the fiscal resources discrepancies because wealthier regions can easily impose fees and charges (OECD, op. cit., 2006, p. 29; Wong, 2000).

The tax reform has substantially increased transfers, which theoretically enabled the central governments to reduce the regional disparities. However, empirical results show that the inequality has remained. Actually, the previous literature shows an inconsistency. According to

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<sup>31</sup> Wang et al (2013) argue that because salaries paid to civil servants, teachers, doctors and government administrative staff are not various, the delivery of basic public services such as education, healthcare, and general public services are equally provided within provinces (Wang et al. 2013, p. 27).

Wang et al. (2013), the transfer largely reduced fiscal disparity across regions (Wang et al., op. cit., p.20). Transfers reduced the Gini coefficient from 0.31 to 0.18 at subnational level in 2010 and from 0.53 to 0.32 at sub-provincial level in 2009 (Ibid., pp. 25-26). However, after the distribution of transfers, the expenditure gap per capita still remains high in China (Ibid., p. 25). On the other hand, others argue that transfers fail to reduce disparities between expenditure responsibilities and revenues across the central and western regions (OECD, op. cit., 2006, p. 29; Liu et al. 2009; Tsui, 2005; Wong, 2000; Zhang et al., 2010). Transfers are pegged to tax collections and have been distributed more to the rich areas (Wong, Ibid., 2000). Nonetheless, both researchers agree that the disparities at subnational regions are still higher when compared with the OECD countries and the disparities at subprovincial regions are still higher than at the provincial level (Wang et al. op. cit., pp. 25-26). Chapter 4 will develop the relationship between transfers and spending.

#### *The usage of intergovernmental transfer*

Due to its unfunded mandate, the 1994 tax reform made the subnational governments largely depend on the transfers from the central government, but there are several problems. First, earmarked transfers increased regional disparity because the poor city and county governments cannot produce the matching funds, which are required for earmarked transfers (Wang et al. 2013, p.26). Western areas have addressed the issue in the National People's Congress and the Chinese People's Political Consultative Conference (CPPCC), but the central government failed to respond with ways to solve it (An interview with a report at a city in Hunan province). Second, intergovernmental transfer was mainly used to meet the diverse priorities of the subnational governments rather than to provide social services. Because the system does not clearly dictate

the uses for these transfers and lacked a sufficient system to monitor them, the subnational governments have an incentive to use the transfers for their own spending priorities (An interview with a report at a city in Hunan province). In particular, provinces do not distribute the transfers to their own lower levels of local government in accordance with their need, instead hold back funds for their own purposes (OECD, op. cit., 2006, pp. 6-7). The major problem is how the transfers at the subnational governments are allocated for the provision of social services, the form of the governmental administrative spending, and any impact on the redistributive effects. Chapter four will delve into the disparities between these basic services and government administrative spending.

#### *The unfunded mandates and the extra system*

Several elements of the current system create perverse incentives for the subnational government to create their own budgeting in various ways. The result is three kinds of budget categories in China: budgetary funds, extrabudgetary funds (EBF) (预算外资金), and the extrabudgetary system. Together with the persistently large gaps between expenditures and the resources, while fulfilling mandate for TRS, the absence of an effective monitoring system, and motivation for economic growth, the subnational governments have a real incentive to utilize on-budget (预算), extra-budget (预算外) and extra-system (制度外).<sup>32</sup>

Extra-budgetary revenues consisted of surtaxes, levies and user charges, which was collected, allocated or arranged by government bureau or by other institutions that carry out responsibility assigned to them by the government (OECD, op. cit., 2006, p. 19-20). Extra-

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<sup>32</sup> OECD and IMF consider extra-budgetary expenditures as general government expenditures. Extrabudget is also high in many developing countries and several OECD countries (OECD, op. cit., 2006, pp. 19-20).

budgetary revenues were repealed in 2011 due to the social problems it generated. As Figure 2.5 shows, the extra-budgetary expenditures of subnational governments reached about 95 percent of total extrabudgetary expenditures in 1997. The ratio rose from 56 percent in 1992 to 85 percent in 1993, it declined to 73 percent in 1996, but has risen again. The extra system consists of self-raised funds (SRF) (自筹资金), indirect liabilities, and tax preferences. SRF consists of fees and charges (OECD, op. cit., 2006, p. 20-21). Indirect (implicit or contingent) liabilities mainly refer to the local government vehicle companies' debt on behalf of the local governments. These companies carry out the construction, and thereby contribute to the growth in liabilities. Tax preference refers to the tax exemption or tax preferences for certain business industries.<sup>33</sup>

As for the extrabudgetary system, the subnational governments are indebted through several types of debt.<sup>34</sup> Legally, subnational governments neither can have debt, nor deficits. Under Article 28 of the Budget Law, the subnational government must balance their budget expenditure in every year, and cannot issue bonds except with the approval of the State Council.<sup>35</sup> In addition, article 73 stipulates that the all subnational government officials will be responsible for

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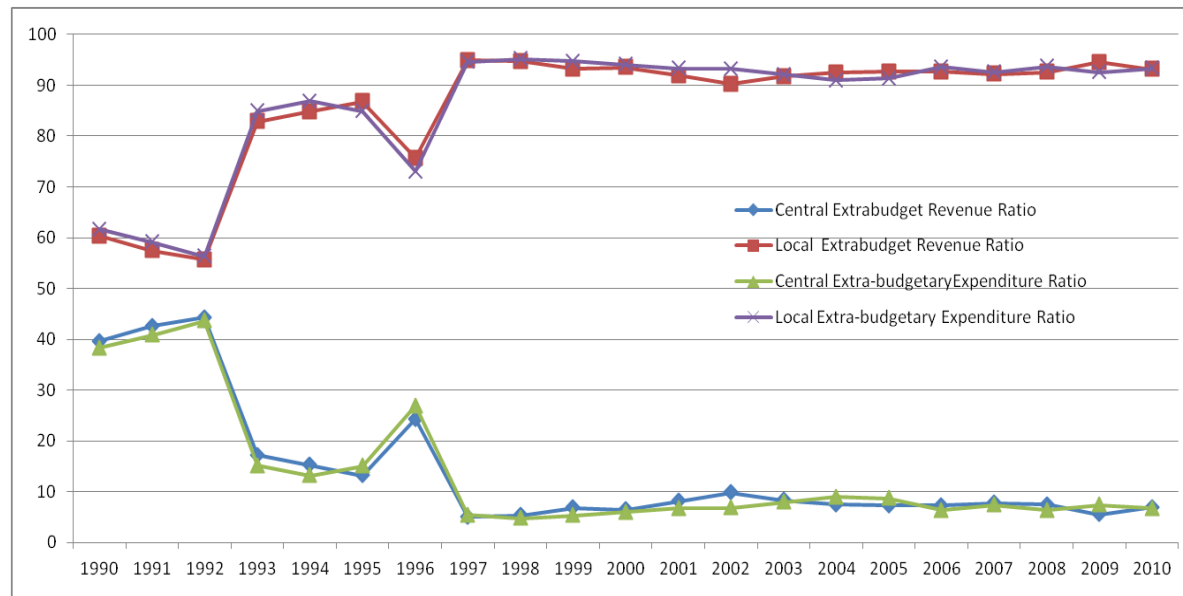
<sup>33</sup> Jing Jin and Heng-fu Zou (2003) analyze how local governments responded to budget constraint before and after the fiscal reform in 1994. Before 1994, local governments (1) expand the local tax base at the expense of the central government; (2) change budgetary funds into extrabudgetary funds in order to avoid sharing with the center; (3) sometimes finance through indirect local borrowing; and (4) engage in tax preferences by establishing SEZs, reducing effective tax rates on enterprise profits below the statutory rate, reducing the size of the taxable income. After 1994, local governments (1) agree on the transfer rule for the assurance of the distribution in 1993; (2) increase local tax ratio among total revenue while Central revenue share is continuously declined after 1994; (3) transfer expenditure assignments to the all the way down and finally devolved to the local residents; (4) resort to SOEs' providing public services, reducing budget constraints on the local governments; In return, SOEs repayment ratio of the bank loan is low when local government control over the credit supply of the local bank branch; (5) create dummy financial companies and borrow internally and externally; (6) give tax preferential policies for foreign investors; (7) supplement local governments' expenditure with extrabudgetary funds and local government self-raised funds

<sup>34</sup> The subnational governments are able to use surplus from the previous year (OECD, op. cit., 2006, p. 33).

<sup>35</sup> Budget law article 28 stipulate that "[t]he local budgets at various levels shall be compiled according to the principles of keeping expenditures within the limits of revenues and maintaining a balance between revenues and expenditures, and shall not contain deficit. The local governments may not issue local government bonds, except as otherwise prescribed by laws or the State Council."

their budget deficit and/or debts.<sup>36</sup>

Figure 2.9: Central and Local Extrabudgetary Revenue and Expenditure



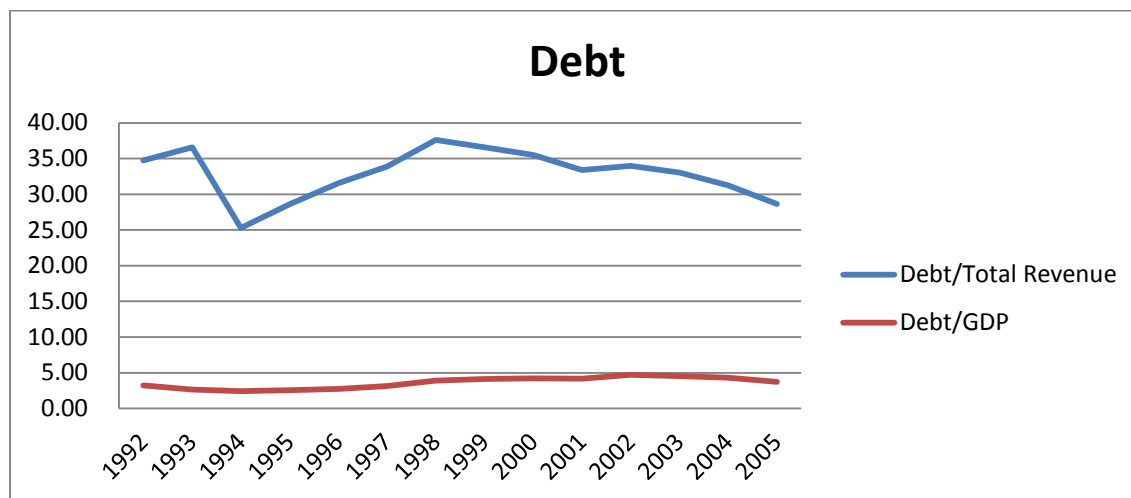
Source: China statistical yearbook (Various years)

In reality, the subnational governments practice in four types of debt (OECD, op. cit., 2006, p. 33-34). First is bonds issued by the central government on behalf of subnational governments in order to reconcile the financial need of local expenditure with lack of revenue after the second half of the 1990s (Ibid.). The bond is the only legally allowed debt. The central government bonds are granted on an ad hoc basis rather than the subnational government fiscal capacities and needs (Ibid.). Second is the wage of the teacher and construction arrears as actual and explicit debt (Ibid., p. 21). An actual but implicit liability is unfunded pension liabilities (Ibid.). Third is non-performing loan (NPLs) created by local financial institutions (Ibid., p. 22). In the past, the government made the banking system support their unprofitable SOEs, which

<sup>36</sup> Article 73 stipulates that “[w]here a government at any level, without an approval afforded in accordance with the law, arbitrarily alters its budget, thus making total expenditures exceed total revenues in the original approved balanced budget or making an increase of the debts to be borrowed as compared with the original approved budget, the person in charge and other persons held directly responsible shall be investigated for administrative responsibility.”

produced the NPLs problem (Ibid., p. 21). Finally, a recent variety of debt is related to the government's investments, including unpaid construction works, guarantees for construction projects for public-private partnerships, and the local government's vehicle companies' debt which was to invest infrastructure on behalf of the subnational governments. As TRS makes subnational governments set a priority for capital spending (investment projects), the debt has been increased (Ibid., p. 34; Smith, op. cit., 2010). OECD expects that if the projects yields lower than expectation, local governments may bail it out (Ibid., p. 34). Moreover, the immeasurability of local government debt would become a problem. Together with the debt accumulated from past, the vehicle companies' debt would manifest as a problem at some point (Ibid., pp. 20-21).

Figure 2.10: Bond issued by central government



Source: *China Finance Yearbook (various years)*

Because the implicit liability is difficult to assess, the Ministry of Finance cannot estimate the size of entire local governmental debt. Figure 2.7 shows only the bonds issued by the central government. While the ratio of bond among total revenue has fluctuated, the ratio among GDP has been stable. The level of central government bond is around 32.45percent of fiscal revenue



(tax, transfer, debt revenue) from 1994 to 2005 and 3.72percent of GDP during same period (China Fiscal Yearbook). It rose after the tax reform, but fell down after the Asian financial crisis in 1998. However, if one includes the indirect debt, the figure changes. According to previous research, the county, township and village debt varied from 3.5percent of GDP to 9.3percent of GDP in 2002 (Lin, 2003; Song, 2003; Zhou, 2004; OECD, op.cit., p. 34-35). According to the OECD calculation, the ratio of local debt of fiscal revenue is the lowest when in comparison with the OECD countries, while the ratio of local debt to GDP is the highest comparing with OECD countries (OECD, op. cit., p. 34-35).

In the formal budget, the balanced budget requirements and prohibition of local debt embedded in the budget law strengthen the centralization tendencies, while reducing the subnational governments' autonomy. In particular, the central government bond issuance and increased intergovernmental transfers make the subnational governments depend on the center (Ibid., p. 32). However, as long as the informal market exists in China, it faces a limitation: Local governments do embark on investment projects and overcome short-term liquidity problems with indirect debt in the extra system.

## **VI. Conclusion**

This chapter examined how the nature of fiscal system in China evolves during the course of its reform, the consequences during its evolution, and the risk to the financial system and the causes of the problems.

First, the chapter examined the nature of the fiscal system, given the goal of expanding revenue and the budget by the central government. This chapter illustrates the result of the

financial system reform—the revenue, expenditure, and transfer change—before and after the tax reform in 1994, using the national statistical yearbook. Motivation for centralization was to increase the central governmental budget. By increasing the revenue per GDP and its revenue to subnational governments, the central government increased the passed on the responsibility for the provision of public services and the intergovernmental transfers influencing to the subnational governments. China's fiscal system became decentralized based on the large degree of devolution of spending responsibility to the local level. However, a closer look at the degree of autonomy reveals a highly centralized system in which the subnational governments do not have their own authority over expenditure decisions, or discretion to raise revenues.

This chapter also discusses the underlying causes for the informal decentralization after the 1994 reform. As the official fiscal system in China shows a high centralization, the subnational governments are expected to act as merely agents on behalf of the central government (Ibid., p. 32). However, a closer look at the system reveals that China has an informal fiscal decentralization.

Each province in China is headed by a centrally-appointed governor, while real power and decision making authority is centralized in the hands of Chinese Communist Party. The high degree of centralization is further accentuated by the lack of political elections. Subnational officials are accountable to the central government rather than citizens under their jurisdiction for their performance (Ibid.). Provincial governments are considered the same as a ministry of the central government and as agencies acting on behalf of the central government, rather than as decentralized entities exercising genuine autonomy. Motivation for an informal decentralization is that the subnational governments are expected to maintain an adequate level of sufficiently providing social services. The idea is that by maintaining the public services previously provided

by governments and transferred from SOEs in pre-reform, the subnational officials are able to increase the probability for their promotion. However, without enough resources and an insufficient monitoring system accompanied by political pressures, the subnational governments actually sought out an informal way to increase their budgets: they used the intergovernmental transfers for their own priority and developed extra-system approach for their investment projects.

Through this process of de-linkage between the revenue assignments and the expenditure mandate, but a linking of the budget management and political factors, the Chinese fiscal system was fundamentally changed. The consequence is a change from formal decentralization to *informal* decentralization.

To summarize, this chapter showed that expanding central government forces and politically motivated intervention in budget management cannot counter the evolutionary forces of the financial decentralization. It inadvertently enlarged the risk within the financial system. Thus, the goal of financial centralization cannot be fully accomplished and the discussions of financial centralization should consider the political incentives which might increase financial system risk in the future.

### Chapter 3

#### Patterns of Local Debt and the Role of Political Connections

##### I. Introduction

This chapter will examine how the subnational governments finance local projects in both the public and private sector by increasing their local debt. The subnational governments provided these public goods not only by depending on taxes, revenue-sharing, and transfers in the intergovernmental fiscal system, but also by borrowing from banks. A major argument in this chapter is that the subnational government intervention affects the local banks loans to the subnational governments, and also their LGFPs, by which the central government sought to prohibit of the building up of debt by the subnational governments, in fact shows lack of accountability or credibility.

What is motivating researches to study the inter-relationship or inter-dependence between the China's sub-national or local governments and the private sector is the looming debt of the former. *De jure*, China's governance has not been completely a federal nor has it been decentralized over the last six decades.<sup>37</sup> However, *de facto*, China has been fiscally decentralized. Subnational governments are responsible for providing public goods and services within their jurisdiction. During 1995-2006, about 55.62 percent of all budgetary collected revenue<sup>38</sup> and about 75.95 percent of expenditure have been directly managed by the localities (China Statistical Yearbook, various years). Even after adding the funds for the intergovernmental transfers from the center to localities, the latter jurisdictions have had 63.46 percent, while being responsible for 75.95 percent of public goods provision during the same

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37 China had experienced a long history of federalism and decentralization since Zhu dynasty.

38 The collected revenue includes local government revenue (tax revenue and non-tax revenue), but does not include transfers from the central government (中央税收返还和补助收入) and the allocated tax revenue share from the central government (上划中央四税收入), which include portions of the state value-added tax (VAT), income taxes and business taxes.

period (China Statistical Yearbook, various years). At the end of 2010, the balance for the local governmental debt was about 86percent of the total local budget revenue<sup>39</sup> (China Jianyin investment security, 2011; China National Audit Office, 2011).

The central issue with the subnational debt occurs when the federal level of state of China is forced to deal with these debts during times of crises at the local level. Since the economic reforms in 1978, China has experienced two major subnational debt crises—in fact or in as conjectured by appearance—in 1999 and 2010. In the first case, the local government of Guangdong clamored for a central government bailout. The central government, unfortunately, denied this request to bail out these provincial debts. In a second case, the central government responded by giving autonomy for the debts to the local governments in order to reaffirm its stand to not assume the local debts and to make the province debts transparent since 2011.

Before the debt issue arose in 2010, the way the central government disciplined the sub-nationals was by to impose a set of very strict budgetary constraints on the sub-nationals.<sup>40</sup> In times of an excessively high budgetary imbalance, the central government limits the local governments' access to borrowing, while maintaining a balanced budget through the transfer of subsidies from the central to the local governments. Nonetheless, the commitment of the central government to maintaining a balanced budget has been suspect as it was largely driven by political incentives.

While the local debt does not influence the promotion of the local governmental official within the party system during these times,<sup>41</sup> economic growth does. China's party system in the

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39 The ratio refers to the local government debt (地方债务余额/可支配收入) is divided by the total local budget revenue (可支配收入), which includes the revenue collected by local government (地方本级收入), intergovernmental transfer (中央转移支付) and fund income (基金收入). Generally, the local debt (地方债务余额) includes the debt of LGFPs (代偿平台债务余额) and the bond issued by the Ministry of Finance in lieu of local governments (财政部代发地方债).

40 According to Rodden (op. cit., 2005), a higher level of government is able to discipline subnational governments by limiting their access to borrowing when vertical fiscal imbalance is high.

41 Chinese media reported that the central government has considered the local debt as an influential factor to

1990s and 2000s encouraged both the party secretary and the provincial head to engage in economic competition between the local governments. This is in addition to the concern over the political stability within the jurisdiction which also has an influence on national stability (Smith, op. cit., 2010).<sup>42</sup> The central government has ignored the local government which has continuously circumvented the law as well.

The literature concerning this issue follows these two threads: One focuses on the incentives to motivate the subnational governments which increase debt (Rodden, op. cit., 2002; Rodden, op. cit., 2006; Clingermayer et al., 1995), and the other literature discusses the way in which these governments increase their borrowing. This chapter focuses on the latter thread. Lynette Ong (2006) studied how township governments borrowed loans from rural finance institutions (such as Rural Credit Foundations (农村合作基金会) and Rural Credit Cooperative (农村信用合作社) and failed to pay back these loans. She elucidated that township governments and party secretaries control the board of directors of the rural finance institutions. This corporate governance structures has enabled township governments to use the finance institutions as their own coffer.

The above observation on the relationship between local government and local banks reveals how deteriorated the centralization efforts within the banking industry were in the sub-national areas of China. Consequently, after the financial crisis in East Asia in 1997, the central government led by Zhu Rongji successfully centralized the banking sectors in order to utilize the financial power for their political survival (Shih, 2004). As a result, local governments were

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turnover local officials since 2011. It implies that before the debt issue surfaced in 2010, the debt was not associated with the promotion.

<sup>42</sup> The priorities of local governments have been slightly changed. During 1990s, the priorities of local governments were to collect taxes and attract investment, while during 2000s, to control family planning and attract investment (Smith, 2010).

expected to lose their capability to manipulate the banking sector in their jurisdiction. The Big Four state bank managers were supervised and promoted throughout the party system, while their lending capability was also reduced, and thus the banks became were freed from local government influence. Meanwhile, the People's Bank of China (PBOC) provincial offices were integrated as regional offices across several provinces. As a result, the provincial government's influence on PBOC was weakened. The new institution significantly reduced the subnational governments' influence on state banks (Ibid., p. 934-935). However, the local government informal influence on bank managers continued (Ibid.). Thus, although the central government might successfully control equitized banks, meaning the Big Four state banks, not all of banks are centralized (Shih, 2010).

Michael F. Martin (2012) in his policy report illuminates that China's local governments have strong and complex ties with other types of banking sectors—policy banks, city commercial banks, and joint-stock commercial banks. Moreover, the competition among the banks cannot ignore the valuable interests based on reliable collateral and guarantors. Ironically, among policy banks, the China Development Bank (CDB) initiated the borrowing to LGFPs, by collateralizing the land. After CDBs, the Chinese commercial banks also began to provide loans to the LGFPs. The city commercial banks, initially established and owned by the regional government at the provincial or municipal level, were privatized during 2000s, but they continued to have a special tie to their local governments as the local governments have shareholding. Although the city commercial banks are overseen by the PBOC and the China Banking Regulatory Commission (CBRC), they also respond to the local governments' preferences. Among the private banks including joint-stock commercial banks and foreign owned banks, the majority of the shareholders of joint-stock commercial banks are also the local governments or government-

owned entities. This suggests that the local governments, up to present, are still directly and indirectly influencing the operation of the banks in sub-national China.

In this Chapter, I intend to emphasize the relationship between the banks' political connections to the subnational-government and the way loanable funds are allocated across industries. Because China's capital and financial markets remain weak and are far from liberalized (Fan, et al., 2007), it is expected that there exists a strong positive correlation between the government's political clout on these local banks and the amount of loans being provided to finance the local projects or those preferred by the government to advance its agenda. Consequently, it is necessary to observe how the subnational government's credibility has been far with its pursuit to comply with the mandate of the central government which prohibited the build up over time of the subnational governments' debts.

