Did government decentralization cause

China’s economic miracle?

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Many scholars attribute China’s remarkable economic performance since 1978 in part to the country’s political and fiscal decentralization. Political decentralization is said to have stimulated local policy experiments and restrained predatory central interventions. Fiscal decentralization is thought to have motivated local officials to promote development and harden enterprises’ budget constraints. The locally diversified structure of the pre-reform economy is said to have facilitated liberalization. We examine these arguments and find that none establishes a convincing link between decentralization and China’s successes. We suggest an alternative view of the reform process, in which growth-enhancing policies emerged from competition between pro- and anti-market factions in Beijing.

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1 Introduction

What roles have political and fiscal decentralization played in China’s economic reforms and in the remarkable boom they fostered? Since the late 1970s, China has liberalized most prices, de-collectivized agriculture, and integrated into world markets. These changes fueled an unprecedented period of growth, with GDP per capita rising from $674 in 1978 to $5,085 in 2004 (in PPP-adjusted 2000 dollars).¹ Scholars have attributed this economic miracle to many causes—recovery from the Cultural Revolution, initial underdevelopment, and a rich diaspora, to name a few. But some suggest the country’s decentralized structures of government and public finance played an important part.²

Those who credit the success of China’s reforms in part to decentralization make five main arguments. First, some focus on the pre-reform economy’s modular organization. Rather than a specialized, nationwide hierarchy, China’s economy consisted of parallel, diversified provincial economies. This reduced dislocations and stimulated competition when markets were introduced. Second, some believe political decentralization encouraged local reform experiments, allowing new ideas to percolate up from the grass roots. Third, some argue decentralization created political checks on the central authorities, limiting predation and convincing investors reforms would last. Fourth, some suggest fiscal decentralization gave local officials strong

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¹ Based on the International Comparison Program, as reported in the World Bank’s World Development Indicators Database. In non-PPP adjusted 2000 US dollars, the increase was from $153 to $1,162.

² For instance, Qian and Weingast (1996) assert that: “The critical component of China’s market-oriented reform, which began in 1979, is decentralization.” Montinola et al. (1996) label China’s political system during the reform era one of “market-preserving federalism,” and suggest this had various economic benefits. Qian and Roland (1998, p.1156) argue that: “one of the most distinct features of China’s transition has been associated with devolution of authority from the central to local levels of government.” For other articles that link the success of economic reforms to political decentralization, see Chen (1993) and Xu and Zhuang (1998). Adherents of this view often note that decentralization can have costs—for instance, increased inequality, policy externalities, and the creation of local “dukedom” economies—but argue that in China’s case these were outweighed by the benefits (Qian and Weingast 1996, p.3). Blanchard and Shleifer (2001) make the more nuanced claim that fiscal decentralization helped in China, but only because it was combined with political centralization.
incentives to stimulate economic growth. Fifth, some contend decentralization helped harden budget constraints on enterprises, forcing them to restructure.

In this paper, we challenge the claim that decentralization had much to do with the success of China’s reforms and its subsequent economic miracle. Grass roots initiatives did, of course, occur, and considerable administrative decentralization took place from the mid-1980s. But the key reforms that reshaped China’s economy began in the late 1970s and early 1980s, when China was still one of the most politically centralized countries in the world. In fact, centralization helped speed the spread of beneficial discoveries. Provincial governors were not then—and still are not—a reliable check on central abuses, and certainly do not guarantee property rights. The most commonly cited example of a governor who resisted Beijing actually ended in victory for the central authorities: the governor was removed and his successor forced to accept Beijing’s preferred policy. Fiscal decentralization cannot explain improved performance because any beneficial effect of a higher local marginal share of tax revenues was offset by the sharp decline in the proportion of GDP collected as taxes and available for sharing. Nor can fiscal decentralization have hardened state enterprises’ budget constraints because these did not harden. In fact, loss-making enterprises multiplied during the years of decentralization and rapid growth, and the state banks virtually bankrupted themselves bailing them out. Budget constraints only hardened after central fiscal and monetary policy was tightened. To be clear, day-to-day control over various economic activities did pass to subnational officials during the 1980s, subject to ultimate review from above. However, increased local discretion had both positive and negative effects, and the evidence does not clearly indicate which on balance dominated.

If decentralization was not a major ingredient in China’s reform success, the explanation must lie elsewhere. We suggest another view of politics in post-Mao China. The driving force behind reform was not initiatives of autonomous local officials but competition at the center between rival factions, with different ideological predispositions and local connections. Factions sought supremacy within the party by demonstrating the effectiveness of their chosen policies
across the chess board of China’s territorial administration. Local officials were linked into these factions, and sought to impress higher-ups with suggestions and sometimes spontaneous—even illegal—initiatives. This view, which actually coincides with many traditional understandings of Chinese politics, can explain the temporal pattern of reform, which waxed and waned with shifts in the factional balance of power rather than with changes in decentralization. It also explains why economic performance has not deteriorated recently despite considerable recentralization. Today, all major factions in Beijing accept the goal of marketization; they differ in their personnel networks, sectoral and regional connections, and commitment to income redistribution.

Decentralization means different things to different people. Based on examination of common usage, we distinguish three types. Administrative decentralization occurs when national authorities permit their subnational agents to make certain policy decisions, subject to review and possible veto from above. Discussions of political decentralization usually imply either or both of two characteristics, which can occur in different degrees. First, a system is more politically decentralized if subnational governments have the right to make certain policy decisions without being overruled by higher levels. The right not to be overruled distinguishes political from administrative decentralization. Since even in the most extreme unitary states subnational officials sometimes act without precise orders, the distinction is important. Second, a system is more politically decentralized if subnational officials are chosen by local residents