This chapter develops Martin (2010) and provides empirical evidence on how subnational governments, as major shareholders, control the bank loan decisions and how the current practices undermine the reforming of these institutions, which then led to the debt crisis in 2010. This chapter also verifies that a political connection is effective in increasing overall loans within the jurisdictions. Adopting the framework of Fan et al. (2007), the political connection is defined herein as the banks' chairman's careers, as former local officials and/or concurrent local politicians, build close ties to ruling officials.

An analysis of a cross-regional data set at city level, will test that local commercial banks' loans to the local companies for a particular use—deemed to be for a public purpose—has been relatively high in the jurisdictions where either the: (1) local bank chairman is politically connected to the subnational government; (2) the composition of the shareholders is related to the subnational government; or (3) both. This combination elucidates the nature of fiscal



decentralization in China where the banks' board is conducive to keeping the local governments' budget maximization. This suggests that the evaluation of local officials based on economic growth and public goods provisions (Li et al. 2005; Huang, op. cit.; Whiting, op. cit., p.280), ironically, has motivated the local officials to take on high debt ratios, reducing the leverage of the central government's fiscal power. The analysis illustrates the way in which the city level governments in China politically and economically distort the central government's fiscal disciplines or sanctions and their commitment in the late of 2000s.

The remainder of the paper is developed as follows. The first section develops the hypotheses of the linkage between the political connections and the local debt. The second section introduces cross-regional data on the chairman of the bank, and shareholders, to demonstrate that even after liberalization, the members of the local bank boards are still affiliated with their local governments. The subsequent sections are detail the cross-regional empirical analysis about the effect of the bank chairman's political connections on the loans from the local banks, and the final section concludes with key arguments and findings.

## **II. Hypotheses Development: Illuminating Differences across the City Commercial Banks**

There have been several types of local banks—city commercial banks, rural commercial banks, urban-rural credit cooperatives, and village and township banks (VTBs). Among them, the focus of this chapter is the city commercial banks. According to the audit report No. 35, reported by the Chinese audit office (2011), the debt balance of city level government is the highest as 43.51percent when compared with the provincial government at 29.96percent and to the county government at 26.53percent, as of the end of 2010.

Most of the city commercial banks were established after 1993, and they are continuously

being reformed. During this time period of the mid 1990s many of urban and rural credit cooperatives were merged or transformed into the city commercial banks. This was pursuant to the Commercial Bank Law, which was promulgated in 1995 (Lin et al., 2009). Recently, as the city commercial banks have been privatized in large part, their name also has changed from being city commercial banks into banks. About 8 banks were merged during the 2000s (Martin, op. cit.). Nonetheless, the banks still have close ties with the city governments at the prefectural level.

*H1: The chairs' political connection with the city governments is associated with a higher construction industry debt in their jurisdiction.*

H1 is based on the conjecture of a positive relationship between the chairs' political connection and the existence of a higher construction industry debt in the jurisdiction where the banks are located during 2000s. H1 applies Fan et al. (2007) framework into China's banking industry. Fan et al (2007) examine that CEOs' political connection with the governments diminishes firm performance and board professionalism.

Historically, the political system in China is characterized by several entrepreneurs at the village level being having bestowed upon them positions at an even higher level in the government (Edin, 2003, p. 46-47),<sup>43</sup> in order for the government to somehow get a hold on them. Likewise, city governments created mechanisms to control the bank and other financial institutions by bestowing concurrent positions at the governmental institution on the bank's current chair or by selecting a chair who used to be a local government official.<sup>44</sup> The chairman's

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43 Maria Edin (op. cit., 2003) finds that the village officials and entrepreneurs are not controlled under the Nomenklatura system of the CCP, and thus the CCP incorporates them into the party-state by bestowing concurrent position at the higher level of government.

44 According to Company Law of China (revised in 2005, 公司法), the chair is appointed and dismissed by local government. Their term in office is often 3-4years.

past or current working experience with the local government is instrumental in building these close ties between the city commercial bank and local government (Martin, *op. cit.*, p. 22). The working experience, in effect, has become one of the conditions in which the banks are more likely to respond to the local governments' preferences, all else being equal (Ibid.). Thus, the government exhibits its political influence (or intervention, to some extent) by appointing the chair who has had a political affiliation with governments at the local level (Fan et al. *op. cit.*).

As expected, this rent-seeking behavior and inefficiency in the local financial market entails a huge cost, primarily leading to misallocation of funds in the jurisdiction. Each city bank's annual reports show that most of leading borrowers for the city commercial banks during the 2009-2010 are located in the jurisdiction where the banks are placed.<sup>45</sup> Moreover, the city commercial bank loan process remains non-transparent. Chief credit officers are recruited within the bank, and thus cannot independently decide credit decisions for the bank operations. Furthermore, city banks do not have a separate auditing program (Hamid, 2005). Actually, the politicians or officials can easily manipulate banking industry relative to other industries (see for example, Dinc, 2005; Rajan et al., 2003).<sup>46</sup> Thus, the institutional feature of city banks facilitates the government to influence loan process for local industry, particularly the construction industry, which the subnational governments have competitively promoted for regional economic growth (Kuijs, 2010)

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45 Of course, one can argue that this is expected since there is less transaction cost if the borrower is close to the source of loanable funds. Nonetheless, the proportion is quite unreasonable, abstracting from the rent-seeking behavior inherent in the current management of the city bank.

46 "First, the asymmetric information between lending banks and outsiders about the quality of a specific loan makes it easy to disguise political motivation behind a loan. Second, revealing the costs of any politically motivated loan can be deferred until the loan maturity. Third, while a non-bank government-owned enterprise operates in a defined industry, which can limit the politicians' ability to transfer resources, banks operate across the whole economy, providing politicians with more opportunity to channel funds. Finally, the political elite can maintain and increase its power through the control of financial resources more easily than open entry barriers in other sectors (Dinc, *op. cit.*; Rajan et al., *op. cit.* )."

*H2: The proportion of local government shareholding of the city commercial banks is highly associated with the level of debt in construction industry within their jurisdiction.*

Similar to the prior study, H2 investigates whether the ownership structure of the city commercial banks in China affects the bank loans for construction industry. The H2 is based on the information that local governments' shareholding ratio in city commercial bank in China varies. Currently city commercial banks have been owned by states, legal entities including state owned enterprises and investment companies, and also by individual investors including the officers of the city commercial banks. In some cases, foreign investors acquired a small portion of shares. If the local governments are the major shareholders of the local commercial banks, the banks would be in favor of projects that the local governments promote at the expense of the banks' own interests (Shleifer et al., 1994; Fan et al., op. cit.). Local governments as a major shareholder, aware of their possibility for influence, they will adopt a strategy to influence the loan process to finance the local industry that the local governments promote.

The consequences of the state ownership and firm performance have long been the source of interest. While most of scholars studying developing countries argue a positive relationship between firm performance and the government relinquishment of control (Boubakri et al., 2005; Fan et al., op. cit.; Xu et al, 1999), Kole and Mulherin (1997) find that the state ownership does not influence the firm's performance in the U.S. right after World War II. Narrowing down the research scope from firms to banks, I. Serdar Dinc (2005) verifies that the government owned banks create inefficiency in financial systems across countries. In developing countries, the government-owned bank provides more loans to finance the government projects compared with the private bank during election period. However, government ownership in developed countries

does not increase the loans (Dinc, op. cit., p. 455).

*H3: The chairman's political connection with the city governments is positively associated with local debt financing for the 2<sup>nd</sup> generation project industry sector.*

H3 has same logic with H1, except that it considers additional loan items not only for construction loan but also for other projects, such as water conservation, environmental projects and public facility management. These sectors of subnational governments' financing are referred to herein as the 2<sup>nd</sup> generation of infrastructure industry (Kuijs, op. cit.) after investing in the construction industry.

*H4: The portion of the city commercial bank shares owned by city governments is positively associated with local debt for the 2<sup>nd</sup> generation project industry sector.*

H4 builds upon the loan items discussed in H2: the local government owned banks are more likely to provide more loanable funds, not only for construction, but also for the 2<sup>nd</sup> generation project industry sector in their jurisdiction.

*H5: The political connections between the chairs and subnational governments are positively associated with construction, transportation and real estate industry sector loans.*

According to Audit report no. 35 published by Chinese audit office (2011), the local government or LGFPs' loans have been used mainly for the following areas: "municipal construction, communication and transportation, land restoration and preservation, education, science culture, public health and low-income housing, water-conservation projects in agriculture and forestry, eco-conservation and environmental protection, fending-off financial risks of local governments, industry, and energy." In particular, the local governments have recently focused more on constructing road and ports (Kuijs, op. cit.). Thus, it is hypothesized that the city governments

have tried to increase these loans. This can be done by utilizing and further enhancing the opportunities to use the governments' connections with the politically appointments or the affiliated bank chairs.

*H6: The city government's shareholding levels in the city commercial banks is positively associated with their local debt for construction, transportation and real estate industry sector loans.*

Extending H5, this hypothesis points to the local government's ownership of the city commercial bank as it influences the loan decision process for the particular industrial sectors mentioned above.

The above six hypotheses—the association between presence of the bank's affiliated chair and local debt, and between the local government ownership and local debt—to the extent that they are warranted, will determine not only the distortion and inefficiency in the banking sector, but also provides an analysis on the undermining of central government's regulation on the localities' budget stature.<sup>47</sup> This chapter provides strong evidence to the conjecture that the politically-motivated loan process at the local level is an unexpected response to the centralization.

### **III. Research Design**

#### **(1) Data and Variable**

The data—city commercial bank's loan, chairman's back ground, and shareholder structure—

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<sup>47</sup> The central government has prohibited subnational government from borrowing of domestic and foreign debt, and demanded balanced budget requirements, while maintaining local governments' spending level under high vertical fiscal imbalance between the center and subnational governments. To compete with other governments in providing public goods, the subnational governments not only depend on intergovernmental transfers, but also search for their independent budget sources—that is accessing to credit. The loan from the banks includes the local government loan and the LGFPs' loan, which is spent on social projects the local governments plan to invest in. Prosperous economy by encouraging local investment, mainly derived from construction industry during 2009-2010, in the jurisdictions implies increased local economic growth and local governments' tax base.

were obtained from each of the City Commercial Banks' annual reports during 2009-2011. Meanwhile, the gross domestic product (GDP) of the cities at prefectural level was obtained from All China Data website.

### ***Dependent variable: Local Government Loan***

The loan structure reported in each bank's annual report was classified according to the quality of loan asset, industry sector, geographical distribution, major borrowers, and security type. Above all, this chapter employs a loan by industry sector analysis. Of the loans taken out by the various industries, this sample only captures a number of industry categories of loans, most of which are assumed to have been borrowed by the government or LGFPs for public purposes.

Actually the loans borrowed by LGFPs (地方融资平台) are perceived as problematic. The LGFPs are particularly set up in order to fund infrastructure spending in the jurisdictions (Ibid.). Nonetheless, the borrower data cannot be used, because banks do not report their entire list of borrowers. Indeed, the names of the top 10 borrowers in the annual reports are not broken down according to the ownership characteristics. Thus, due to the data feasibility, the borrowers' data cannot be analyzed.

Admittedly, both loans from the city government and LGFPs do not equal the loans for the various industrial sectors for the 1<sup>st</sup> generation and 2<sup>nd</sup> generation projects.<sup>48</sup> The industrial sectors for the 1<sup>st</sup> generation projects include construction, traffic and transport, real-estate. Meanwhile, the 2<sup>nd</sup> generation projects consist of water conservation, environment and public facility management. Nonetheless, because the local governments have been highly engaged in,

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<sup>48</sup> These industries refer to traffic and transport, real estate, water conservancy, environment and public facility management and sewage systems.

and encouraged infrastructural spending (i.e. construction industry for roads and ports) since late 2008 (Ibid.), it is justified that the construction industry sector largely reflects the subnational governments' direct and indirect investment. Similarly, governments have recently begun to emphasize sewage and environmental projects. Thus, the selected industry loans for this analysis are mainly those used by the government or LGFPs for these public purposes. I.Serdar Dinc (2005, p. 455) supports my justification in that although the ratio of loans among total assets in the government-owned banks does not differ from the private banks across an election cycle, the government-owned banks<sup>49</sup> in developing countries finance more government projects than do private banks.

***Independent variables: The Chair's politically connection and Banks' ownership structure***

*The Chair's politically connection*

The profile of the chairs for each bank was obtained from the "the directors, supervisors, senior management and staff of the rank" section of the annual reports and other internet websites, which contained the demographic information relating to the age, gender, education, and employment history of the chairs.

The chairs have often worked in various departments in the city governments at the prefecture level. Table 1 describes the positions/offices the chair has held in the past and currently holds. Some of them had worked for the local finance bureau or local construction bureau, while others are concurrently holding positions as member of the People's Congress, the political consultative conference or they are the Party Representative at the city level. Some of them have worked only

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<sup>49</sup> In Dinc (2005), the government-owned bank does not refer to local government but national level of government.



for banks. The political connections are based on previous work at local government as it refers to the same city governments. In fact, over 90percent of chairs who hold a concurrent position in the government institutions used to work in banks, rather than in government offices. Meanwhile, all of bank chairs are concurrently holding the position of the Secretary of Party Committee of CCP Party of their banks.

#### *Banks' ownership structure*

In addition to the chair's data, the ownership structure for each bank was obtained at the "Changes in Share Capital and Major Shareholders" section in the annual reports, which generally disclose the shareholding ratio of three groups of shareholders—the state, legal persons (institutions), and individuals. Only some bank annual reports specifically sort out legal person into state owned enterprises, domestic, and foreign legal persons. For this reason, the disaggregation of legal persons was not considered in this paper and state ownership was thereby defined as direct state ownership.

Table 3.1: The Chairs' Previous Offices Held

	<b>Offices held in the City Government</b>	<b>Offices held in the other sector</b>
Working Experience	Provincial <i>Audit Office</i> (审计厅) The General Office of the People's <i>Government</i> of City (政府办公室秘书) Local Tax Bureau (地税局) Finance Bureau (财政局) <i>Grain of Bureau</i> (粮食局) Bureau of Railroad Railway <i>Bureau</i> (铁路局) <i>Auditing Bureau</i> (审计局) Bureau of Building Industry (建筑业管理局) <i>Statistics Bureau</i> (统计局)	Banking Industry State Owned Enterprises (SOEs) CBRC (银监局)
Concurrent Position	City or District People's Congress People's Political Consultative Conference (政协) The standing committee of Municipal, City or District People's Congress (市人大常委会委员) Financial & Economic Committee of City People's Congress (CPC) (市人大财政经济委员) Standing <i>Committee</i> of the CPPCC Municipal or City <i>Committee</i> (市政协委员会) The Chairman of LGFPs City Party Representatives (市党代表)	The member of National People's Congress (全人大) People's Political Consultative Conference (全国政协)

***Control variable: Listed Companies, Total Loan and Total Shares***

***Listed Banks***

3 city commercial banks among total 81 banks—Ningbo, Nanjing, and Beijing—are listed in the stock market. For these banks, the shareholding structure is divided into both restricted sales, and publicly offered. Because it is difficult to identify the portion of city government ownership for

the public offered shares, the listed banks are controlled.

#### *Total Loan and Total Shares*

The total loans and total shares are also included in the annual reports. Total loans include corporation loans, individual loans, and discounted bill, and excludes reserves.

#### *Selected Period: 2009 and 2010*

This research covers the period from 2009 to 2010. The major reason for selecting this period is the availability of data. Each bank's annual report is available from 2007 to 2011 as a maximum period. However, many banks already have removed their annual report for 2007-2008 and did not upload for 2011, while most of them contain information from 2009 to 2010.

Indeed, these years are worthwhile for consideration. For one thing, this is the period characterized by the heavy central government interventions amidst the looming global economic recession. To avoid a recession influenced by the U.S. financial crisis in 2008, the central government stimulated the subnational governments to ramp up their infrastructure spending. Nonetheless, the central government still prohibited the subnational government borrowing, and did not increase their intergovernmental transfers. Thus, the debt at the subnational regions increased greatly for the infrastructure investments after late 2008. Although the LGFPs have steadily borrowed over the years, their borrowing during this period skyrocketed.

## **(2) Variable Description**

#### *The Change of Construction Loan*

The construction loan as a dependent variable refers to the percentage change in the construction loan between 2009 and 2010. It is calculated from the differences of construction loan in 2009 and 2010, divided by construction loan in 2009.

#### *The 1<sup>st</sup> Generation Public Project Loan*

Table 3.2 illustrates the loans borrowed by each industry sector. Among the sector, the industries in left column were selected because these industries are estimated to be mainly used for public projects. The other loans are used for mining sector, manufacturing sector, sales industry sector, etc. As these industries are the typical source of borrowing by the private sector, they were not considered in the analysis.

#### *The 2<sup>nd</sup> Generation Public Project Loan*

Because, the industry sectors such as sewage and environmental management are now emphasized as the second generation of infrastructure (Kuijs, op. cit.), the 2nd generation public loan is defined as a loan to construction, and water conservation, environment and the public facility management industry sector.

Table 3.2: Loan Items by Industry Sector

<b>Loan item considered to spend for public projects</b>	<b>Loan item not considered for the analysis</b>
1st Generation Public Project Industry Construction Traffic and transport, Storage and postal service Real estate  2nd Generation Public Project Industry Water conservancy, environment and public facility management	Mining Agriculture, forestry, animal husbandry, fishery Manufacturing Wholesale and retail Accommodation and catering Information transmission, computer services and software Finance Lease and business services Culture, sports and entertainment Scientific research, technical service and geologic prospecting Productions and supplies of electric power, gas and water Residential services and other services Public administration and social organizations Public Utility Personal loans
Remarks: Industries such as education and hygiene, social security and social welfare are included as major source of loan for Audit Report no. 35 issued by Chinese audit office. For simplicity, this paper does not include these items.	

### *Chairman's Political Connection*

The chairman's political connection is a dummy variable. This dummy variable equals one (1) if the chairs have a political connection with local governments, and zero (0) otherwise. During 2009-2010, four chairmanships of 113 commercial banks were changed. The analysis is based on the differences between 2009 and 2010, and the backgrounds of the the newly appointed chairs in 2010 were considered.

### *State ownership*

State ownership refers to the fraction of shares of the city commercial banks currently held by the local governments.

#### *Bank Size*

Total outstanding shares of banks are controlled for the effect of bank's size.

#### *Total loan*

To control for the factors driven by the size of the total outstanding loan, the total outstanding shares of bank and total loan are included. The total loan is run to control the changing effects of the general loan. The total loan measured the rate of change of the total loan between the year 2009 and 2010.

#### *GDP in 2009*

GDP in 2009 is considered for the city, where banks are registered. While 82 cities are located in prefecture level cities, 2 banks are located at county level cities.

#### *The Change of GDP*

The difference between 2009 and 2010 is considered as the change of GDP.

## **IV. Result and Analysis**

### **(1) Descriptive Results**

#### *Sample Description*

Table 3.3 summarizes a sample of loans, chairman's political connection, and shareholders in 84 banks. Of the 84 banks, the sample in table 3 captures 32 construction loan and 57 chairman data of all City Commercial Banks.

Panel A provides a description of the change of construction loan and public project loan. I obtain the loan by construction industry for 32 banks from the 2009 to 2010, representing 38percent of the total number of city commercial banks in China. Mean value of the change of construction loan in each city was 29percent. The available data for loan for 1st generation public projects and 2nd generation projects was for 37 banks and 35 banks respectively. Mean value of the change of these projects in each city was not high, increased by 6.85percent and 1.85percent respectively from 2009 to 2010.

Panel B describes the profile of chairs in the sample. The chair data for 57 City Commercial Banks during the 2009–2010 represents 70 percent of the total number of City Commercial Banks in China over that period. Almost 38percent of the chairs from the sample of banks are politically connected with the local governments. Of the these politically connected chairs, 50percent were former government bureaucrats and 50percent are currently the members of the People's Congress, the People's Political Consultative Conference (CPPCC), or the Party representative at the city level. Only one chairman is the city party representative. Meanwhile, 23percent of the chairs have continuously worked for bank without any political connections with city government. The proportion of politically connected chairmen in the banks implies that the subnational governments significantly influence the chairman's appointments in the majority of subnational banks.

Panel C in Table 3 provides a description of the ownership structure of the sampled banks. The shareholder data for 51 City Commercial Banks during the 2009–2010 represents 62percent

of the total number of City Commercial Banks in China over that period. The local governments are found to be the major shareholders of City Commercial Banks across the sample period. On the average, local governments own 15percent of the bank share. The largest state shareholders account for 57 percent of the outstanding shares in 2009. This provides a qualitative indication supporting of H2 and H4; that is, that the local government ownership might be an important source of bank decisions for some city commercial banks.

Panel D shows that the scale of city commercial banks has drastically increased from 2009 to 2010. The total loan base was increased by 22 percent from 2009 to 2010. Nonetheless, the change for construction loans is still higher than the change in total loan, implying banks prefer to lend to the construction industrial sector compared to other industrial sectors. The finding implies that bankers still view the construction industry, which has been supported by governments, as a prospective investment area during 2009 and 2010 and the debt could be manageable as long as the annual growth in real estate prices and inflation stability remained high in China.

Panel F illustrates that GDP for the sample cities in China in 2010 increased enormously on the average from 2009; the growth rate ranged from 13percent to 37percent across cities.



Table 3.3: Descriptive Statistics of City Commercial Bank Loan

Variable	Observations	Mean	Standard Deviation	Minimum	Maximum
<b>Panel A: Loan</b>					
Construction Loan	32	28.9	71.53	-60	341.49
2nd Generation Project	35	1.85	36.9	-57.14	87.44
1st Generation Project	37	6.850622	37.67338	-57.01014	155.0088
<b>Panel B: Politically connected Chairman</b>	57	0.53	0.5	--	--
<b>Panel C: Shareholder</b>					
State Ownership in 2009	51	15.29	12	0	46.76
<b>Panel D: Others</b>					
Total Loan Changes	51	22.41	18.37	-98.78	45.47
Total Shares in 2009	55	1800000000	1760000000	176000000	8620000000
<b>Panel E: Listed Bank</b>	80	0.04	0.19	--	--
<b>Panel F: GDP</b>					
GDP in 2009	82	2320.308	2416.164	287.97	15046.45
GDP Change	82	19.59341	4.432798	13.32	36.85

## (2) Correlation

Table 3.4 describes the correlation among variables. The results are statistically significant. The major independent variable, chairman's political connection, has positive correlations with construction loan and 1st generation project loan—construction, transportation and real estate industry sector. The change of GDP between 2009 and 2010 also has high correlation with the construction loan.

Table 3. 4: Correlations Coefficients (N =84).

Variables	1	2	3	4	5	6	7	8	9	10
1. Constructi on Loan	1									
2. 2nd Project Loan	0.5582***	1								
3. 1st Project Loan	0.6828***	0.6865***	1							
4. Politically Connected Chair	0.4157**	0.219	0.3222*	1						
5. State Ownership	-0.013	0.1881	0.3082*	0.0158	1					
6. Total Loan	0.1593	0.0801	0.0605	0.1342	-0.0488	1				
7. Total Share	-0.1463	-0.0986	-0.0201	-0.2694*	-0.1421	-0.3735**	1			
8. Listed Banks	-0.0799	-0.1696	-0.0352	0.0663	-0.0398	-0.5359***	0.2373*	1		
9. GDP in 09	-0.1851	-0.1568	-0.1602	-0.187	-0.0147	-0.5242***	0.5169***	0.3709***	1	
10. GDP Change	0.488***	0.0945	0.1276	0.2204*	-0.05	0.1326	0.0645	-0.0321	-0.2742**	1
*p < .1. **p < .05. ***p < .01.										

### (3) Main Results

This section presents the results of the multivariable linear regression analyses examine the effects of the chairs' political connections and local government ownership on construction loan or other public project loan provided by the city commercial banks.

#### *H1 Test Result*

Table 3.5 empirically tests the effect of having a politically connected chair to the change in actual loans for the construction industry.

Table 3.5: Regression Results of the Change in Construction Loan on the Political Connection of the Bank's Chair and Other Variables

	(1) Change of Construction Loan	(2) Change of Construction Loan	(3) Change of Construction Loan
Politically Connected Chairman	39.58** (2.09)	-	37.38 (1.68)
State Ownership 2009	-	0.83 (0.68)	0.58 (0.59)
Change of Total Loan	-0.25 (-0.45)	-0.09 (-0.11)	-0.33 (-0.55)
Total Share 2009	0 (-0.11)	0 (-0.53)	0 (0.08)
Listed Bank	-30.25 (-0.67)	-19.32 (-0.29)	-37.29 (-0.76)
GDP 2009	0 (0.2)	0 (0.12)	0 (0.07)
Change of GDP	1.26 (0.45)	13.15*** (3.8)	2.95 (0.84)
Constant	-22.28 (-0.41)	-206.24* (-2.7)	-51.11 (-0.75)
N	27	26	24
adj. R-sq	-0.0258	0.2906	-0.0701

t statistics in parentheses

\* =  $p < 0.10$  \*\* =  $p < 0.05$  \*\*\* =  $p < 0.01$

Column 1 in Table 3.5 shows the test result of H1—the effects of the chairs' political connections on construction loan of the city commercial banks. Consistent with the correlation results reported in Table 3.4, the results from this regression supports H1, indicating that banks with politically connected chairs are associated with a higher amount of construction loans. This result demonstrates that the banks with politically connected chairs increased their construction loans by 39 percent higher than those without the politically connected chairs during covered period. The high rate of construction loans, associated with the politically connected chairs is signaling that government intervention has been effective.

### *H2 Test Result*

Column 2 in Table 3.5 shows the results of the regression analysis that examines the effects of local governments' shareholding on the change of construction loans. The independent variables are the fraction of shares held by the local governments and the foreign entity. Control variables are the same in Model 1. The result does not show statistically convincing evidence for the hypothesis that the banks mainly owned by local governments are associated with higher increases in construction loans. Thus, unlike the findings of prior studies on government-owned firms, the local governments' ownership proportion does not predict significant local government control on the amount of construction loans. Other control factors, the change of GDP during 2009-2010 influence city commercial bank's construction loan.

### *Full Model Test Result*

Table 3.5 demonstrates the results of multivariable regression that examines both the effects of politically connected chairs and the local governments' shareholding ratio on construction loan changes. The dependent variable is the construction loan. The independent variables refer to both the politically connected chairs as the dummy variable and the fraction of shares held by the local governments. Total share, total loan, listed bank at stock market, GDP in 2009 and the change of GDP are still controlled.

The regression result in Column 3 in Table 5 is not statistically significant, although the coefficient is consistent with the H1 and H2 result reported in Table 5. Banks with politically connected chairs tend to lend high construction loan. The coefficient of the chair's political connection continues to be positive as the 37.38 at the p-value 0.11.

Summing up, the outcomes in Tables 3.5 suggest that city commercial banks in China tend to concentrate on construction loan when their chairs have a political connection with local governments with their former government position or a current position in the City People's Congress or the Political Consultative Conference at the city level.

### *H3 and H4 Test result*

In this section, I examine the relationship between the percentage change in the 2nd generation projects loan and our variables the politically connected chairman and city government ownership. Table 3.6 provides the results of the regression models (4), (5), and (6).

Column 1 of Table 3.6 depicts the Model 4 which tests the relationship between the percent change in the 2nd generation project loans and the political connection of bank chairs. The control variables are still same as H1 test. The result shows no statistically significant evidence illustrating that banks led by politically connected chairs lend more 2nd generation project loans relative to their politically unconnected counterparts.

Column 2 of Table 3.6 tests the relationship between the 2nd generation project loans and the fraction of local governments' ownership of the city commercial banks. Again, the control variables are same as the H2 test. The estimated coefficient on the local government's ownership ratio is found to be not statistically significant, suggesting that states which retain a large ownership of the city commercial banks have no significant influence on bank's lending decision.

Finally, Column 3 reports the regression with both the previous variables included in the model. That is, maintaining the change in 2nd generation project loans as the variable being explained by the political connection of the bank chairs and the ownership percentage of the local governments, as well as control variables used in the previous models. Again, there was no

statistically significant evidence suggesting that the change in 2<sup>nd</sup> generation project loans increases, as chairs are becoming politically connected nor as more shares are being held by the government.

Table 3.6: Regression Result on the Politically Connected Chairman, State Ownership, and 2<sup>nd</sup> Generation Project Loan

	(4) Change of 2 <sup>nd</sup> Generation Project Loan	(5) Change of 2 <sup>nd</sup> Generation Project Loan	(6) Change of 2 <sup>nd</sup> Generation Project Loan
Politically Connected Chairman	23.1 (1.35)	-	20.64 (1.02)
State Ownership 2009	-	1.02 (1.31)	0.91 (1.02)
Change of Total Loan	-0.39 (-0.79)	-0.32 (-0.62)	-0.44 (-0.81)
Total Share 2009	1.46 (0.31)	2.65 (0.05)	1.25 (0.21)
Listed Bank	-46.64 (-1.14)	-37.26 (-0.89)	-47.32 (-1.07)
GDP 2009	0 (-0.48)	0 (-0.72)	0 (-0.61)
Change of GDP	-0.80 (-0.32)	2.35 (1.09)	-0.29 (-0.09)
Constant	17.09 (0.35)	-35.10 (-0.73)	2.34 (0.04)
N	28	28	25
adj. R-sq	-0.11	-0.08	-0.138

t statistics in parentheses

\* = p<0.10 \*\* = p<0.05 \*\*\* = p<0.01

#### *H5 and H6 Test result*

In this section, I examine whether the 1st generation project loan—construction, transportation, and real-estate industry—is associated with the politically connected chairman and city government ownership. The table 3.7 illustrates the results of the multiple regression model (7), (8), and (9). The regression results in Table 3.7 is consistent with the H5 and H6, which shows

statistically significant between the 1st generation project loans and the politically connected chairman, and between the 1st generation project loans and city government ownership.

The results of Model 7, which tests the relationship between the 1st generation project loan and the politically connected chairman dummy variable are presented in Column 1 in Table 3.7. The result shows the banks led by politically connected chairs tend to increase their lending to 1st generation project loans relative to their counterparts. To point out, the coefficient of the political connected chairs is consistent with the H5 as the 19.71 at the p-value 0.078: the 1st generation project loans and the politically connected chairman are still (although less) significantly positive. The result suggests that a political connection has an influence on the city commercial bank loan decision. This provides support to the conjecture that government intervention, by appointing bank chairs with ties to them, is effective in increasing the local governments' preferred loans.

Table 3.7: Regression Result on the Politically Connected Chairman, State Ownership, and 1<sup>st</sup> Generation Project Loan

	(7) Change of 1 <sup>st</sup> Generation Project Loan	(8) Change of 1 <sup>st</sup> Generation Project Loan	(9) Change of 1 <sup>st</sup> Generation Project Loan
Politically Connected Chairman	19.71* (1.85)	-	21.24* (1.82)
State Ownership 2009	-	1.21* (1.8)	0.09 (0.17)
Change of Total Loan	0.09 (0.29)	0.05 (0.1)	0.05 (0.16)
Total Share 2009	0 (1.15)	0 (0.61)	0 (0.59)
Listed Bank	-1.19 (-0.05)	2.92 (0.07)	-2.51 (-0.09)
GDP 2009	0 (0.21)	0 (-0.65)	0 (0.33)
Change of GDP	-0.86 (-0.57)	2.1 (1.04)	-1.15 (-0.62)
Constant	-6.42 (-0.22)	-50.53 (-1.13)	-0.28 (-0.01)
N	28	30	26
adj. R-sq	-0.0894	-0.0619	-0.1476

t statistics in parentheses

\* = p<0.10 \*\* = p<0.05 \*\*\* = p<0.01

Column 2 tests the relationship between the change in the 1<sup>st</sup> generation project loans and the city governments' ownership level of the commercial banks. The coefficient on the government ownership is positive, providing support to the claim that the industrial loans preferred by the local government have slightly increased when the governments retain high shares in the banks. Finally, the results of the full model, which includes both the political connections of the bank chairs, and the level of ownership of the city government in these banks in explaining the variation in the change in loanable funds for the 1<sup>st</sup> generation projects, are presented in Column



3. It is found that while the politically connected chairs positively influence the 1st generation industrial loans, the level of local government ownership appeared to be statistically insignificant in predicting the change in loanable funds for the projects.

## **V. Conclusion**

This paper examines the extent by which the local governments, through appointing politically connected chairs and/or holding a significant share in the bank, influences the loan decision process towards favoring its preferred industry in China. The results of the analysis show that the banks with politically connected chairs are more likely to lend more to the construction projects, which local governments are pushing ahead in pursuit of greater economic growth, as compared to their counterparts. However, the proportion of shares held by local governments does not significantly explain the differences in the amount lent to the local construction industry.

Overall, this result contributes to the literature by expanding the previous research findings by focusing beyond the performance of politically connected firms in the stock market in China (Fan et al., op. cit.), but also looking at the impact of this seemingly rent-seeking behavior for the local government-preferred industries. This study provides significant evidence that while the Chinese local banks are partially privatized instead of wholly belonging to local governments, the government intervention has continued and still posing a considerable influence on the way funds are being allocated across sectors.

The findings have considerable policy implications. First, it calls for the re-examining of the extent of information asymmetry between the banks and its clients, particularly in the banks' loan processes. As implicitly pointed out in the discussion, the rent-seeking behavior emanates from this information advantage of the banks, which then provides the ability for the

management to extract rents (in the form of increased probability of being appointed to higher positions). The findings also suggest that limiting the governments authorized right to appoint chairs could enhance the efficient allocation of funds to the least costly and most productive sectors. This paper, however, does not attempt to compare the prospects in each investment area. On the other hand, the analysis found that the loan process provides a good potential for rent-seeking, which may then seek to limit the competition for loanable funds. Ultimately, this limit in competition will create inefficiencies in the financial market. Making it costly and even difficult for the government to appoint their preferred leaders in the banks is deemed to improve China's local bank loan processes, and to reduce agency problems between the central government and local governments and/or between bureaucrats/politicians and banks.

Finally, a caveat in this paper still needs to be addressed. The paper's major limitation points to the lack of accurate data for loans as directly borrowed by local government and LGFPs, this paper uses the loan in the city commercial banks mainly borrowed by the regional enterprises for a particular industrial sector as a proxy for the local government and LGFPs' loans. Although the loan is mainly spent for the regional construction industry and urban development, the data on loans borrowed by local government or LGFPs would still be required to confirm the finding of this paper. Given such, the findings of this paper can still be reinforced to realistically deal with the looming crisis in China related to the local government's financial debt. Moving forward, there is a strong need to seek empirical evidence which will determine the direction and extent by which these institutions' political connection with the subnational government affect local government debt.

The subnational government debt financing raises questions about the central government's fiscal leverage, and the subnational governments' incentives to take risks. The

central government has failed to discipline subnational governments, which have built up debt by evading the rules in the bond market. Although the subnational governments' debt is jeopardizing the country, myopically, debt-taking may help economic growth and the provision of public services in the jurisdictions, while transferring the costs to the central government or to other jurisdictions. The rational of the subnational officials is that they will be promoted, based on economic growth and the good provision of public services, regardless of their debt taking behavior.<sup>50</sup> Thus, further research is suggested for the correlation that exists between local governments' debt-taking and personnel turnover at the provincial level.

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<sup>50</sup> Economic growth (Li et al. 2005) and provisions of public goods (Enikolopov et al., 2007; Huang, 1996; Whiting, 280, 2001) are highly associated with political incentives, such as promotion, demotion and turnover.

## **Chapter 4**

### **Distributional consequences: Intergovernmental Transfers and Expenditure in China**

#### **I. Introduction**

Along with a disparity in the intergovernmental transfer process and the expenditures among industries, there appears to be another prominent problem in China during reform period. This is a territorial disparity, in particular between the east and west of China, (Harwit, 2005; Lu et al. 2003). If the central government justifies the revenue centralization, these disparities called for an adjustment in overall government spending. Among other industries, backwardness in the agrarian sector caused the peasants to suffer from lack of resources, and forced them to engage in collective action against the fee burden imposed on them (Lu et al., op. cit., 2003).

Although the tax reform in 1994 enabled the central government to increase the intergovernmental transfers in China, the objectives of the transfer policies for redistribution were not clear until 2000. Even after the centralization in 1994, the fiscal revenue and expenditure system is highly decentralized in the world (OECD, op. cit., 2006, p. 5). However, while administration of spending and taxation is decentralized to the subnational governments, this decentralization is subject to extensive centralized oversight over the local authorities for their spending and taxation powers (Ibid.). Furthermore, the Hu-Wen regime, which acquired power in 2003, encouraged the central government to set reconciling the inequality between the regions as a new priority. A Ministry of Finance (MOF) decree states “transfer payments are aimed at reversing the trend of an increasing budgetary divergence between regions and to gradually effect the equalization of the local governments’ ability to provide public services in order to realize their goal of comprehensively building the small prosperous society” (Shih et al,

2007; MOF, 2003).

However, despite the central government's rhetoric stating they favor reducing inequality through an allocation of resources, previous empirical research reveals that the overall transfers have failed to improve equality across the regions. While the Jiang-Zhu regime sustained itself by successfully conducting their growth goals, the Hu-Wen regime failed to reduce the disparity through these intergovernmental transfers. Confronting these problems, this chapter questions: (1) how have intergovernmental government transfers been used throughout the whole country?; (2) if the transfers cannot mitigate the problem, how do the subnational governments divert the intergovernmental transfers and reduce the effect of the inequality of the purposed transfers?; and (3) how do the transfers, originally planned to help with equalization, fail to promote equalization?

This chapter focuses on the first question and explores the discrepancies between the intergovernmental transfer scheme and the actual usage of the transfers. It proceeds by explaining the features of the various types of transfers after the 1994 tax reform, and then analyzes the trends of intergovernmental transfers relating to expenditures per capita. By analysis, it provides empirical evidence on the consequences of the current intergovernmental transfer and the expenditure system. There is an emphasis on the issue of the fiscal disparities across the sub-provincial level. Using county-level transfer data, this paper finds a tendency for a different usage of the transfers between the fiscally- dependent and independent counties (i.e. resource poor counties and affluent counties) between of the end of the 1990s to the early 2000s. This finding has policy implications for China's transfer scheme across regions with differing strategies.

The paper proceeds as follows. The following section introduces the transfer system from the

central government and provinces to the county government after the 1994 tax reform. This is followed by a literature review about the intergovernmental transfer in China. The subsequent section describes the hypotheses, and the data and methodology used to analyze China's transfer scheme. In the conclusion, the analysis is interpreted and further policies are suggested to improve the transfer schemes in China and ultimately for the equality across regions.

## **II. Intergovernmental Transfers in China**

From 1994 to 2007, there have been several periods of reform in the intergovernmental transfer system of China. The transfer system became complicated.<sup>51</sup> The central government transfers are now established via a range of criteria, from the amount of taxes collected by provinces, to partially assessed actual needs. For example, the tax rebate transfer, which is tied to collected taxes in the area, is seen to increase the regional disparity, but can carry out efficiency. On the other hand, the original system subsidy, transfer subsidy, and wage transfer have been designed to reduce inequality since 2001 (Zhang, 2006). Meanwhile, the earmarked transfers would apply for specific purposes regardless of disparity.<sup>52</sup>

Table 4.1 illustrates the portion of each transfer among the total transfers. The equalization transfer in the TSS system has been introduced over several years. The central government has introduced several new transfers to the county-level governments to reduce the disparity through the 1994 tax reform. The central government has manifested its intervention for equalization across the jurisdictions by an increase in the equalization transfer items since 2000

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<sup>51</sup> The Ministry of Finance adopted the term “transfers” (转移支付) only about the past decade ago. Previously, it was called as “subsidies” (补贴) (Wong, op. cit., 2009, p. 936).

<sup>52</sup> The transfer is distributed to make up including temporary abolition of fixed assets investment orientation regulation tax (固定资产投资方向调节税) and to subsidize environmental project and transform of farmland to forestland or grassland at the end of the year.

(Chinese Statistical Material for Prefectures, Cities, and Counties Nationwide, various years; Martinez et al., op. cit.). A tax return transfer, original transfer, and earmarked transfers were all introduced during the early period of Tax Sharing System (TSS), while the transfer subsidy, wage transfer, and annual balance fiscal subsidy transfers were introduced in 2000. A minority transfer and a tax for fee transfer were introduced in 2001 and 2002. Meanwhile, the original transfers only changed their goal to increase regional equality in 2002.

Table 4.1: The Portion of Each Transfer among Total Transfer

Year	Tax Return	Earmarked	Original	Transfer Subsidy	Wage	Minority	Tax for Fee	Settlement	Subtotal for General
1997	52.7	30.6	16.7	n.a.	n.a.	n.a.	n.a.	n.a.	16.7
1998	50.8	34.8	14.3	n.a.	n.a.	n.a.	n.a.	n.a.	14.3
1999	44.3	44.1	11.6	n.a.	n.a.	n.a.	n.a.	n.a.	11.6
2000	35.9	29.9	9.8	6.1	9.2	n.a.	n.a.	9.1	34.2
Sub Total	183.8	139.4	52.5	6.1	9.2	0.0	0.0	9.1	76.8
Sub Average	45.9	34.8	13.1	1.5	2.3	0.0	0.0	2.3	19.2
2002	29.8	25.0	6.3	6.5	19.3	1.3	5.6	6.2	45.2
2004	29.5	25.7	5.6	9.9	16.4	1.8	4.9	6.2	44.8
2006	19.6	31.3	5.2	13.8	16.5	1.9	3.8	8.0	49.1
2007	15.3	35.2	6.1	13.7	17.1	1.4	5.4	5.7	49.5
Sub Total	94.3	117.2	23.2	43.9	69.4	6.4	19.7	26.0	188.5
Sub Average	23.6	29.3	5.8	11.0	17.3	1.6	4.9	6.5	47.1
Total	278.1	256.6	75.6	49.9	78.6	6.4	19.7	35.1	265.3
Average	34.8	32.1	9.5	6.2	9.8	0.8	2.5	4.4	33.2

Sources: Chinese Statistical Material for Prefectures, Cities, and Counties Nationwide (全国地市县财政统计资料)

## TAX REBATE TRANSFER

The tax rebate transfer refers to the ratio of tax revenue shared by the subnational governments in proportion to that of the central government. The central government collects tax and hands over tax rebate transfer to the tax base areas. Tax rebate transfer is regressive one. To reduce local resistance against the tax reform, to reach compromise with the subnational governments, and to maintain revenue incentive for local governments after the tax reform, the central government guarantees that local tax revenue be no less than the previous one through the tax rebate transfer

(Tsang et al., op. cit., 1994, p. 780). The tax rebate transfer is for value added tax (VAT), consumption tax, and income tax. The higher levels of governments handed over 30 percent of the growth for VAT and consumption tax collection based on 1993 tax collection base amount (基数) (Liu et al., 2009; Tsang et al., op. cit., p. 781). Thus, the larger the tax base a jurisdiction has, the larger the tax rebate it receives. Because the collection of these taxes has spatial characteristics for distribution, this tax collection has intensified the regional inequalities.

The ratio of tax return transfers among total transfers has been expected to decrease since its introduction in 1994. Table 4.1 shows the ratio of tax return transfer among total transfers was 52.7 percent in 1997 and 15.3 percent in 2007.

## EQUALIZATION TRANSFER

Progressive transfers have drastically increased during the same period from 0 percent to 49.5 percent. The equalization transfers are the original system transfer, transfer payment subsidies, rural-tax-for-free reform fiscal transfer, grants for minority regions, and wage subsidies for civil servants. The details of the equalization transfers designated by the central government are as follow:

### *Original system transfer (原体制补助 or 体制定额补助)*<sup>53</sup>

The original system transfer assures both a minimum amount of total revenue in 1993 and the same amount of transfers which the local governments received in the previous fiscal system

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<sup>53</sup> The fixed/original system transfer(原体制补助) includes the fixed/original system transfer and subsidy for Agriculture tax reduction (农业税灾减免及企事业单位预算划转补助). Since 2002, the fixed/original system transfer has merged the fixed/original system transfer subsidy for subsidy for Agriculture tax reduction (农业税灾减免及企事业单位预算划转补助), and fiscal subsidy (结算财力补助) ([http://yss.mof.gov.cn/2012zhongyangyusuan/201203/t20120322\\_637099.html#](http://yss.mof.gov.cn/2012zhongyangyusuan/201203/t20120322_637099.html#)).



before 1994 (Shih et al., op. cit., 2007; Liu et al, op. cit.).<sup>54</sup> In 2002, the central government altered the purpose of transfers aiming toward an equalization of the fiscal capacities of the western areas (Ministry of Finance, 2012).

#### *Transfer Payment Subsidies (一般性转移支付)*

The central government introduced transfer payment subsidies to reduce the fiscal disparity and tax capabilities across the subnational governments (Shih et al., op. cit., 2007; Lou, 2002). Transfer payment subsidies comprised 6.2 percent of all the transfer payments to counties from 2000 to 2007 (Chinese Statistical Material for Prefectures, Cities, and Counties Nationwide).<sup>55</sup>

#### *Rural tax-for-fee reform fiscal transfer (农村税费改革转移支付)*

The rural tax-for-fee reform fiscal transfer concept was introduced to compensate for abolishing a slaughter tax and fees for township and village, and for reducing special cultivation products (Zhang, 2006). It is calculated based on the difference between “standard expenditure” and fee collection for reform (Liu et al., op. cit.). The transfer has been mostly distributed to minority and dependent areas, where inhabitants are mainly engaged in agriculture and cultivation (Zhang, op. cit., 2006). The rural tax-for-fee reform fiscal transfer constitutes only 2.5 percent of all transfer payments from 2002 to 2007. Due to the small portion of total transfer, it was seen as not being influential on the expenditure for agriculture. Thus, its aim to adjust loss of fees for areas in cultivation cannot be easily accomplished.

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<sup>54</sup> The original transfer has existed prior to tax reform in 1994 (Lü 2011).

<sup>55</sup> According to World Bank (2002), the transfer payment system formed a small portion of the central transfer payments within the TSS system. The transfer payment system does not have a significant influence over expenditures in 2001 (World Bank, 2002; Shih et al. 2009, p.9). However, as the portion of transfer payment system increases, its role has been increased.

### *Wage Subsidies for Civil Servants* (调整工资转移支付)

A wage subsidy for civil servants was introduced in 2000 to subsidize poor counties (Shih et al., op. cit., 2007; Zhang, op. cit., 2006). The central government enabled an increase in the salary and pensions of personnel in public administrative agencies through this grant. Because the eastern, middle, and western areas respectively received 4percent, 49percent, and 47percent of the subsidy in 2004, the east coastal wealthy areas—Beijing, Shanghai, Jiangsu, Zhejiang, Guangdong, Fujian—could not significantly benefit from this subsidy (Ibid.). Shen (2012) argues that provincial governments inflated payrolls and increased the number of employees in order to get more funding. Thus, the wage subsidies for Civil servants increased the administrative expenditures.

### *Grant for minority regions*<sup>56</sup>

In 2002, grants for the minority regions were introduced to reduce the fiscal difficulty of the minority regions, and the regional fiscal disparity between the minority regions and other regions. The central government expected the subnational governments to use this transfer for public administration and to reduce the local debt (Ministry of Finance, 2010). The minority regions received a billion in transfer and a VAT increase of 80percent to those regions every year (Zhang op. cit., 2006). Nonetheless, because it only occupies 0.8 percent of the total transfer, the grants for minority regions play an insignificant role in the increased expenditures.

### *The annual balance fiscal subsidy* (年终结算财力补助 or 结算补助)

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<sup>56</sup> Not significant due to lack of data.

A yearly fiscal subsidy is distributed to balance and to subsidize particular items, such as environmental projects and land improvement projects (changing farmland into forestland or grassland), and to make up for any foregone fiscal revenues including the temporary abolition of the fixed assets investment adjustment tax (固定资产投资方向调节税) at the end of the year (Ibid.). The annual fiscal subsidy constitutes 4.4 percent of all transfer payments from 2000 to 2007. The annual balance fiscal subsidy is expected to increase agricultural and administrative expenditures.

### EARMARKED TRANSFERS

Earmarked transfers were introduced to reinforce the centralization and to pay compensation for policy changes (Wong, 2009, p. 936). Earmarked subsidies are distributed based on an *ad hoc* negotiated basis between governments for specific purposes, such as agriculture, infrastructure and construction, basic education for poor areas, healthcare, disaster relief, social security, and governmental administration (Liu et al., op. cit.; Shih et al., op. cit., 2007). Earmarked transfers also include subsidizing bonds.

Earmarked subsidies were not necessarily distributed to reduce inequality. As the distribution of the funds required local matching funds (配套资金) in most cases, affluent regions had the advantage to take the earmarked subsidies (Liu et al., op. cit., 2009). Due to the nature of the *ad hoc* negotiation, the relationships between the local governments and the upper levels of government significantly influenced the distribution of the funds (Tsui, 2005; Zhang, op. cit.). To acquire more funds through the lobbying of the central government, the local governments built their offices at Beijing (驻京办), and engaged in competition (interview with Chinese citizens, 2011 at Wuhan City). In 2004, for example, sixteen provinces received the transfer: they were twelve poor western provinces and four rather affluent provinces, Jilin, Fujian, Shandong and

Hainan (Shen, 2012)

### **III. Literature on Intergovernmental Transfer**

The literature on the Chinese intergovernmental transfers emphasizes three main points. First, the literature focuses on how an intergovernmental transfer reduces inequality. They argue that the transfer failed to reduce the regional inequalities. (Tsui, op. cit., 2005; Shen, 2012). A second, emphasis is an analysis of the relationship between the local government expenditures and transfers at the county level (Shih et al., op. cit., 2007). Finally, a modicum of literature focuses on how local governments distorted the central government goals and distributed the intergovernmental transfer for their own purpose (Liu et al., op. cit.).

Shen (2012) compared the two methods in measuring inequality, using the Gini coefficient and decomposition of transfer effect, showed contradicting results with the role of the transfers on equalization. The Gini coefficient method showed that central transfers have equalized the fiscal resources at both the provincial and county level. After the distribution of the central government transfers, the per capita revenue was more dispersed than the per capita expenditures from 1998 to 2005. In addition, the gaps in revenues have been increasing, while the gaps in expenditures have been decreasing.

On the other hand, applying the decomposition of transfer effect, Tsui (2005) and Shen (2012) both concluded that the individual effects of each fiscal transfer scheme and the aggregate impact of the overall transfer system failed to equalize the distribution of the fiscal resources (expenditure) across counties. Shen (2012), in particular, found that all of the major transfers show distinct effects on equalization at the provincial level, while these contribute to a counter-

equalizing effect at the county level.<sup>57</sup> Among the fiscal transfers, the tax rebate had a regressive effect on the inequality of provincial per capita expenditures, as expected. Earmarked grants, grants for minority regions, and original system subsidies (pre-1994 subsidies) slightly increased fiscal disparity at the provincial level. Grants for increasing the wages of civil servants, the grants for rural tax reform, and the equalization transfer have had trivial effect on equalization across the provinces.

Although publishing earlier than Shen, Tsui (2005) provided empirical analysis to support the claim that the tax reform in 1994 failed to effectively reduce fiscal disparity. This failure was across counties within provinces and between provinces in 1994 and in 2000, despite the central government increases revenue resources.<sup>58</sup> In addition, Tsui (2005) found that the tax system imposed on different industries generally failed to decrease fiscal inequality up to 2000. Taxes (i.e. VAT, business tax, enterprise income tax, personal-income tax) linked to the secondary and tertiary industries contribute to fiscal disparities in large, while taxes linked to the agricultural industry contribute much less to fiscal disparities. Because the collection of these taxes has spatial characteristics for distribution, the tax collection intensified regional inequality.

According to Tsui (2005), interestingly, intergovernmental fiscal transfers, that aimed to promote equality among counties, contributed to increase fiscal gaps in 2000 across all jurisdictions. For the province level, as expected, the tax return (VAT and consumption tax) increased the fiscal disparities. Much worst, the transitional intergovernmental transfer system, which was introduced to decrease inequality, actually had the opposite effect. Only the net

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<sup>57</sup> Shen (2012) stated that “[t]he aggregate contribution of the transfer system to the inequality of per capita expenditure at the county level is about 39 percent in 2004, lower than the provincial level where it is more than a half.”

<sup>58</sup> Tsui (2005) also examines the trend of intergovernmental transfer contribution to disparity from 1994 to 2000. The disparity has been increasing between provinces, while moderately declining within province.

original-system subsidies—the differences between original system subsidy and original system remittances—largely decreased fiscal disparities, but this was decreased its importance vis-à-vis the other transfer systems. For counties, all the transfer schemes increased the fiscal gap. Even the net original-system transfers increased the fiscal disparities within provinces.

There are several shortfalls in the analysis as presented by Shen (2012) and Tsui (2005). First, Shen (2012) overlooked the magnitude of the regressive features of the tax return transfers. Because she ignored the effect of tax return transfers over the expenditures, her conclusion might be incorrect. Second, Tsui (2005) argued that the central government is not willing to reduce provincial disparity through intergovernmental transfers. However, the possibility cannot be ruled out that the subnational governments themselves distorted the central government's willingness. Finally, while Tsui (2005) and Shen (2012) identified the effect of the individual intergovernmental transfer and tax revenue on the fiscal expenditures, they did not show how each transfer and revenue influenced each expenditure item. Total expenditure is an important indicator to estimate equality across localities (Shah, 1996). Nonetheless, as a need-based transfer system exists, the analysis of the relationship between individual transfer and expenditure items appeared to be significant as it can show how the local governments actually interpreted or distorted the central government's intentions by discretionally allocating the funding scheme.

Making up Tsui (2005) and Liu et al. (2009), Shih et al. (2007) argued that the subnational governments diverted the transfers to expand their local bureaucracy and to increase the number of their staff. Shih et al. (2007) also found that the implementation of the tax sharing

system (TSS) did not reduce the economic disparity across the counties.<sup>59</sup> Subsidies in the TSS system have been distributed more to the richer, industrialized counties, and has provided for the officials and retiree's wages and benefits, than to the poorer, agrarian counties with fiscal shortfalls. In particular, because administration expenditures drove subsidy increases in 1995 and in 2000, the subnational governments increased themselves so the big government administrative institution would increase the subsidies. The provincial government was also found to be more concerned with reducing the deficit of counties rather than with economic equity. Meanwhile, by controlling the province, it was found that although the central government tended to allocate subsidies to the agrarian provinces, the provincial governments were not systematically in favor of the agrarian counties.

One of the caveats of these studies, however, is that they randomly selected their independent variable. In particular, because they did not describe the specific subsidies, they in turn have overlooked the role of tax return transfer, which was designated to return to the rich counties. While this tax return represented 34.8percent of the total subsidies from 1997 to 2007, as a corollary it concluded that it is difficult for the total subsidy to accomplish equalization. (Martinez et al., op. cit., 2014) As a side issue, they are logically suspicious. They showed the positive relationship between “the ratio of fiscal dependents to total population” and “total per capita subsidies,” while arguing that subsidies are distributed for wages increases. Nonetheless, the increase in the number of fiscal dependents which benefitted from subsidies does not necessarily imply wage increases because the county governments increased their fiscal

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<sup>59</sup> Shih et al.(2007, p. 152 and pp.157-158) adopt the dependent variable as “total per capita subsidies received by a county in a given year,” and the independent variables as “county agricultural and industrial output, county fiscal shortfall, the ratio of agricultural output to total output at the county level, a dummy for nationally designated poverty counties, and the ratio of fiscal dependents to total population in a county.”

dependents to get more subsidies from higher levels of government.

Liu et al. (2009) demonstrated through a principal-agent problem to show how the local governments in China offsets the central government's constraint over the uses of the transfers, and how a county government diverted these transfer schemes. Through a case study of a county in north-western China, the author found that the local officials at the county level in China bypass the central government's policy mandates, amidst the central government strengthening of the formal regulation of transfer uses. They still diverted intergovernmental transfers for their designated purposes or for "political projects". As a result, the educational and agricultural and rural development sector faced a shortage in operational funds, while the county administrative institutions increased their operational funds. While laudable, the study failed to generalize the county governments' behavior throughout China as it only focused its case study, on a particular poor county. Liu et al. (2009) focused on a single county government in the northwest of China which did divert its transfers for designated expenditures. Shih(2009) emphasized the fiscal inequality across the jurisdictions, what Liu et al.(2009) missed is that the northwest is a relatively poor and a fiscally dependent area within China. Due to a lack of reliable data sources, my hypothesis cannot be built to prove the exact way in which the funding is actually diverted at the county governmental levels across China. Instead, it would show how the equalization transfers are associated with the administrative, the agricultural, and the educational expenditures in the fiscally dependent counties in China.

Improving on previous studies, this chapter intends to find empirical support to previous literature on the relationship between the role of transfers and the expenditure at the county government level. It develops Liu et al.'s case (2009) to the whole counties and analyzes whether county level governments throughout whole country spend the intergovernmental transfers for



their designed usage. The study extends Tsui (2005) in figuring out how individual transfer item play the role for equalization at county level. Instead of looking for the relationship between each transfer and total expenditure, this chapter compares the impact of individual transfer on the individual expenditure of the administrative agencies, the agriculture, and the education sector among total expenditure.<sup>60</sup> This paper distinguishes the behavior of the fiscally dependent and independent areas in which the transfers could be differently spent (Shih et al., op. cit., 2007). As Shih et al. argue, the transfers could be distributed more to the rich industrialized counties. Therefore, it is noteworthy to look for the potential differences between these areas and other areas.

#### **IV. Nature on Expenditure**

It is noteworthy that the trend of expenditure of local government in general moves toward the direction of increase social welfare, while decreasing administrative expenditure in China as Figure 4.1 and Figure 4.2. However, government administrative spending is higher than social welfare.

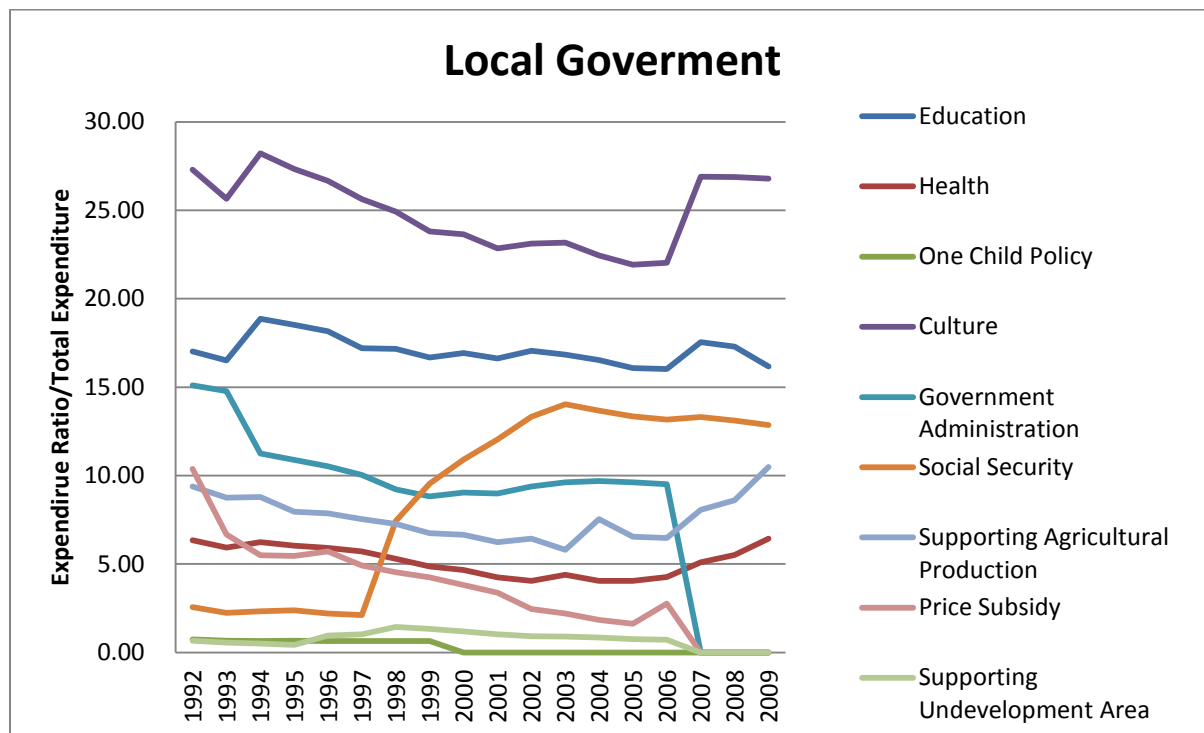
Figure 4.1 illustrates the ratio of each expenditure item among total expenditure for the county governments. Three changes are strikingly paid attention at this subnational level: the skyrocketing of social security, upward of agriculture and health expenditure, and the downward

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60 The total expenditures of the county government are composed of construction, agriculture, forestry, water conservancy and weather, education, science and technology, medical and health care, social security, general public services, affairs of law-enforcement authorities, and other expenditure (Chinese Statistical Material for Prefectures, Cities, and Counties Nationwide (全国地市县财政统计资料)). Liu et al. (2009) compare number of personnel and operational expenditure of the three sectors: the education sector, the agricultural and rural development public service units, and the county administrative agencies. Unfortunately, the data for the number of personnel of those sectors is not available for whole country. Thus, this paper only focuses on the expenditures of each agency.

trend of government administration.<sup>61</sup> The social security was increased from 2 percent to 7 percent in 1998 and maintained at 13 percent during 2000s, while the central government spending for social security decreased from 8 percent to 3 percent during 1998-2003.<sup>62</sup> The supporting agricultural production has been increased after Hu-Wen, implying Wen's promise was accomplished somewhat at the subnational level. On the other hand, the administration expenditures were decreased during 1990s from 15 percent to 9 percent during the 2000s.

Figure 4.1: Each Expenditure among Total Expenditure for Local Government



<sup>61</sup> My own interview in 2011 with a government official of a tax bureau of a prefecture government at Shandong province shows consistency with the statistics. According to him, his prefecture and other eastern areas as a very affluent government, spending in the order of wage for government official, social security, investment, construction, and agriculture. However, a large part of spending of the public funds of the other poor prefectures are in investment, while failing to guarantee government official wages and benefits, unfortunately, due to the data limitation, it is difficult to generalize for whole areas of China.

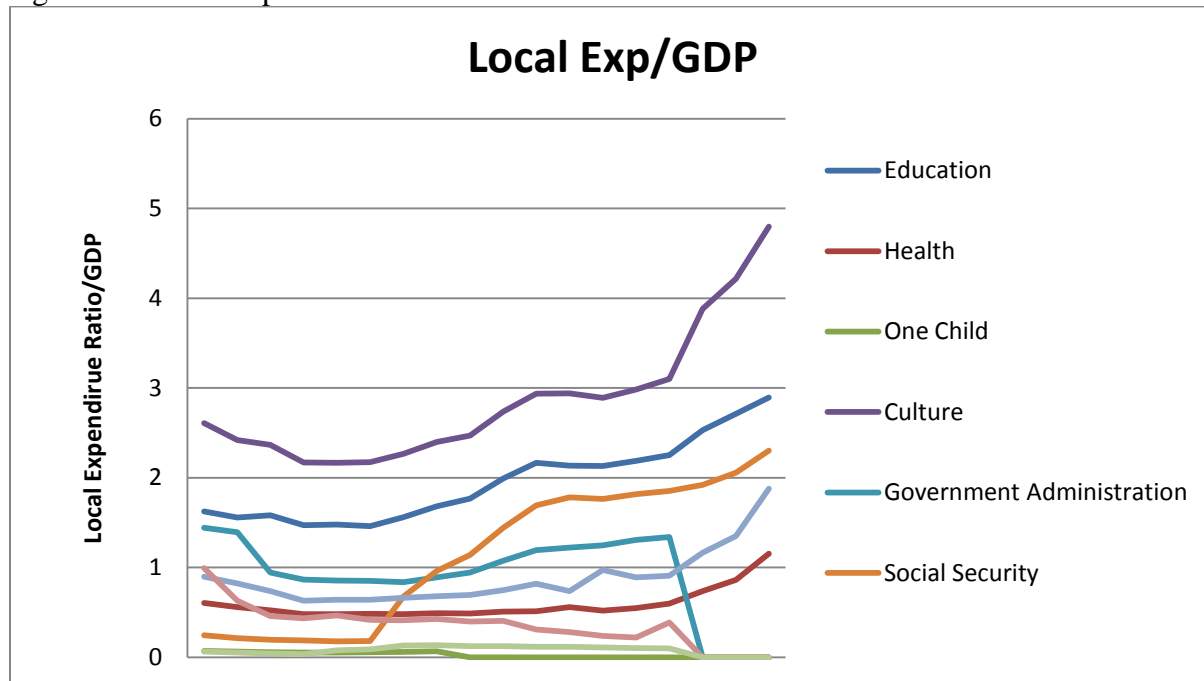
<sup>62</sup> The comparison between the center and subnational governments shows that most of the major expenditures—education, health, and social security—exhibit a higher level at 17percent, 5percent, and 9percent as an average of total spending from 1992 to 2009, while these items are only at 3percent, 0.28percent, and 3percent in average for the central level.

Source: China Financial Statistical Yearbook (Various years)

Remarks: (1) There is no data for government administration, production price subsidy, and supporting the undeveloped area from 2007 to 2008 in China Financial Statistical Yearbook.

(2) Here education spending is broad. It does not purely education spending, but also includes cultural spending, media, and etc.

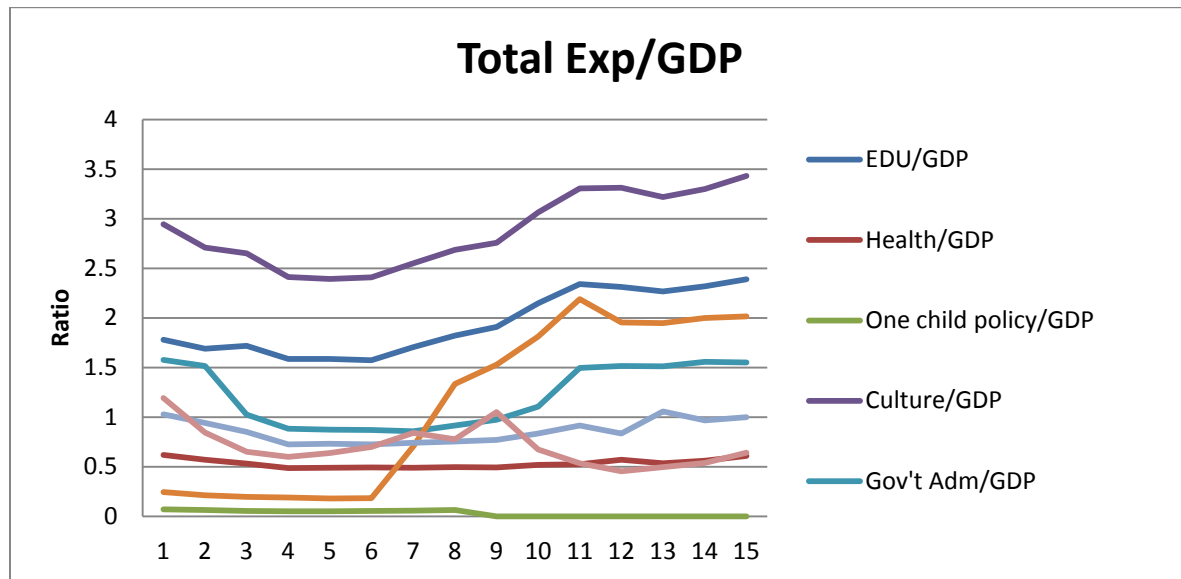
Figure 4.2: Each Expenditure/GDP for Subnational Governments



Source: China Financial Statistical Yearbook (Various years)

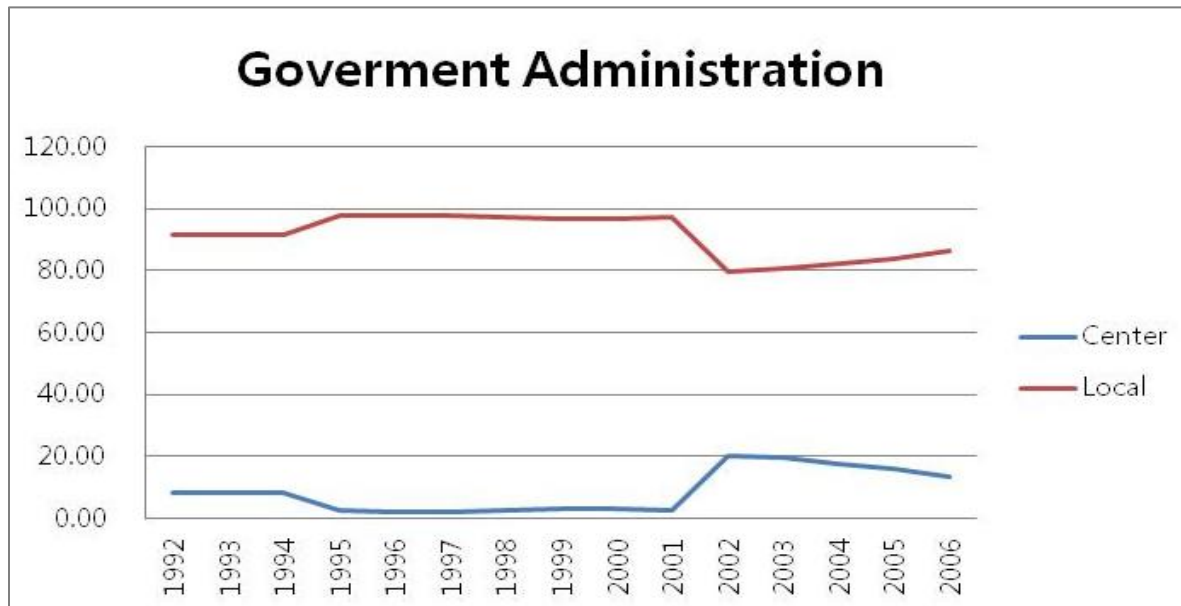
Figure 4.2 illustrates the ratio of each expenditure item among GDP for the local governments. After the tax reform in 1994, all the government expenditures were increased. While social security has been dramatically increased, education, agriculture, and administrative expenditures have gradually increased. The social security was increased from 0.2percent in 1994 to 1percent in 2000 and 2percent in 2008. The administration expenditure was 0.94 percent in 1994 and maintained at the same level in 2000, but then increased to 1.3percent in 2006. The expenditure for agricultural production was 0.7percent in 1994 and stayed the same in 2000, but increased to 0.9 in 2006 and increased again to 1.9 in 2009. Education expenditure was 2.4percent in 1994, and stayed at a similar level of 2.5percent in 2000, but increased as 3.1percent in 2006.

Figure 4.3: Total Expenditure/GDP for the central and Subnational Governments



Source: China Financial Statistical Yearbook (Various years)

Figure 4.4: Expenditure Ratio of Government Administration for the central and Subnational Governments



Source: China Financial Statistical Yearbook (Various years)

Although the expenditure trend of the subnational governments shows progress, it still has problems (OECD, op. cit., 2006, p. 6). As Figure 4.3 and 4.4 shows the Chinese government

spent a relatively large proportion for public administration, and in particular almost all of the spending is spent by subnational governmental levels. The Sub-national governmental administrations were criticized for overstaffing (Ibid.). Investment and public spending have both occupied a larger share of total government spending in the past, when compared with other large developing countries (Ibid., p. 2). On the other hand, the Chinese government spent less for basic welfare and development needs, such as education, health, science, and social security, compared with that of most developing countries (Ibid.).<sup>63</sup> While maintaining their higher administrative costs to bolster their local government authority, the local government officials assigned funding to more visible projects such as construction work (面子工程) than to the less visible areas such as education and health.<sup>64</sup> Furthermore, the low levels of government expenditures for basic welfare have led to inequalities in education and health spending between eastern and western provinces of the country.

According to OECD report, the public spending outcomes in China will be doomed because of anticipated differences in literacy rates, years of schooling, and life expectancy between the rural and urban areas (Ibid.).

## **V. Hypotheses Development**

The main hypothesis of this chapter is to point out the differences in the usage of the intergovernmental transfers at county level while comparing it across the provinces. The hypothesis supports the previous literature: the equalization transfer fails to increase the

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<sup>63</sup> It is questionable the OECD argument that “Furthermore, the share of total spending going to education, health, and science has fallen over the last decade (OECD, policy brief, 2006, p. 2).” Official statistics shows opposite result.

<sup>64</sup> All Chinese citizens criticized the construction work during my field trip in 2011.

agriculture expenditures, while the earmarked transfers increases the governmental administration (Liu et al. op. cit.; Shih et al., op. cit., 2009).

*H1: The tax rebate transfer (税收返还) is associated with a low level of agriculture expenditure and the high level of education and administrative expenditure regardless of the fiscal independence of the jurisdiction.*

H1 seeks to examine the alleged regressive character of the tax rebate transfers. The tax rebate transfer is a transfer based on the collection of VAT, consumption taxes, and individual and corporate income taxes. These taxes are imposed on secondary and tertiary industries. Thus, the tax rebate transfers have mainly been returned to those industrialized and rich jurisdictions, rather than to the agricultural areas. The governments of these areas will tend to spend less for agricultural industry and corollary fields. Thus, it is hypothesized that the tax rebate transfers are negatively associated with agricultural expenditures, while positively associated with education and administrative expenditure in the jurisdiction.

*H2: The equalization transfers influence different expenditure categories depending on the the degree of fiscal independence: the equalization transfers are associated with administrative expenditures in the fiscally dependent counties, while with agriculture and education expenditures in the fiscally independent counties.*

H2 seeks to examine the role of the equalization transfers on the expenditures of the dependent and independent counties from 1994 to 2007. This will require extending the scope of Liu et al.

(2009) to the whole of China, and applying Shih et al. (2007) as related to the fiscally independent and dependent jurisdictions. As previously mentioned, the equalization transfers were introduced to increase the agricultural, educational, and administrative expenditures mainly to the poorer or fiscally dependent areas. The original transfer system and the transfer payment subsidies were used to decrease the fiscal disparity of the poor western areas. The transfers of the annual balance fiscal subsidy and the rural tax-for-fee reform type of fiscal transfer were designed to increase the expenditures for agricultural industry, while the transfers of grants for the minority regions and the wage subsidies for civil servants were intended to increase administrative expenditures. However, the evidence will show that these transfers did not necessarily increase the agricultural and education expenditures.

According to Liu et al. (2009), the subnational governments distorted the transfer scheme at their discretion. That is, each fiscal transfer was used to increase the subnational government's expenditures for such "political" items as administrative expenditures, and diverted away from those critical sectors which included health care, and agriculture.<sup>65</sup> Traditionally the prioritization of the expenditure at the sub-provincial government in China has been to meet urgent spending needs. These regions divided the expenditure for previously guaranteed spending and any conditional spending (if additional funds are available) (Martinez et al., op. cit., p. 309-310).

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<sup>65</sup> Major expenditure components of county governments are education, government administration, health care, agricultural expenditure, capital investment, social security, and scientific research (Martinez et al., 2014, p. 309). While the target responsibility system (TRS) makes the subnational government enforce their expenditure policy according to the central government decisions, the county governments are able to determine discretionarily their priorities. Only the basic guidelines of expenditure responsibilities between central or local governments are defined in the 1994 TSS reform (Ibid., p. 304). There is no explicit formulaic assignment at the sub-province level, either. The provincial government has the discretionary power for the expenditure assignments of the sub-provincial governments (Ibid., p. 305). Local governments have significant local autonomy for the determination of their own spending priorities (Ibid., p. 304). Subnational governments at different levels have overlapping expenditure mandates. As a result of a lack of a formal expenditure assignment and the widely overlapping and very vague responsibilities between the center and subnational levels, some cases are over-provided and some other cases are under-provided (Ibid., p. 304).

Currently, the priority of the poorer county areas is government administration costs. As they are barely met, the government administration costs are called a feeding finance (吃饭财政) (Ibid.).<sup>66</sup> For some county governments in the central and western regions, the salaries for civil servants and elementary and secondary public school teachers have not been sufficient.

Although the central government evaluates the subnational governments with TRS, an effective supervisory system has not been established. (Interview with a reporter at the township level of Hunan province, 2011). Transfers are distributed in the following process. Both the National Development and Reform Commission (NDRC) of State Council and the Ministry of Finance examine transfer items and approve the plans. Meanwhile, the subnational governments apply for the transfer of funds to support their plan to the central government. The central government then dispatches specialists to the areas in order to examine whether the projects correspond to their plan, and then they distribute funding. The allocation criteria are mostly unregulated and differ across China (OECD, op. cit., 2006, p. 29). The problem is that the monitoring system does not properly work, because the social networking (关系) effectively prohibits the supervision process of the supervisory organization (监督委员会, 检察院) within the CCP. The society is ruled by social and human networks (人治社会), not by the law (法制社会). Therefore, due to the lack of monitoring system, the equality transfers were also seen to fail to reduce the social welfare disparity at the regional level (Shih et al., op. cit., 2007).

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<sup>66</sup> My own interview in 2011 with a government official of the tax bureau of a prefecture government in Shandong province shows consistency. According to him, his prefecture and other affluent eastern areas prioritize their spending first for wages for the government officials, followed by social security, investment, construction, and agriculture. However, even though a large part of the public spending funds in the poorer prefectures fail to guarantee the government official wages and benefits, they still invest in capital projects. Unfortunately, due to data limitations, it is difficult to generalize this for all of China.



## **VI. Research Design: Data and Variable Description**

### **DATA**

#### *The budgetary accounting system in China.*

While there are four levels of subnational governments in China, this paper focuses on the county level governments. The data for this chapter was largely obtained from Statistical Material for Prefectures, Cities, and Counties Nationwide (全国地市县财政统计资料) published by the Chinese Ministry of Finance spanning several years. This data source provides information on revenue, expenditures, and the transfer of county-level administrative units—counties, county-level cities, and urban districts.

#### *Selected Period: From 1997 to 2007*

This paper examines the period from 1997 to 2007. To highlight the role of transfer in the tax assignment system, this research is intended to focus on the period after 1994; however, the available statistical data was only available from 1997. The available years at the China National Library and Peking University are 1997, 1998, 1999, 2000, 2002, 2004, 2006, and 2007 when I conducted field research at 2011.

### **VARIABLE DISCRIPTION**

*Dependent variable: county government expenditure for agriculture, education, and administration*

The expenditure structure is reported in the Chinese Statistical Material for Prefectures, Cities,

and Counties Nationwide (全国地市县财政统计资料).<sup>67</sup> Total expenditures encompass agriculture, public administration, education, social security, medical and health care, construction, environment, and science and technology at the county level. Based on previous literature, this chapter expounds on the ratio of agriculture, education, and public administration to the total expenditure from 1997 to 2007. Expenditure of the administrative agencies refers to expenditure for general public services and legal service expenditure. Expenditure of the agriculture includes subsidy for agricultural products, expenditure for agriculture, forestry, and water conservancy and weather.

*Independent variable: Transfers*

The county governments receive transfers from provincial governments or prefectural governments (Tsui, op. cit., 2005; Shen, op. cit.). These transfers are divided into three categories: tax rebate transfers (税收返还), general transfers (财力型补助), and earmarked transfers.<sup>68</sup> The tax return transfer is regressive across the regions, while the general transfer is progressive. General transfers include an original transfer, a transfer subsidy, a wage transfer, an annual balance fiscal subsidy transfer, a minority transfer, and a tax for fee transfer.

*Control variables: budget size, and the degree of fiscal independence.*

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<sup>67</sup> Another way to calculate total expenditure is add up total revenue and fiscal transfer.

<sup>68</sup> Chinese Compendium of Local Fiscal Statistics (地方财政统计资料) provides the information of transfer type from the central government to province for three categories: tax rebate transfers (税收返还), fixed original system transfers (原体制定额补助), and transfer payment (转移支付补助).

Transfers include the tax rebate transfer (税收返还补贴), the original system subsidies (原体制补助 or 体制定额补助), transfer payment subsidies (转移支付补贴), general transfers (财力型补助), earmarked transfers (专项补助), the transitional intergovernmental fiscal transfer scheme (过渡期财政转移支付) bond issuance subsidies (增发国债补助) and wage increase subsidies (增发工资补助).

### *Budget Size*

Budget size is illustrative of the scale of the government which could be a positive influence on its expenditures overall. For example, a larger government with its scale is able to reduce fixed expenses while using its various policy arms for spending. The size of the budget for each jurisdiction is identified from their total expenditures (本年支出) during the current year.

### *Fiscal Independence*

Fiscal dependent areas are run to control to test the differences between areas. According to Budget law, subnational government could not have deficit at the end of their fiscal year, thus transfers are allocated in advance for the annual balance (Shih et al., op. cit., 2007), which the level of fiscal independence influences the governmental behavior for these expenditures. For example, fiscally independent governments are relatively free from the restraints of the central government to decide budget expenditure. This budget independence is measured as the ratio based on the tax revenue divided by total expenditure in the current year. Almost half of provinces rely on intergovernmental transfers for 30percent or more of their fiscal resources (OECD, op. cit., 2006, pp. 5-6). Fiscally dependent areas are a dummy variable. The dummy variable equals one (1) if budget independent is less than 50 percent, otherwise it is zero (0). Also considered are several interaction terms of the dependent areas and all the transfers.

## **VII. Analysis and Results**

### DESCRIPTION

### Sample Description

Table 2 summarizes the budget size, budget independence, and the ratio of various transfers of the sampled county governments during 1997 to 2007. Panel A describes the mean ratios for agriculture, education, and administration expenditures relative to the total expenditure; respectively, the values were 7.1, 19.1, and 21. This finding implies that on the average, the county governments spend relatively more on administrative institutions and education than on the agriculture sector.

Panel B provides a description of the budgets of the county governments. I obtained the budget size and the degree of independence of the county governments from 237 observations during the years of 1997 to 2007. The degree of fiscal independence ranges from 13.6 to 92.2, which implies a serious fiscal inequality at the county level across the provinces of China.

Table 4.2: Sample Description on Expenditure, Budget Size, and Transfer on Counties

Variable	Observation	Mean	Standard Deviation.	Minimum	Maximum
<b>Panel A: Ratio of Expenditure</b>					
Ratio of Agriculture Exenditure	237	7.063324	2.233168	1.669783	13.90238
Ratio of Education Expenditure	237	19.08733	3.058925	12.03135	26.64796
Ratio of Administration Expenditure	237	21.03914	6.896282	11.24617	43.56033
<b>Panel B: Budget Size</b>					
Budget Size	237	14.73852	1.026143	12.10868	17.15458
Independent Degree	237	57.21411	17.16248	13.55457	92.18478
<b>Panel C: Ratio of Transfers</b>					
Tax Return Transfer	220	14.70708	6.399865	2.163142	36.50985
Earmarked Transfer	237	13.79437	6.757937	0.2246727	34.38326
Original Transfer	191	3.956211	7.203786	0.007718	55.66999
Transfer Subsidy	136	4.827817	3.716744	0.3470148	19.32996
Wage Transfer	128	7.594362	4.447836	0.0165445	19.03919
Annual Balance Fiscal Subsidy	140	3.299197	3.832439	0.0014278	21.62032
Minority Transfer	49	0.7730652	0.9599907	0.0006064	3.321768
Tax for Fee Transfer	105	2.416389	1.427881	0.0112273	5.390916

Panel C describes the transfer items. The mean value of the tax return transfers and earmarked transfers were as high as 14.7 and 13.8 percent respectively. On the other hand, the mean value

of the minority transfers, taxes for fee transfer, and the annual balance fiscal subsidy transfer were low—0.8, 2.4, and 3.3 percent respectively. Because the minority transfer, the tax for fee transfer, and the annual balance fiscal subsidy were recently introduced in 2002, the number of observations of these transfers was only 49, 105, and 140 respectively.

## CORRELATION

Table 4.3 describes the correlation among the variables. The results are statistically significant. The budget size and the ratio of education are negatively correlated. The degree of fiscal independence and the tax return transfer were found to be negatively correlated with the agricultural and administration expenditures, while having a positive coefficient for education. Contrary to this, the dependent counties have a positive correlation coefficient for both their agricultural and administrative expenditures. This implies that the counties with less flexibility in allocating their fiscal transfers tend to spend more for their agricultural expenditure and for their administrative expenditure.

While the tax return transfer is negatively correlated with the fiscally dependent counties all other transfers are positively correlated with these dependent counties. The equalization transfers such as the transfer subsidy, the wage transfer, the minority transfer, and the tax for fee transfer, have positive correlation coefficients except for the annual balance subsidy, which is not significant. This demonstrates that the equalization transfers help to increase the subnational levels of government expenditures.

Table 4.3: Correlation Matrix for Selected Variables

Variables	1	2	3	4	5	6	7	8	9	10	11	12	13	14
1. Ratio of Agriculture	1													
2. Ratio of Education	0.0633	1												
3. Ratio of Administration	0.3476***	0.2008***	1											
4. Budget Size	-0.0736	-0.2756***	0.0431	1										
5. Budget Independence	-0.4868***	0.1248*	-0.3245**	0.2486***	1									
6. Tax Return Transfer	-0.3516***	0.1009	-0.3967**	-0.0285	0.5430***	1								
7. Original Transfer	0.0878	0.0833	0.4081***	-0.4644***	-0.3779***	-0.3136***	1							
8. Earmarked Transfer	0.5100***	-0.1478**	0.2626***	-0.3536***	-0.7507***	-0.4854***	0.2752***	1						
9. Ratio of Transfer Subsidy	0.4253***	0.2382***	0.3850***	-0.1527*	-0.5895***	-0.6128***	0.1776*	0.4665***	1					
10. Ratio of Wage Transfer	0.4532***	0.3287***	0.1623*	-0.2793***	-0.7433***	-0.4217***	0.0441	0.4625***	0.5381***	1				
11. Ratio of Annual Balance Transfer	-0.2966***	-0.2059**	-0.2217***	-0.0994	-0.0029	0.0463	-0.1014	-0.1142	0.0669	0.0388	1			
12. Ratio of Minority Transfer	0.5053***	0.0833	-0.0556	-0.205	-0.3100**	-0.2929**	0.1349	0.1578	0.1628	0.3617**	-0.2704*	1		
13. Ratio of Tax for Fee	0.3451***	0.3277***	0.0368	-0.1269	-0.4439***	-0.1472	-0.3251***	0.2035**	0.1412	0.5261***	-0.0266	0.1067	1	
14. Fiscal Dependent Counties	0.4430***	-0.0979	0.2949***	-0.0163	-0.7929***	-0.5617***	0.1812**	0.6058***	0.4515***	0.5975***	-0.0715	0.3929***	0.3546***	1

\*p<.1. \*\*p<.05. \*\*\*p<.01.

Regarding the relationship between transfers and local spending, table 4.4 shows that the total local spending at county level is separate into the amount financed by transfers and thus the amount financed locally, which does not show in the table. When the Chinese central government subsidizes transfers to local governments, a public spending is larger than an equivalent increase in the total transfer of the jurisdiction.<sup>69</sup> It shows similar results with the US.

Table 4.4: Total Expenditure vs. Transfers, 1997-2007 (unit: 10,000 yuan)

Year	Total Expenditure	Δ (A)	Total Transfers	Δ (B)	Variation (A-B)
1997	49,152,075		21,983,901		
1998	56,462,671	7,310,596	23,725,804	1,741,903	5,568,693
1999	64,515,945	8,053,274	27,225,188	3,499,384	4,553,890
2000	73,943,088	9,427,143	31,456,350	4,231,162	5,195,981
2002	109,505,289	35,562,201	51,934,259	20,477,909	15,084,292
2004	152,520,453	43,015,164	72,104,425	20,170,166	22,844,998
2006	230,222,872	77,702,419	99,056,322	26,951,897	50,750,522

<sup>69</sup> Regarding the relationship between transfers and local spending, literature on the flypaper effect in the US, a grant from the federal often results in a proportionately more public spending than an equivalent exogenous increase in the total income of the local community. People are not maximizing on the true budget constraint.

2007	295,361,491	65,138,619	134,730,706	35,674,384		29,464,235
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*Sources: Chinese Statistical Material for Prefectures, Cities, and Counties Nationwide (Various Years)*

The correlation in table 4.3 shows the relations between the each category of spending and the each category of the transfer. However, it is not possible to divide the each category of local spending into the amount financed by transfers and the amount financed locally due to the data limitation for specific category of transfer. Thus, it is impossible to know how the earmarked transfers increases such that total spending increases by the amount of the transfer and the increase in local spending. Same limitation applies on agriculture spending and transfers. Nonetheless, it is known from correlation that the earmarked transfers have a positive correlation coefficient for the agricultural and administrative expenditures, but surprisingly have a negatively correlated with the education expenditure. At the same time the earmarked transfers have significantly negative coefficients on the budget size, on fiscal independence, and the tax return transfer, implying that the earmarked transfers are still designed toward reducing the fiscal disparity.

## MAIN RESULTS

Fixed-effects regression models were used to examine the association of the central government transfer with expenditures on agricultural, education, and administration at the county government level. Since county government level has multiple intergovernmental transfer data throughout year, a fixed-effects model would underestimate standard errors of the regressors. To correct for this underestimation, the year fixed-effect regression model was employed. Table 4

provides the regression results of transfers on expenditure variables controlled with fiscal dependent counties throughout the several years from 1997 to 2007.

### *Model 1*

Model 1 illustrates the relationship of the transfers and expenditures of the county level governments. Model 1 analyzes the transfer items—tax return transfer original transfer and earmarked transfer—, which have been introduced since the beginning of the TSS system. The results show the county governments' behavior throughout the TSS system from 1997 to 2007.

The ratio of agriculture expenditure =  $\alpha_0 + \alpha_1 \text{Budget Size} + \alpha_2 \text{Tax Return Transfer} + \alpha_3 \text{Original Transfer} + \alpha_4 \text{Earmarked Transfer} + \alpha_5 \text{Dependent Areas} + \alpha_6 \text{Dependent Areas} * \text{Tax Return Transfer} + \alpha_7 \text{Dependent Areas} * \text{Original Transfer} + \alpha_8 \text{Dependent Areas} * \text{Earmarked Transfer} + \alpha_9 \varepsilon$  (1)

The ratio of education expenditure =  $\alpha_0 + \alpha_1 \text{Budget Size} + \alpha_2 \text{Tax Return Transfer} + \alpha_3 \text{Original Transfer} + \alpha_4 \text{Earmarked Transfer} + \alpha_5 \text{Dependent Areas} + \alpha_6 \text{Dependent Areas} * \text{Tax Return Transfer} + \alpha_7 \text{Dependent Areas} * \text{Original Transfer} + \alpha_8 \text{Dependent Areas} * \text{Earmarked Transfer} + \alpha_9 \varepsilon$  (2)

The ratio of administrative expenditure =  $\alpha_0 + \alpha_1 \text{Budget Size} + \alpha_2 \text{Tax Return Transfer} + \alpha_3 \text{Original Transfer} + \alpha_4 \text{Earmarked Transfer} + \alpha_5 \text{Dependent Areas} + \alpha_6 \text{Dependent Areas} * \text{Tax Return Transfer} + \alpha_7 \text{Dependent Areas} * \text{Original Transfer} + \alpha_8 \text{Dependent Areas} * \text{Earmarked Transfer} + \alpha_9 \varepsilon$  (3)

In general, the results confirm the hypothesis (Table 4.5). At the county level, the budget size has a positive coefficient sign for agriculture, while a significant negative coefficient for education and administration. Meanwhile, although it is not significant, the counties receiving high tax return transfer tend to spend relatively at a lower level on agriculture, thus confirming the first hypothesis. The Tax return transfer in the fiscally dependent counties has a negative coefficient on agricultural expenditure.



Table 4.5: Regression Result on the Fiscal Transfers

	(1) Agriculture	(2) Education	(3) Administration
Log Budget Size	0.31* (1.66)	-1.67*** (-5.27)	-1.22*** (-2.81)
Tax Return Transfer (TRT)	-0.02 (-0.48)	0.00 (0.13)	0 (-0.01)
Original Transfer (OT)	0.10*** (2.79)	0.04 (0.60)	0.09 (1.00)
Earmarked Transfer (ET)	0.16*** (4.30)	-0.17*** (-2.70)	-0.17* (-1.96)
Fiscally Dependent Counties (FDC)	5.14*** (4.62)	1.18 (0.63)	-6.07** (-2.36)
FDC *TRT	-0.14** (-3.01)	0.02 (0.25)	0.13 (1.17)
FDC *OT	-0.17** (-4.34)	-0.08 (-1.17)	0.39*** (4.18)
FDC *ET	-0.10** (-2.03)	-0.05 (-0.65)	0.18 (1.63)
Constant	0.13 (0.04)	45.55 (9.27)	41.50 (6.14)
N	180	180	180
adj. R-sq	0.33	0.13	0.08

t statistics in parentheses

\* = p&lt;0.10 \*\* = p&lt;0.05 \*\*\* = p&lt;0.01

At the same time, the results for the equalization transfers are consistent with the hypothesis. Fiscally independent and dependent counties respond to the equalization transfers differently from each other. The results show that the original transfer and the earmarked transfers have significantly increased their relative expenditures in agriculture, meaning the equalization transfers helps the agricultural spending in general. Here, the earmarked transfer has a significant negative coefficient on the education and administration expenditures. The earmarked transfers have multiple purposes. Earmarked transfers are highly associated with particular expenditures including agriculture, education and administrative expenditures within the jurisdictions. Sometimes it is distributed to reduce a regional disparity, but sometimes not.

Because the purpose of the funding distribution is clear, a local government cannot discretionally divert these funds for their own purpose (Zhang, 2006). Thus, the earmarked transfer might be variably used according to a specific purpose.

Interaction term for the dependent areas shows an opposite result when compared to the general model. Original transfer and earmarked transfer of dependent areas show a negative effect on the agricultural expenditures. Conversely, the effect of the original transfer for dependent areas used for an administrative expenditure tends to go to the opposite direction. The original transfer, which has been supposed to serve as an equalization transfer since 2000, has failed to increase the agricultural expenditures in the poorer dependent counties, but significantly increased the administrative expenditures for these areas. Earmarked transfer also tended to have a negative effect on the agricultural expenditure. Nonetheless, as previously mentioned, the original transfer had not been seen as an equalization transfer at the beginning of TSS system but it was changed into an equalization transfer in 2000. Thus, to support the hypothesis, additional equalization variables should be considered, as illustrated below in Model 2.

### *Model 2*

The ratio of agricultural expenditure =  $\alpha_0 + \alpha_1 \text{Budget Size} + \alpha_2 \text{Tax Return Transfer} + \alpha_3 \text{Original Transfer} + \alpha_4 \text{Earmarked Transfer} + \alpha_5 \text{Dependent Areas} + \alpha_6 \text{Transfer Subsidy} + \alpha_7 \text{Wage Transfer} + \alpha_8 \text{Settlement Transfer} + \alpha_9 \text{Dependent Areas} * \text{Tax Return Transfer} + \alpha_{10} \text{Dependent Areas} * \text{Original Transfer} + \alpha_{11} \text{Dependent Areas} * \text{Earmarked Transfer} + \alpha_{12} \text{Dependent Areas} * \text{Transfer Subsidy} + \alpha_{13} \text{Dependent Areas} * \text{Wage Transfer} + \alpha_{14} \text{Dependent Areas} * \text{Settlement Transfer} + \alpha_{15} \varepsilon$  (1)

The ratio of education expenditure =  $\alpha_0 + \alpha_1 \text{Budget Size} + \alpha_2 \text{Tax Return Transfer} + \alpha_3 \text{Original Transfer} + \alpha_4 \text{Earmarked Transfer} + \alpha_5 \text{Dependent Areas} + \alpha_6 \text{Transfer Subsidy} + \alpha_7 \text{Wage Transfer} + \alpha_8 \text{Settlement Transfer} + \alpha_9 \text{Dependent Areas} * \text{Tax Return Transfer} + \alpha_{10} \text{Dependent Areas} * \text{Original Transfer} + \alpha_{11} \text{Dependent Areas} * \text{Earmarked Transfer} + \alpha_{12} \text{Dependent Areas} * \text{Transfer Subsidy} + \alpha_{13} \text{Dependent Areas} * \text{Wage Transfer} + \alpha_{14} \text{Dependent Areas} * \text{Settlement Transfer} + \alpha_{15} \varepsilon$  (2)

The ratio of administrative expenditure =  $\alpha_0 + \alpha_1 \text{Budget Size} + \alpha_2 \text{Tax Return Transfer} + \alpha_3 \text{Original Transfer} + \alpha_4 \text{Earmarked Transfer} + \alpha_5 \text{Dependent Areas} + \alpha_6 \text{Transfer Subsidy} +$

$$\alpha_7 \text{Wage Transfer} + \alpha_8 \text{Settlement Transfer} + \alpha_9 \text{Dependent Areas} * \text{Tax Return Transfer} + \alpha_{10} \text{Dependent Areas} * \text{Original Transfer} + \alpha_{11} \text{Dependent Areas} * \text{Earmarked Transfer} + \alpha_{12} \text{Dependent Areas} * \text{Transfer Subsidy} + \alpha_{13} \text{Dependent Areas} * \text{Wage Transfer} + \alpha_{14} \text{Dependent Areas} * \text{Settlement Transfer} + \alpha_{15} \varepsilon \quad (3)$$

The regression results illustrated in Table 4.6 includes other transfer items—transfer subsidy, wage transfer, and annual balance fiscal subsidy—except for the minority transfer and the tax for fee transfer. The regression results confirm the hypotheses (H1 and H2).<sup>70</sup> In general, the county level governments have spent the transfers for agriculture, education, and administrative expenditure evenly, but in the fiscal dependent counties they mainly spend it for administrative expenditures.

Similar to Model 1, the budget size has a positive effect on agricultural expenditures, while a negative one on education. Meanwhile, the fiscally dependent areas tend to disburse funds less for administrative expenditures. This variable does not appear to have a significant effect on their agriculture and education expenditure.

Overall, the tax return transfer does not support H1. However, the interaction of dependent counties and the tax return transfer supports the hypothesis. The interaction term is negatively related to the agricultural expenditure but positively related with administrative expenditure coefficients. Fiscally dependent counties spend less for agriculture expenditures, while spend more for administrative expenditures. This suggests that the tax return transfer is still a rebated one for industrialized counties.

This result moderately supports H2. That is that fiscally dependent and independent areas

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<sup>70</sup> The regression for all of the transfer items to county governments cannot run at this moment due to insignificant result. These insignificant results can be attributed to having a very small number of samples to include in the tax for fee transfer and minority transfer, which were recently introduced. As mentioned in the previous sections, the tax for fee transfers and the minority transfers were introduced during 2001 to 2002. Thus, the sample dramatically decreased from 105 and 42, respectively. With this small number of sample, it is difficult to capture any large variability with these newly introduced equalization transfers.

behave differently. Counties in general have spent equalization their transfers evenly. The transfer subsidy tends to increase agriculture expenditures, while the wage transfer shows a positive effect on the education and administrative expenditures. However, the annual balance fiscal subsidy has a negative coefficient on the education expenditure. Meanwhile, the earmarked transfer shows a significant positive effect on the agriculture expenditure, but a significant negative effect on the education expenditure.

The equalization transfers were found to have no significant impact on budget dependent areas in the second model. Most of interaction terms between dependent counties and equalization transfers were not significantly related to any expenditure, except for the interaction term between the dependent counties and the original transfer for administrative expenditures which was found to have a significantly positive effect. The interaction between the dependent counties and the earmarked transfers are not significant on this expenditure, either.

The overall results for the dependent counties are consistent with the hypothesis. The equalization transfers do not significantly increase the expenditure on agriculture and education, but the original transfers increased the expenditure on the administrative institutions.

Table 4.6: Regression Result on the Transfer and Expenditure

	(1) Agriculture	(2) Education	(3) Administration
Log Budget Size	0.69** (2.16)	-1.48*** (-3.16)	0.16 (0.29)
Tax Return Transfer (TRT)	0.03 (0.35)	0.09 (0.77)	-0.14 (-1.00)
Original Transfer (OT)	-0.04 (-0.43)	0.13 (1.04)	-0.4 (-0.28)
Earmarked Transfer (ET)	0.14* (1.77)	-0.43*** (-3.78)	-0.21 (-1.56)
Transfer Subsidy (TS)	0.29* (1.70)	-0.04* (-0.15)	0.09 (0.31)
Wage Transfer (WT)	0.13 (1.55)	0.42*** (3.38)	0.44*** (2.98)
Settlement Transfer (ST)	-0.15 (-1.13)	-0.51*** (-2.60)	-0.12 (-0.55)
annual balance fiscal subsidy(BS)			
Fiscally Dependent Counties (FDC)	3.09 (1.43)	-4.92 (-1.56)	-8.77** (-2.33)
FDC *TRT	-0.18* (-1.92)	0.17 (1.31)	0.42*** (2.64)
FDC *OT	-0.04 (-0.41)	-0.07 (-0.53)	0.66*** (3.96)
FDC *ET	0.02 (0.19)	0.21 (1.51)	0.03 (0.19)
FDC *TS	-0.29 (-1.59)	0.19 (0.70)	0.07 (0.23)
FDC *WT	0.06 (0.65)	-0.13 (-0.92)	-0.09 (-0.58)
FDC *BS	0.06 (0.38)	0.32 (1.39)	0.24 (0.89)
Constant	-7.48 (-1.48)	43.33 (5.86)	22.21 (2.52)
N	100	100	100
adj. R-sq	0.54	0.27	0.01

t statistics in parentheses

\* = p&lt;0.10 \*\* = p&lt;0.05 \*\*\* = p&lt;0.01

### Model3

The ratio of agricultural expenditure =  $\alpha_0 + \alpha_1 \text{Budget Size} + \alpha_2 \text{Tax Return Transfer} + \alpha_3 \text{Original Transfer} + \alpha_4 \text{Earmarked Transfer} + \alpha_5 \text{Dependent Areas} + \alpha_6 \text{Transfer Subsidy} + \alpha_7 \text{Wage Transfer} + \alpha_8 \text{Settlement Transfer} + \alpha_9 \text{Minority Transfer} + \alpha_{10} \text{Tax for fee Transfer} + \alpha_{11} \text{Dependent Areas} * \text{Tax Return Transfer} + \alpha_{12} \text{Dependent Areas} * \text{Original Transfer} + \alpha_{13} \text{Dependent Areas} * \text{Earmarked Transfer} + \alpha_{14} \text{Dependent Areas} * \text{Transfer Subsidy} + \alpha_{15} \text{Dependent Areas} * \text{Wage Transfer} + \alpha_{16} \text{Dependent Areas} * \text{Settlement Transfer} + \alpha_{17} \text{Dependent Areas} * \text{Minority Transfer} + \alpha_{18} \text{Dependent Areas} * \text{Tax for fee Transfer} + \alpha_{19} \varepsilon$  (1)

The ratio of education expenditure =  $\alpha_0 + \alpha_1 \text{Budget Size} + \alpha_2 \text{Tax Return Transfer} + \alpha_3 \text{Original Transfer} + \alpha_4 \text{Earmarked Transfer} + \alpha_5 \text{Dependent Areas} + \alpha_6 \text{Transfer Subsidy} + \alpha_7 \text{Wage Transfer} + \alpha_8 \text{Settlement Transfer} + \alpha_9 \text{Minority Transfer} + \alpha_{10} \text{Tax for fee Transfer} + \alpha_{11} \text{Dependent Areas} * \text{Tax Return Transfer} + \alpha_{12} \text{Dependent Areas} * \text{Original Transfer} + \alpha_{13} \text{Dependent Areas} * \text{Earmarked Transfer} + \alpha_{14} \text{Dependent Areas} * \text{Transfer Subsidy} + \alpha_{15} \text{Dependent Areas} * \text{Wage Transfer} + \alpha_{16} \text{Dependent Areas} * \text{Settlement Transfer} + \alpha_{17} \text{Dependent Areas} * \text{Minority Transfer} + \alpha_{18} \text{Dependent Areas} * \text{Tax for fee Transfer} + \alpha_{19} \varepsilon$  (2)

The ratio of administrative expenditure =  $\alpha_0 + \alpha_1 \text{Budget Size} + \alpha_2 \text{Tax Return Transfer} + \alpha_3 \text{Original Transfer} + \alpha_4 \text{Earmarked Transfer} + \alpha_5 \text{Dependent Areas} + \alpha_6 \text{Transfer Subsidy} + \alpha_7 \text{Wage Transfer} + \alpha_8 \text{Settlement Transfer} + \alpha_9 \text{Minority Transfer} + \alpha_{10} \text{Tax for fee Transfer} + \alpha_{11} \text{Dependent Areas} * \text{Tax Return Transfer} + \alpha_{12} \text{Dependent Areas} * \text{Original Transfer} + \alpha_{13} \text{Dependent Areas} * \text{Earmarked Transfer} + \alpha_{14} \text{Dependent Areas} * \text{Transfer Subsidy} + \alpha_{15} \text{Dependent Areas} * \text{Wage Transfer} + \alpha_{16} \text{Dependent Areas} * \text{Settlement Transfer} + \alpha_{17} \text{Dependent Areas} * \text{Minority Transfer} + \alpha_{18} \text{Dependent Areas} * \text{Tax for fee Transfer} + \alpha_{19} \varepsilon$  (3)

The regression runs depicted in Table 4.7 do not show any significant correlation between the independent variables and the regressors, except for the budget size. For this model, all of the transfer items to county governments were included. The insignificant results can be attributed to having a very sample size to include in the data for the tax for fee transfer and minority transfer, which were recently introduced during 2001 to 2002. Thus, the sample dramatically decreased to 105 and 49, respectively. With this small sample size, it is difficult to capture the scope or variability of these newly introduced equalization transfers.

Table 4.7: Regression Result on the Transfer and Expenditure

	(1) Agriculture	(2) Education	(3) Administration
Log Budget Size	1.88*** (3.09)	0.06 (0.06)	1.09 (1.01)
Tax Return Transfer (TRT)	0.14 (0.09)	-2.96 (-1.02)	0.17 (0.06)
Original Transfer (OT)	1.43 (1.43)	1.30 (0.70)	1.18 (0.66)
Earmarked Transfer (ET)	0.09 (0.09)	-2.58 (-1.28)	-0.13 (-0.07)
Transfer Subsidy (TS)	0.71 (0.35)	1.06 (0.28)	2.15 (0.59)
Wage Transfer (WT)	-1.56 (-0.42)	8.08 (1.18)	-4.52 (-0.68)
Settlement Transfer (ST)	0.53 (0.13)	7.28 (0.96)	0.16 (0.02)
annual balance fiscal subsidy(BS)			
Minority Transfer (MT)	0 (omitted)	0 (omitted)	0 (omitted)
Tax for Fee Transfer (TFT)	3.70 (0.52)	-13.11 (-0.99)	9.79 (0.77)
Fiscally Dependent Counties (FDC)	5.31 (0.30)	-39.94 (-1.22)	7.62 (0.24)
FDC *TRT	-0.3 (-0.19)	3.31 (1.14)	-0.07 (-0.02)
FDC *OT	-1.21 (-1.16)	-1.31 (-0.68)	-1.59 (-0.86)
FDC *ET	0.12 (0.11)	2.18 (1.11)	-0.2 (-0.10)
FDC *TS	-0.86 (-0.42)	-0.99 (-0.26)	-2.2 (-0.61)
FDC *WT	2.01 (0.54)	-6.99 (-1.02)	4.96 (0.75)
FDC *ST(BS)	-0.42 (-0.10)	-7.53 (-0.99)	-0.12 (-0.02)
FDC *MT	0.53 (1.93)	-0.13 (-0.25)	0.19 (0.39)
FDC *TFT	-3.88 (-0.55)	12.02 (0.93)	-10.14 (-0.81)

Constant	-31.49 (-1.50)	53.21 (1.38)	0.77 (0.02)
N	42	42	42
adj. R-sq	0.68	0.30	0.00

t statistics in parentheses

\* =  $p < 0.10$  \*\* =  $p < 0.05$  \*\*\* =  $p < 0.01$

### VIII. Implication

This chapter proves that the intergovernmental transfers have not effectively addressed the regional gaps at the county level, while the reforms in 1994 strengthened the central government's ability to distribute the transfers. The fiscal decline during the 1980s and early 1990s eroded the central government's capability to assist the poor local governments (Wong, 2009, p. 935-6). To attempt to redress the problem, the central government increased its revenue through the 1994 reforms and gradually introduced the equalization transfers. While the transfer between central and local governments reduces revenue gaps, it fails to prevent the disparity between expenditure responsibilities and revenues in most of provinces, particularly in the central and western provinces (OECD, 2006, p. 29). It also fails to decrease expenditure gaps at county levels (Shih et al., 2007; Tsui, 2005). Thus, the social welfare in specific regions has not been properly provided for.

Before the tax reform in 1994, which followed a reduction in the revenue from the central government, it appears the intergovernmental transfers steeply declined (Wong, op. cit., 2009, p. 936; Guolianwang Shuju Zhongxin (国研网数据中心), 2011). The central government announced the reduction of the budgetary transfers to poor provinces from 1987 onward. The subsidies had fallen from the 100percent level in 1986 as an index year, to 93percent in 1987, 79percent in 1988, and 66percent in 1989 (Wong, op. cit., 2009, p. 935-936). Nonetheless, before the tax reform, most transfers were implicit under the system. Because the ratio of shared



revenue was negotiated between the central and provincial governments, the poor provinces were able to keep a high ratio of the the revenues collected in their provinces, while the rich provinces turned over a higher ratio of revenues to the central government (Ibid., p. 936).

After the tax reform, the central government transfer increased from 30percent of total expenditure in 1993 to 65percent in 2009 (Guolianwang Shuju Zhongxin (国研网数据中心), 2011). The implicit transfer was changed into an explicit form. Following that, with an equalization transfer increase after 2000, it was expected that the expenditures to improve the industrially backward, and educationally poor counties would benefit from the transfers, However, the analysis proves this to be a failure. The equalization transfers were expected to help agriculture, education, and administration expenditures in the fiscally dependent counties. The statistical analysis results show that the fiscally dependent counties did not increase their spending for agriculture expenditures but for administrative expenditure with equalization transfers and earmarked transfer.

There are many possible reasons for the problem. It might be that a small portion of the transfer among total transfer is not able to play a significant role in their particular spending efforts as explained above. It might be the distortion and diversion of funds by the local governments. This is because the fiscally dependent counties have a greater concern for their administrative expenditures than for education and agriculture. Or it might be that the central government commitment was diluted during the downward funding process. This process exacerbated the gap severely between the expenditure responsibilities and the financial resources for the lowest levels of government – the counties, townships and villages (OECD, 2006, p. 29).

## **IX. Conclusion**

This paper examined the relationship between the fiscal transfers from China's central government and the expenditure at the county level. The results provide additional empirical support to the literature which suggests that the county-level governments tend to spend the fiscal transfers from the central government to fund their own "political expenditures". While previous literature emphasized the effect of this reallocation on inequality across regions, this paper went beyond this framework by providing evidence suggesting that the individual transfers can be associated with different expenditure types. This paper contributed to the literature by analyzing the extent by which the county-level governments reallocate the transfers for different expenditure items, and how their degree of fiscal dependence influences these transfer reallocations.

The results of the analysis show that the equalization transfer was able to help increase expenditures in general, but particularly failed to increase the expenditures for counties which have been fiscally dependent. All the transfers significantly increased the administrative expenditures, while they decreased the agricultural expenditure for these fiscally dependent counties. The regression analysis results suggest that the original transfer did not help the agriculture industry; rather, it took away resources from the sector to increase the support for administrative institutions. A similar effect was observed for the earmarked transfers.

The findings of this analysis call for policy makers to revisit China's current policy on central government transfers. As dependent counties tended to mainly spend for administrative expenditure, the agriculture sector is being left behind, which theoretically will have an adverse effect increasing any inequality within their jurisdiction.

At present, the central government does not direct the usage of the original transfer, the transfer

subsidy, or the settlement transfer. It is for this reason that the central government must impose limitations on the disbursement of these transfers at the county level to reduce the regional disparity. In addition, the upper level governmental levels must focus the supervision the usage of these transfers for the fiscally dependent counties. The fiscally dependent county governments were observed to have the tendency to divert the transfers to support their administrative institutional structure rather than to help improve the agricultural industry and education. It is therefore critical that the central government build a different yet cost-minimizing supervising mechanism for addressing the different regions and to eliminate an information asymmetry, which tends to provide the incentive for the county level governments to depart from the central government's goals.

## **Chapter 5**

### **Conclusion**

This final chapter supplies the conclusions of the dissertation, places them in a larger context of institutional theory, and discusses some predictions and suggestions with policy implications. It summarizes the arguments and evidence presented in this study which demonstrates that understanding the governmental transfer from one jurisdiction to another can help sort out some of its complexity, and also points out the danger of informal fiscal decentralization in recent decades. Furthermore, it reinforces the basic theoretical framework of the dissertation—how rational choice institutionalism is applicable to the informal fiscal decentralization in China. The findings presented in this study help to point out some concrete conclusions about the conditions under which the informal features of fiscal decentralization present themselves, and these findings suggest some useful policy implications. The chapter also provides a discussion on where future research questions could be raised and properly considered for further studies.

#### **I. An *Informally* Decentralized State**

This study demonstrated that China is an *informally* decentralized state by showing the tension that exists between the central government and the subnational governments in China. While the tax reform measures in China in 1994 improved the central tax collection, an imbalance in the ratio of revenue and expenditures between the central and subnational governments drove the subnational governments to depend excessively on intergovernmental transfers. However, the subnational governments have also been pursuing their own budgetary autonomy by building up their revenue resources beyond the legal boundary, and establishing their own priorities for the transfer spending, thereby distorting the transfer scheme.

This dissertation described the nature, analyzed the causes of tax reform in 1994, and emphasized unintended consequences of centralization. The recentralization in 1994 has changed the budget share between the central and its subunits in 1994. The reform has significantly reduced subnational government revenue sources and derived them to seek off-budgetary revenue sources. However, the reform did not work as planned, but only resulted in unintended consequences, or semi-intended at most, in China. After empirical test, I find that the system actually increases pending debt of the local government to credit institutions. The case study over Chinese cities suggested that bank chairs with past working experience in the government run larger debt for the government projects. Political connection still serves the impending needs of the local governments and the leaders. Fiscal indiscipline may increase under the environment that subnational governments are positioned to easily get borrow with political connection. I also find that the system actually facilitates improper distribution of intergovernmental transfer. The case study over counties demonstrated that poorer counties not only spend more for administrative expenditure than other counties, but they also spend less for agriculture industry. The distribution suggests that local official highly politically concern for maintaining public administrative body rather than the meeting of the equalization transfer needs. There is remarkable variety among these cases of borrowing across cities depending on political connection. The cities having strong political network with creditors easily get credit. There are also large differences spending patterns across counties depending on fiscal dependency. The poor counties usually spend more intergovernmental transfers to maintain administrative institution.

The informal decentralization have three main features: centralization only increases transaction cost to collect local information; local governments apply strategies against local

information revelation to maximize their interest through political connections; and, informal institution reacts opposing to centralization in the centrifugal path. The subnational government bank loans and the distribution of intergovernmental transfers are often practiced following a political logic rather than any of the direction of welfare economics.

The fiscally dependent subnational governments were found to have diverted their intergovernmental transfers toward the support of their bureaucratic institutions, rather than assisting their local education and agricultural sector. LGFPs served the purpose of financing the debt on behalf of the subnational governments. Although not fully elaborated, the local governments enlarged and built up these extra-budgets. The local governments did not only rely on fees from private enterprises, but also, illegitimately, extracted fees from peasants in poor rural regions. These extra-budgetary means were repealed in 2012 due to peasant resistance as studied by Bernstein et al. (2003), and also due to criticism from academics, and mass media both inside and outside of China. The previous chapters established this phenomenon as follows.

Chapter two illustrated the nature of formal fiscal system, the cause of the problem due to the formal political and revenue centralization, and the consequences of this formal centralization. This fiscal centralization increased the central government's revenue, but reduced the subnational governments' resources, and thereby caused these subordinate governments to face a limitation to allocate fiscal resources at their jurisdiction. The unintended consequence of the decentralization was caused by political party structure and discipline and the promotion of their local leaders. Having a Targeted Responsibility System (TRS) without assuring proper funding sources, plus an imperfect monitoring system from the central government level to down, resulted in a failure to prohibit the subnational governments from off-budgeting. They did operating borrowing, which is prohibited by law, and diverted the intergovernmental transfers.

Thus, the intervention together with a politically motivated incentive resulted in an enhanced risk to the entire financial system as everybody might exploit common resources for private political goal. Provincial level politicians behold to national interests, engaged in detrimental competition over their provincial affairs, strengthen their economic growth, but increased their off budgets with an extra-system. This created a form of informal decentralization as an unintended consequence.

Chapter three highlighted how the central government has prevented subnational governments from building up their debt through the legal system, and thus the subnational governments have used the LGFPs to take the debt on behalf of them. This chapter proved that political connections between the local governmental officials and the local commercial bank presidents at the city level have increased the local government debt financing. A cultural factor of strong close networking in Chinese society influences the local government borrowing capability and the local officials utilized the cultural factors to increase their performance.

Chapter four demonstrated that intergovernmental transfers failed to reduce the gap in agricultural and educational expenditures for different regions. Progressive intergovernmental transfers increased for administrative spending, while they did not increase the educational and agricultural expenditures for the fiscally dependent counties across the country. As a result, the intentions of the central government failed to equalize the public welfare through these transfers. The progressive transfer did not properly provide for agricultural investment, nor did it increase the opportunity for basic education in the poor counties. Chapter four suggested some improvements in the transfer system for regional equalization. To be effective, the transfers needed to include clear definitions and parameters for the allocation of the transfers in order to avoid having them diluted as they passed downward through the various tiers of government;

from the central government, to provincial governments, the prefectures, and finally to the counties.

Therefore, the merits of the decentralization began to disappear away as an *informally* decentralized state emerged as its fiscal system. This *informal* decentralization guaranteed the local government political and fiscal autonomy, increased local competition, and thereby lead to economic growth. However, with an *informally* decentralized state, such as China, where its revenue centralization, and its expenditure responsibility was decentralized via an unfunded mandate, the informal borrowing autonomy and lack of transfers only increased the fiscal instability and gaps across the jurisdictions .

Within a highly centralized political and fiscal system, the political motivation of the officials does not necessarily contribute to the progress of the financial system. This study suggests that a better understanding of the relationships between the central and local governments and that of financial institutions of other countries would be required, before we recommend a policy design for either centralization, or decentralization.

## **II. Key Findings: New Institutionalism, Informal Decentralization to Fiscal Decentralization**

Based on rational choice institutionalism, previous literature argues that the Chinese Communist Party's (CCP) cadre evaluation system has promoted local bureaucrats to compete with each other to produce high growth and increase local revenue collection. However, taking a closer look at the consequences of revenue centralization discloses the politically inefficient equilibrium in which local governments exploit the extrabudgetary revenue base, have been resistant to centralization efforts to a certain extent, and result in fiscal indiscipline even though



its costs are high. The case study shows that subnational government behavior undermines the goal of the CCP, and CCP cadre evaluation system fail to control these unintended consequences.

This dissertation applies rational choice institutionalism to realm of fiscal decentralization, but emphasizes unintended negative consequence in China and suggests some prescriptions over the problems. It has focused on nature, cause, and consequences—fiscal reform and the fiscal externalities subnational governments create opposition to the fiscal centralization reform. Literature on China proves how political centralization helps efficiency. The incentive of the CCP Nomenklatura system is a way of driving economic growth and increasing revenue collection against the excessive tax competition. It has been analyzed by scholars, Yasheng Huang, and Susan Whiting, whose argument is based on rational choice institutionalism. They analyzes political incentive in the party-state drives the intermediate level of governments to reveal the information regarding subnational economy and tax revenue (Huang, 1996; Choi, 2006). The competition between subunits has been highlighted by advocate of decentralization led by Yingyi Qian and Barry R. Weingast. Applying rational choice institutionalism, this dissertation has questioned why the central government in China fails to show tight fiscal discipline even after the fiscal centralization, while subnational governments abuse the common revenue resources. The answer has highlighted larger questions about unintended consequences of fiscal reform and the endogenous design problem of centralization.

A key question is how and why some countries, like China and Russia, develop prevalent *informal* decentralization with fiscal indiscipline, while informality has not been rare in other countries. Ostrom argues that the reason, why some CPRs do not effectively govern their resources depends on commitment, monitoring efforts, and information about rule compliance in the CPRs (Ostrom, op.cit., p.186-187). The central argument emphasizes with an unintended

consequence facing the center in informal decentralization. The centralized unitary state is explicitly mentioned in the Chinese Constitution. Nonetheless, recent informal fiscal decentralization is one of the major concepts that the Chinese subunits have conducted and the central government has forced to accept. Informal decentralization is driven under intergovernmental bargaining rather than legal basis. Local officials might have expectations that they can maintain informal decentralization. When the center takes away subnational government taxing power to fund their expenditure dominating the political power, it cannot maintain centralization in the event of a local fiscal funding limitation. The central government in China does not allow subnational government access to credit markets, either. However, knowing that the center will ultimately tolerate informal decentralization and will not punish subnational officials for running debt and distributing the transfer for their priority; knowing that regardless of constitutional stipulation, the basic rules of the relationship between the center and the provinces were negotiated and necessary for their agreement for reform; and knowing that the central government is often incapable of monitoring its subnational government, subnational officials have weak incentives for fiscal discipline. Thus rational choice institutionalism is correct in pointing out that the policy may not result in optimal consequences with the violation of rule of law, lack of commitment and monitoring system. In response to centralization, the subnational governments fall into inefficient equilibrium in which the role of political logic is obvious.

By using rational choice institutionalism, this dissertation can also answer to the question why strong partisan discipline between the national and subnational governments is still associated with fiscal indiscipline. Previous literature searches for answers interpreting factors, but this dissertation has paid attention to the role of bargaining as Zheng (2007), social norm, and

the endogenous problem of mechanism designed by the center. In this equilibrium, politically hierarchical party fails to discipline to decrease debt due to mechanism problems. From the plethora of empirical research, it is well known that the fiscal reform effort is more likely to succeed when the strong party discipline enables to control subnational official behavior pursuing self-interests and drives them pursuing national interests. Under the strong party discipline, the inefficient equilibrium, that local governments exploit the common revenue pool across whole country, is only explained by either the unintended consequences or mechanism design problem, or both. On the other hand, under weak party discipline, local politicians are more willing to oppose to reform if they can get sufficient resources from the status quo though it is costly for the whole country. In the countries, such as Brazil and Russia, local representatives under the weak party discipline involve a strong deal of regional interests in the legislative process (Rodden, *op. cit.*, 2005; Stoner-Weiss, *op. cit.*, 1998).

Party discipline is quite strong in the China. Subnational officials in China are set in a hierarchical and integrated party system that forms their career prospectus. Carrying out target responsibility for whole national interests is generally a priority for local officials that provide career incentives. Meanwhile, CCP tries to harness on aggressive regional self-interest pursuing in policy enforcement, but shifts its burdens onto the local government through unfunded mandates. Paradoxically, the career prospectus has placed limits on the central government that has encouraged subnational officials exploiting common resources at the expense of the whole country. Subnational officials opportunistic attempts to illegally borrowing and conveniently distributing transfers would not be damaging to the careers of these officials, but only promoting them as long as carry out public good provision and meet impending national target. Under this context, while subnational government rational strategies in distributive funding sources play

significant role, both political network and bargaining process with the center as widely accepted Chinese norm have served to support subnational official strategies by enabling them to meet the demand for funding. The strategies might be rational for all levels of government including the central government whose priority lies on political stability rather than the distributional politics.

### **III. Suggestion for Institutional Transformation**

Based on rational choice institutionalism theory, this study elaborates the factors which derives unintended consequences in the central-subnational relationships in China, but postulates that success of the future of formal centralization in China is not rosy. The fiscal centralization model in China with its numerous centrifugal forces has been reshaped by the central government's *ex post* management throughout the reform process.

It appears that the Chinese central government has revamped its process of building well-functioning institutions by industrializing the tax structure in 1994, by increasing its transfer role in 2002, and by abolishing its extrabudget revenue in 2011. There has been some progress in revenue collection through tax reform. The tax revenues have rapidly increased since the tax reform in 1994. With industrialization, the major revenue source in China is now coming from the industrial and service sectors, rather than from the agricultural sectors, which is a switch from the past during the period of Mao's when it subsidized the industrial sector.

The central government has suggested further reform thus far, but there are still persisting problems. While subnational governments have taken on debt through their LGFPs, this behavior could gradually disappear as the central government experiments with a policy switch to allow local government debt in some jurisdictions. This is until, finally, the local governments' autonomy for debt financing would be recovered. However, even at this moment, the subnational

government debt and the real-estate bubble they created is alarming, and the Chinese economy is increasingly facing the possibility of crisis. With Beijing's abolishment of the extrabudgetary revenue in 2011, the excessive fee-burden facing the peasants was checked. The remaining illegitimate fee extraction of off-budgetary revenue, which cannot be truly estimated at this point in time, should be addressed and abolished. Intergovernmental transfers have not only provided for a high proportion of the subnational government expenditures, but these governments are highly dependent on these expenditures. The biggest outstanding problem that the central government needs to solve now is how, with its improved fiscal capacity, it can provide the fiscal assistance to enable the equalization.

Some remained problems are also tied to the centrifugal forces, which have been supported by Chinese traditional political network. This dissertation has not debated long-noted distinction of the benefit and problem over decentralization. Nonetheless, it accepts that decentralization stimulates efficiency. As well known argument of Charles Tiebout (1956), decentralization facilitates information revelation under electoral freedom. However, if the division of sovereignty is not well differentiated among levels of government that weakens commitment of level of governments, federalism facilitates to increase subnational government irresponsibility and their debt as shown in Argentina, Brazil, Nigeria, and Germany during the 21st century (Rodden, op. cit. 2005, p. 334). Debt in some jurisdiction became a problem for whole country as these countries faced crisis in their histories. On the other hand, as some literature has captured, centralization enhances redistribution and welfare—that does not justify Chinese the centralization with rampant inequality. Simply reducing autonomy to subnational government without cutting their reliance on extrabudget system for funding only exacerbates the extrabudgetary system exploiting and threatens common resources. The solution to the

subnational government funding problem is to fund projects through a highly decentralized taxation system based on rule of law, and commitment of levels of governments conditioning the center's increased capability to monitor the funding process of the local projects. It would not be easy in China, having legal tradition of Chinese characteristic.

#### **IV. Contribution, and Suggestions for Further Study**

A contribution of this dissertation is to figure out the condition for the unintended consequence in formal fiscal centralization. Historical new-institutionalism might be the adequate theoretical framework to highlight in China from its creation, to its consequences, including power change between levels of governments. However, the framework cannot predict the necessary condition, although not sufficient, to the causes of the problem, but also fail to prescribe remedies. Indeed, the effort to find out the factors for prediction makes it possible to suggest a mechanism which manages fiscal indiscipline facing Beijing.

The Chinese fiscal system is unique in that strong political hierarchical system cannot prohibit subnational government exploiting common revenue resources while greatly influenced by political network in society. However, Ostrom's remedy for global world can also redress the unintended negative consequences in China— the central government commitment for rule of law rather than tolerance and bargaining strategy based on the strengthened monitoring system will reduce the effect of the negative consequences. In addition to the general prescription, this dissertation comprehended the social norm and political factors that sustain informal institutions at behind. This case study understands the conditions under which an informal fiscal structure comes out, contributing to comparative studies on decentralization around the world. Thus, one

can safely conclude that political and fiscal institution in China affect fiscal indiscipline, and inequality.

Though this dissertation mentioned the connection of TRS and promotion among a variety of mechanisms and information revelations based on previous literature, it did not fully analyzed the relationship across the whole country. There is a question about the motivation of the informal decentralization on the nexus of issues related to hierarchical party discipline. Future work need to extend to cover the mechanism.

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## **Appendix**

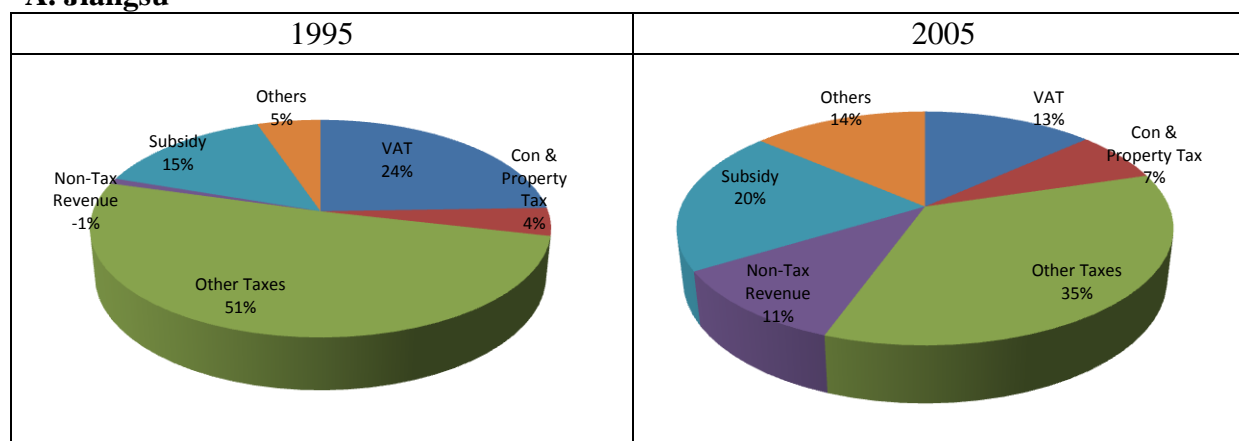
### A.1: Financial Account of Budgetary Revenue

(Unit: 100 mil. Yuan)

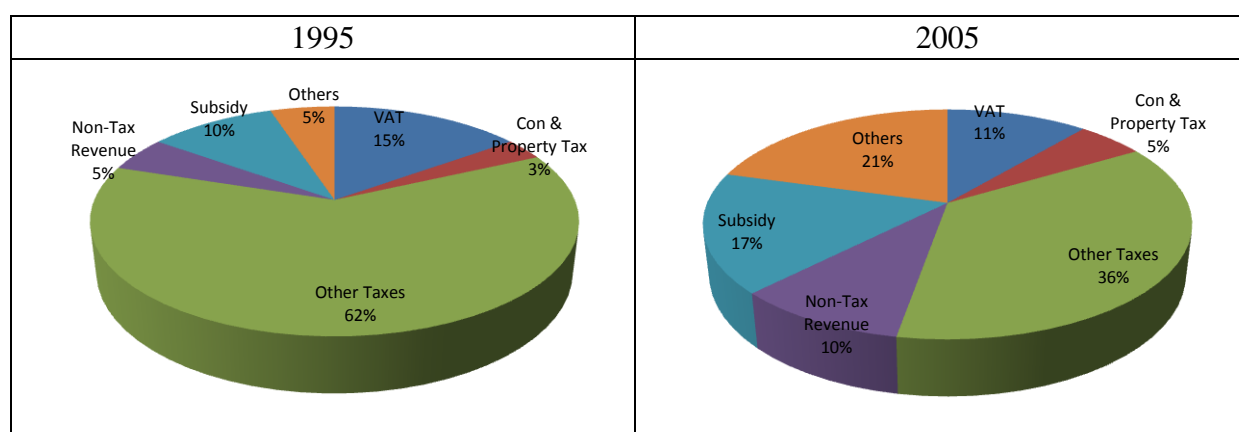
Region	Year	Budgetary Revenue							Extra-Budget Revenue
		VAT	Construction & Property Tax	Other Taxes	Non-Tax Revenue (Fee, Dividend)	Subsidy	Others (loan)	Budget Total	
Jiangsu	1992	47.5	8.0	98.4	(1.6)	28.2	10.1	190.6	
	1998	79.1	28.5	168.1	20.9	192.6	88.3	577.5	272.1
	2002	153.2	60.9	351.2	78.4	294.2	130.0	1,067.9	442.3
	2005	265.6	140.2	701.5	215.4	399.5	272.7	1,994.9	504.3
Guangdong	1992	39.6	8.1	162.0	12.9	26.3	13.4	262.3	
	1998	92.8	45.3	420.5	82.2	196.4	182.7	1,019.8	196.5
	2002	205.8	92.4	734.2	169.3	389.0	279.7	1,870.3	499.4
	2005	323.6	153.8	1,049.6	280.2	488.3	597.7	2,893.3	677.6
Liaoning	1992	50.9	10.8	96.9	(6.9)	46.4	4.1	202.1	
	1998	48.5	33.6	151.5	31.1	181.9	83.4	529.8	118.5
	2002	74.3	50.0	208.8	66.6	355.1	158.8	913.5	184.2
	2005	113.1	80.5	334.9	146.9	525.2	258.1	1,458.6	238.8
Sichuan	1992	35.4	6.4	55.2	3.0	35.1	41.7	176.7	
	1998	29.6	18.2	118.2	31.3	124.2	48.2	369.7	159.1
	2002	41.9	29.6	153.9	66.5	410.2	73.5	775.5	166.2
	2005	71.1	52.2	238.4	118.0	611.6	115.4	1,206.6	173.0
Shaanxi	1992	10.1	2.8	40.7	(2.6)	13.6	1.3	65.8	
	1998	16.3	10.4	52.9	13.7	76.1	28.5	197.9	85.0
	2002	26.5	18.8	80.3	24.8	243.1	61.9	455.3	122.3
	2005	55.3	32.0	119.3	68.7	386.8	110.7	772.8	116.3
Gansu	1992	8.8	2.0	28.8	0.4	11.4	0.3	51.7	
	1998	10.8	6.8	29.0	7.5	71.6	13.9	139.6	27.2
	2002	15.1	9.5	40.8	10.8	119.1	94.0	289.4	47.3
	2005	25.3	15.0	51.7	31.5	310.5	44.0	478.0	52.8

## A. 2: Local Government's Revenue Structure Change

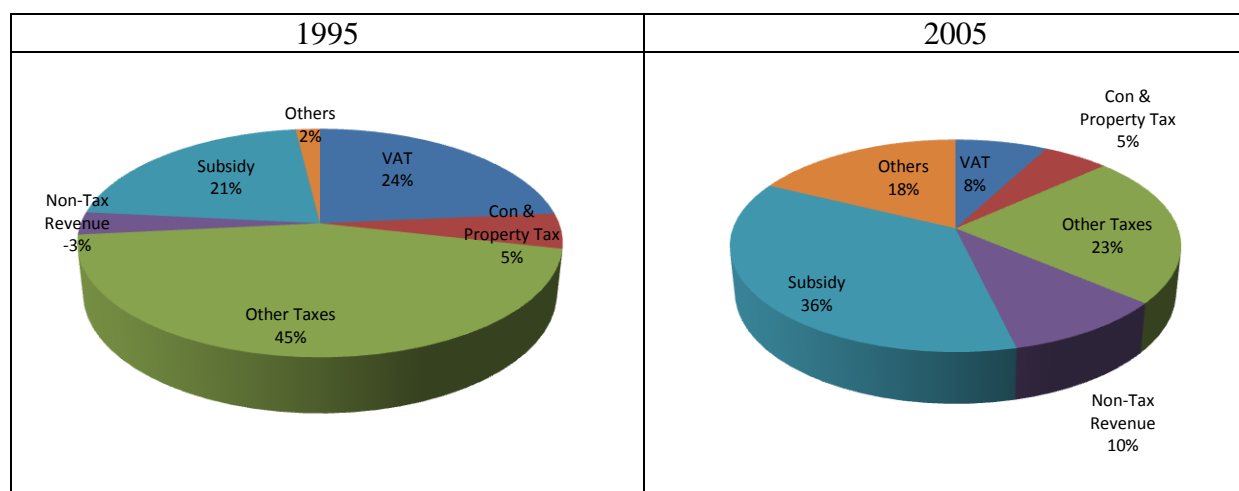
### A. Jiangsu



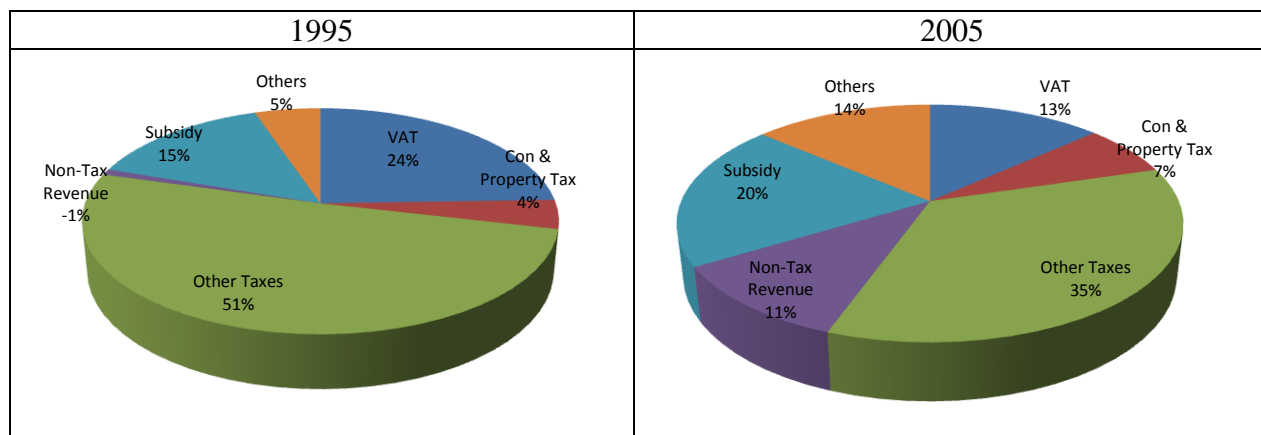
### B. Guangdong



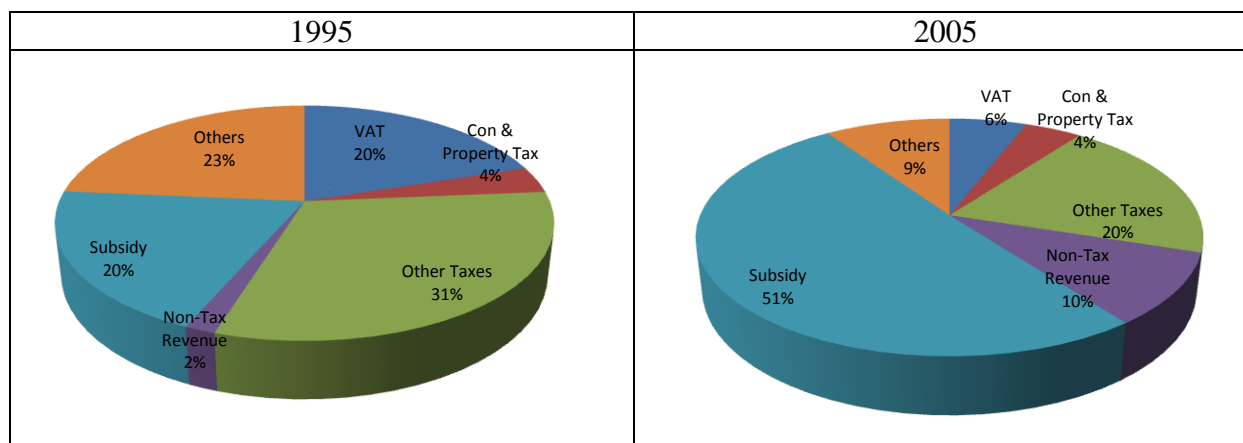
### C. Liaoning



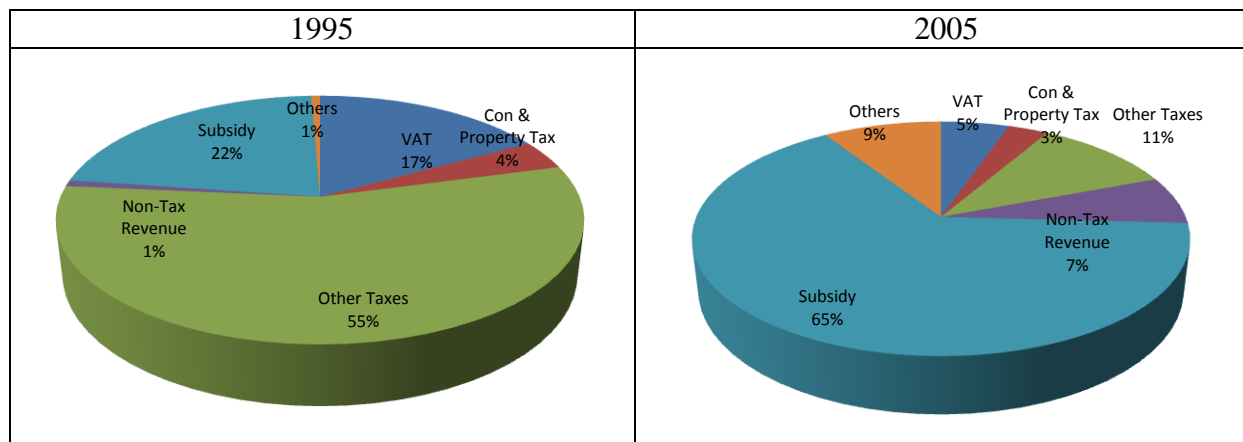
## D. Sichuan



## E. Shaanxi



## F. Gansu



A.3: Main Items of National Government Revenue of the Central and Local Governments  
(2008) (100 million yuan)

Item	National Government Revenue	Central Government	Local Governments
<b>National Government Revenue</b>	<b>61330.35</b>	<b>32680.56</b>	<b>28649.79</b>
<b>Total Tax Revenue</b>	<b>54223.79</b>	<b>30968.68</b>	<b>23255.11</b>
Domestic Value Added Tax	17996.94	13497.76	4499.18
Domestic Consumption Tax	2568.27	2568.27	
VAT and Consumption Tax from Imports	7391.13	7391.13	
VAT and Consumption Tax Rebate for Exports	-5865.93	-5865.93	
Business Tax	7626.39	232.10	7394.29
Corporate Income Tax	11175.63	7173.55	4002.08
Individual Income Tax	3722.31	2234.23	1488.08
Resource Tax	301.76		301.76
City Maintenance and Construction Tax	1344.09	7.79	1336.30
House Property Tax	680.34		680.34
Stamp Tax	1311.29	949.68	361.61
Stamp Tax on Security Exchange	979.16	949.68	29.48
Urban Land Use Tax	816.90		816.90
Land Appreciation Tax	537.43		537.43
Tax on Vehicles and Boat Operation	144.21		144.21
Tax on Ship Tonnage	20.12	20.12	
Vehicle Purchase Tax	989.89	989.89	
Tariffs	1769.95	1769.95	
Farm Land Occupation Tax	314.41		314.41
Deed Tax	1307.53		1307.53
Tobacco Leaf Tax	67.45		67.45
Other Tax Revenue	3.68	0.14	3.54
<b>Total Non-tax Revenue</b>	<b>7106.56</b>	<b>1711.88</b>	<b>5394.68</b>
Special Program Receipts	1554.10	200.65	1353.45
Charge of Administrative and Institutional Units	2134.86	372.88	1761.98
Penalty Receipts	898.40	31.72	866.68
Other Non-tax Receipts	2519.20	1106.63	1412.57

#### A.4:Glossary

**AUTONOMY:** “Autonomy” is not a legal term in constitutional law, but “in some real sense the right to be different and to be left alone; to preserve, protect, and promote values which are beyond the legitimate reach of the rest of society. In a few instances, demands for autonomy may be satisfied only by the emergence of a new, independent state in which the dissatisfied segment can exercise “sovereign” authority (Hannum, 1994, p. 4).”

**BANKS IN CHINA:** There are policy banks, state banks, and joint-stock commercial banks at the national level in China. At the local level, there are city commercial banks, rural commercial banks, urban-rural credit cooperatives, and village and township banks (VTBs).

**POLICY BANKS:** Policy banks were established in 1994 by the State Council to support People’s Bank of China (PBOC) in the policy-directed lending (PIM China, n.d.; Caijingwang, 2009). These banks can offer preferential lending with a flexible payment schedule (Caijingwang, op. cit.). Although these banks were focused on policy goal in the past such as promoting and financing the infrastructure construction, exportation, and food productions, they not making profit. As a result, the government recently emphasized the commercialization of these banks with a goal of having a balanced portfolio (Ibid.). There are three policy banks—the Export-Import Bank (Exim), the Agricultural Development Bank, and the China Development Bank (CDB) (PIM China, op. cit.; Caijingwang, op. cit.)

**THE BIG FOUR STATE BANKS:** The state-owned banks are called the Big Four commercial banks (四大商业银行) because they take over the role of commercial banking businesses from People’s Bank of China (PBOC), while PBOC still concentrates on monetary policy issues. The Big Four banks are the following: the Bank of China, the China Construction Bank, the Industrial and Commercial Bank of China, and the Agricultural Bank of China. The state holds most of these banks’ stocks (PIM China, op. cit.)).

**JOINT-STOCK COMMERCIAL BANKS:** Joint stock commercial banks refer to the banks owned by several investors in a financial institution (wisegeek n.d.). There are twelve commercial banks of this type—CITIC Bank, China Merchants Bank, Minsheng Banking Corp, Huaxia Bank, Shanghai Pudong Development Bank, China Everbright Bank, Shenzhen Development Bank, Guangdong Development Bank, Industrial Bank, Evergrowing Bank, China Zheshang Bank, and China Bohai Bank (China daily Online, 2009).

**CHINESE POLITICAL IDEOLOGY:** The Communist Party of China (CCP) portrays themselves as communists. This is supported by Article 24 of the Constitution, which stipulates that “[t]he state strengthens the building of socialist spiritual civilization.” In reality, however, the CCP has lacked a coherent ideology since Deng Xiaoping's leadership in 1978. This lack of coherent ideology is linked to political battles, which then forms specific groups’ arguments and ideals. Wang Hui argues that “every great political battle was inextricably linked to serious theoretical considerations and policy debate” (Wang, 2010, p.6 in Brown, 2012).

**CHINESE LAW (LEGALITY):** The Chinese legal system has enormous shortcomings. The Chinese legal institutions are highly politicized and judicial independence is not guaranteed. Judges are drawn from the members of the Communist Party, and are also supervised by the Party Organization Departments (Cohen 1997 and Zhao 2003 in Landry 2002, p. 209). While citizens have the ability to appeals, judicial reviews are often done improperly, and the execution of civil judgments is doubtful (Clarke 1995 in Landry 2002, p. 209). The populace has difficulties in filing charges against the state actors or the state itself, and doing so is often very costly (Gallagher 2005 and O'Brien and Li 2005 in Landry, 2002, P.209).

The Chinese authoritarian regime is committed to modernizing the legal system and building a rule of law (法治), even under the current adverse conditions (Landry, 2002, P. 209). Over the years, the Chinese legal institution has been gradually progressing and has built autonomous judicial and legal institutions (Diamant, Lubman, and O'Brien 2005; Peerenboom 2002; Potter 2003; U.S. Congressional-Executive Commission on China 2002 in Landry, 2002, P.216).

**CHINESE CONCEPT OF OWNERSHIP:** Since the establishment of Communist China in 1949, the state or collectives have owned the land. In the beginning, the Communists took away landlord holdings and distributed the land to peasants. The communes, however, immediately persuaded peasants to give back their land (James, 2007). Since then, the state has owned land in urban and collectives have owned agricultural land in rural areas.

After an economic reform in 1982, the Chinese Constitution adopted the concept of property rights in China. Article 13 of the Constitution in 1982 provided that "[t]he State protects the right of citizens to own lawfully earned income, savings, houses and other lawful property," and "[t]he State protects according to law the right of citizens to inherit private property." In 2004, the Constitution was amended to strengthen Article 13, revising it to add that "[t]he lawful private property of citizens is inviolable" and "[t]he state protects according to law the right of citizens to own and inherit private property." The imposition of property rights was strengthened in China with the passage of the Property Law in 2007. Article 39 of the Property Law protected profits from property by stipulating "the right to possess, utilize, dispose of and obtain profits from the real property" to the owner. However, Article 7 emphasized public interests in that "[t]he attainment and exercise of property rights shall comply with laws, social morality and shall not do harm to the public interests and the legitimate rights and interests of others."

Property rights should not be confused with ownership. Article 2 of Land Administration Law promulgated in 1999 stipulates that "[n]o organization or individual may appropriate, buy, sell or lease land, or unlawfully transfer land in other ways." Rather, people only have the right to use land as such that "[t]he right to the use of land may be transferred in accordance with law." Article 10 of Constitution in 1982 confirms that "[l]and in the cities is owned by the state. Land in the rural and suburban areas is owned by collectives except for those portions which belong to the state in accordance with the law; house sites and private plots of cropland and hilly land are also owned by collectives." Chapter II Article 8 of Land Administration Law promulgated in 1999 also stipulates the same content. Even collective owned land, state can expropriate according to Article 2 of Land Administration Law, which stipulates that "[t]he State may, in the

public interest, lawfully requisition land owned by collectives.” In 2004, Article 13 of the fourth amended Constitution added “[t]he state may, in the public interest, appropriate or requisition private property of citizens for its use in accordance with the law, while making compensations” in order to enable the State’s appropriation or requisition. Because land is owned either by collectives or by the state, according to Article 10 of Constitution promulgated in 1982, appropriation of rural land only refers to the withdrawal of land use rights. According to Article 22 of Constitution in 2004, the Chinese government has been able to reclaim any private property from an individual, as long as it is for the public interest and in accordance with the law and the government makes compensation for expropriation (征收) or requisition (征用). Subsidiary legislation, Article 42 of Property Rights Law promulgation in 2007 stipulates that “[f]or the purpose of public interest, the collectively-owned land, houses and other real property owned by institutes or individuals may be expropriated in line with the procedure and within the authority provided by laws.”

**EXTRA-BUDGET:** “[E]xtra-budgetary funds” had a specific, narrow meaning, [often] referring to funds that were raised, managed, and disposed of by government or public units outside of the regular annual budget” (Bernstein et al., 2003). Extra-budgetary revenue (EBR, 预算外收入) refers to various kinds of non-tax revenues. Extra-budget (预算外) operates outside the formal budgetary process, but is legal and is recorded in official statistics as is tax revenue. It is collected by different government agencies (Zhan, n.d.). “For example, Bureau of Personnel (人事局) can charge fees for granting professional certificates, and State Drug Administration (药品监督管理局) can charge fees for authorizing the production and sales of drugs” (Ibid.). However, the local governments can manipulate the extra-budgetary funds easier, compared to the budgetary funds. This happens because extra-budgetary funds are not precisely defined items in the budget of the government (gov.cn, 2006). In 2001, the government unified the whole extra-budgetary system into the budgetary management system (Speech of Wen Jiabao, 2012).

**“DECENTRALIZATION BY DEFAULT”:** Christine Wong (2008) calls unfunded mandate “decentralization by default” when large expenditure had occurred in China, but reactive changes on the revenue and expenditure were not able to coordinate the expenditure.

**FEDERALISM:** Federal refers to “[h]aving or relating to a system of government in which several states form a unity but remain independent in internal affairs” (Oxford dictionary). Federalism is a concept in which a group of members come and are being held together by a contract (Latin: foedus). The contract for federation could be reluctantly or voluntarily agreed (Riker, 1987, pp. 9-10). “In this context, federalism is often regarded as a form of government that differs from unitary forms of government, in terms of the distribution of power between central and sub-national governments; the separation of power within the government; and the division of legislative powers between national and regional representatives. In this sense, a true federation has both a distribution of political power specified in the constitution and a direct relationship between political power and the individual citizen” (Zheng, op. cit., 2008, p.32).

**CONSTITUTIONAL FEDERALISM:** The U.S. Constitution does not explicitly mention the term federalism (U.S. Constitution Online). However, the Constitution



embodies it with many other concepts. According to the Constitution, the framers produced a federal system in the U.S. Thus, Rodden (op. cit., 2005, p. 327) defines political federalism as “a special type of incomplete constitutional contract between the federal government and provinces.”

**CONSTITUTIONAL SOVEREIGNTY:** Constitutional federalism in the United States has evolved according to politics since its implementation in 1787 (U.S. Constitution Online). Two kinds of federalism—dual federalism and cooperative federalism— have been debated. Narrowly interpreting parts of the Constitution, dual federalism holds that the federal government and the state governments have equal sovereign. The federal government has limited powers explicitly listed in the Constitution. On the other hand, cooperative federalism holds that the federal government has supreme power over the states. Even so, local governments retain a considerable amount of legal autonomy and legislative power to build their own law in Australia, Canada, and the United States (Nathan et al., 1990 in Zheng, op. cit., p. 35-36).), while the counter parts of Brazil, India, and Soviet Union retain little autonomy over major economic and political policy decision (Ibid.). Constitutions extensively empower the national government with the right to veto state legislation and take over the administrative function of states under emergency in India and Brazil. “In Brazil, the federal constitution explicitly specifies how the internal political institutions of the states are to be organized. In India, state powers are constrained by the fact that the governors of the states are appointed by the country’s president on the recommendation of the Prime minister” (ibid.). On the other hand, China’s central-local relations cannot be understood based on a formal institutional perspective due to the lack of a sound legal infrastructure in the country. A system of rule of law never binds local governments in China. The center and the provinces need to bargain to enforce laws, regulations and contracts, which just often mean the beginning of “business”. Therefore, actual function of Chinese central-local relation should be analyzed based on *de facto* federalism (Ibid.).

**FISCAL AUTONOMY (KINDS OF):** “Fiscal decentralization refers to the set of policies designed to increase the revenues or fiscal autonomy of subnational governments. Fiscal decentralization policies can assume different institutional forms such as an increase of transfers from the central government, the creation of new subnational taxes, or the delegation of tax authority that was previously national” (Falleti, op. cit., p. 329).

Fiscal decentralization in Chapter 2 of this dissertation “includes a wide range of factors: (1) the tax sharing is guaranteed in the system; (2) subnational governments collect and use the higher amount of budget; (3) subnational governments have decision-making authority of tax rate and base, and budget priorities, and (4) subnational governments have borrowing autonomy.”

**FISCAL REFORM PURPOSES:** Over the past decades, the Chinese government carried out large scale fiscal reforms. In 1978, China changed its planned economy into market economy. In accordance with the overall economic reform, the former highly centralized fiscal system was transformed into decentralized fiscal system. Prior to the 1978 market reform, the fiscal system in China highly conforms to the centralized and planned economic system. The local

governments turn over all their revenues to higher governments, which then allocate the expenditure to the local governments. Likewise, the state-owned enterprises (SOEs) turn all their profits to the fiscal department. The fiscal department sets the expenditure of the SOEs based on the unified standards, and transfers subsidies for the losses of the SOEs. The Ministry of Finance examines the expenditure of the administrative departments and public institutions and allocates funds to them. Yang (2001, pp.1-2) argues that the current fiscal system during this era was not able to meet the demand of the economic reform.

China reformed its fiscal system again in 1994. After the fiscal reform in 1978, the former highly decentralized fiscal system drastically reduced both the total revenue and the central government revenue vis-à-vis local government. This is mainly because the local governments engaged in revenue competition. The central government did not have enough resources to carry out public finance. To increase revenue and to prevent local interference in central tax collection, the central government centralized the revenue and established its tax collection bureau, the National Tax Bureau (NTB), at each local jurisdiction in 1994 (Choi, op. cit., p.47). The NTB collects tax and allocates portion of revenue to the local governments for their expenditure. While expenditure is decentralized, the central government enforces unified control over revenue rate throughout China. With significant increases in the total revenue and the central government revenue, the fiscal reform in 1994 is able accomplish its goal,

**INFORMAL INSTITUTION:** The term informal institution was coined by institutionalists who divided institutions as formal and informal (North, op. cit.). Formal constraints are rules that human devised, including statute law, common law, and contracts between individuals, among others. Informal constraints, on the other hand, include things such as conventions, codes of behavior, and norms of behavior (Ibid., p.4-6). Informal institutions are not a set of written constitutional rules, but are based on the local history and culture, accepted, and enforced outside of the official system. (Thanh et al. 2011).

**INFORMAL DECENTRALIZATION:** Informal decentralization is also called *de facto* decentralization. Informal decentralization refers to the decentralization embodied beyond the formal authority assigned to the local government by the central government. Informal decentralization goes beyond constitutional division of powers between two levels of government. Informal decentralization can be created through the information advantage in the jurisdiction. The local leaders gain local information through their social networks, their adoption of norms, or their enforcement services in their jurisdiction (Thuy VU et al., 2011). Yongnian Zheng (2008) define *de facto* federalism as "...a relatively institutionalized pattern which involves an explicit or implicit bargain between the centre and the provinces, one element in the bargain being that the provinces receive certain institutionalized or *ad hoc* benefits in return for guarantees by provincial officials that they will behave in certain ways on behalf of the centre" (Zheng, op. cit., p.39).

**IRON-TRIANGLE IN CHINA:** In general, the "iron triangle" refers to collusive interactions amongst three-sided parties among politicians, bureaucracies, and a particular industrial or interest group. There is no clear division between politicians and bureaucracies in China. Rather, there is a strong collusive three-sided relationship between politicians (or bureaucracies), and

particular two-sided industrial or interest groups. Their social network is stronger than the counterparts in western countries. For example, city or prefecture level local governments, city banks and local financial platform companies have a close relationship and make a favorable lending decision for governments.

## **KINDS OF INTERGOVERNMENTAL TRANSFERS**

**CONDITIONAL TRANSFERS (EARMARKED TRANSFERS):** The upper level government designates the usage of the funds to support a particular purpose. The grants are divided into matching and non-matching transfers

**MATCHING TRANSFERS:** For every amount of fund given by the upper level government, a certain proportion of the fund must be provided by the lower level governments.

**NON-MATCHING TRANSFERS:** The upper level governments give a fixed amount of money with the specification that it is spent on public goods without request of a certain amount of funds provided by the local government as its counterpart fund.

**UNCONDITIONAL TRANSFERS:** The upper level governments give an unrestricted lump sum grant without specification on the use of funds. Usually, unconditional transfers are distributed to decrease disparities in expenditure.

**2. LOCAL GOVERNMENT FINANCING PLATFORMS (地方融资平台):** Local Financing Platforms are also called local government vehicle companies. These platforms are government-sponsored investment companies through which local governments raise funds for the construction of infrastructure, such as roads, airports, bridges, and power plants (Caixin, n.d.). These platforms also help local governments prepare matching funds for the central government's transfer of subsidies to local governments (Ibid.). These companies were first established in the 1990s, and drastically increased in 2008, when a stimulus plan of four trillion Chinese yuan for economic growth was introduced (Ibid.).

## **OFF-BUDGET OF EXTRA-SYSTEM (制度外) :**

Off-budget revenue is also called extra-extra budget revenue. Off-budget revenue differs from EBR because the former is illegally collected by local government and their agencies (Zhan, op. cit.).

**OWNERSHIP:** Ownership refers to “the act, state, or right of possessing something” (Oxford dictionary). “Ownership of property may be private, collective, or common and the property may be objects, land/real estate, or intellectual property. Determining ownership in law involves determining who has certain rights and duties over the property. These rights and duties, sometimes called a ‘bundle of rights,’ can be separated and held by different parties” (Lin et al., 2009).

**PARTY STATE:** Party-state is a type of state in which a political party dominates the government. Party state refers to the one-party leadership, which indistinguishably directs the administrative functions of the state. Party and state are intertwined, however, they are not same.

The party play role like the legislature initiating policy, and the state like the executive (Cheek 1997, p. 4). The party state also refers to a party that has the absolute central power in politics. Made by Deng Xiaoping, Four Cardinal Principles, for which debate is not allowed in Chinese politics, is the party's leadership, upholding Marxism, and socialist system, and the people's democracy and dictatorship (Ding, 2013, p. 63). Deng Xiaoping and Jiang Zemin later emphasized that the Party assumes responsibility and coordinates all other political institutions and organization—the government, congress, political consultative conference, and the masses organizations (Ibid.). China is a *de facto* party state. *De facto* single-party state nominally allows multiparty, but does not tolerate balance of power and the opposition from the other parties over the policy.

**PRIVATIZATION:** Privatization refers to “transfer (a business, industry, or service) from public to private ownership and control” (Oxford dictionary). Chinese privatization began from rural areas. The disintegration of people’s communes into family management led to the privatization of China’s agricultural production. In 1995, privatization of SOEs in urban areas is enforced in three areas under the slogan “grasping the large and letting go the small” (抓大放小) (Cao et al. 1999): “(i) privatization of small SOEs at the county level; (ii) mass lay-offs of SOE workers at the city level; and (iii) mergers (兼并), groupings/conglomerations (集团化), corporatizations (公司化), and initial public offerings (IPO) (上市) of some large SOEs, which often involve the central government” (Ibid.). Accordingly, Chinese banks have been divided into several categories (policy bank, commercial bank, etc.), and then offered at stock market for public offering.

**RATIONALITY:** Rationality is simply assuming that economic agents prefer more to less. This is the foundation why we can have a well-defined utility function; and therefore, analyze economic phenomenon.

#### **POLITICAL RATIONALITY**

Paul H. Conn et al. define rational political action as “action that is motivated by the pursuit of power payoffs resulting from control of political office” (Conn et al., 1973, p. 224-225).

**RENT-SEEKING:** Rent-seeking implies the redistribution of resources (Rowley et al. 1988) by increasing one’s share of resources without creating any resources or profits, or by capturing privileges at the expense of other parties. Thereby, rent-seeking behavior imposes large social costs on an economy, decreases efficiency, and increases economic inequality. Rent-seeking was first coined by Gordon Tullock (The Economist, n.d.).

**Slide 19 REVENUE SHARING:** In general, revenue sharing refers to unconditional grants. Revenue sharing in China, however, refers to taxes being returned to the jurisdictions where the taxes are collected.

**TARGET RESPONSIBILITY SYSTEM:** The cadre responsibility system is “a governance mechanism that integrates political incentives with political control” (Edin, 2003, p. 13). The cadre responsibility system is introduced to improve the efficiency of the bureaucracy (Ibid., p.3). The cadre responsibility system is a process in which cadres are evaluated for their performance

with monetary compensation and political promotion (Ibid., p. 5). Recently, at the local level, only the leading cadres (领导干部) are evaluated by the cadre responsibility system and managed by the party organization department (Ibid., p. 3). In other words, leading cadres are controlled by the party organization departments (组织部) through the Nomenklatura system, while ordinary cadres are the responsibility of the personnel departments (人事部) and evaluated by the civil service regulations through the bianzhi (编制) (Ibid., p.7).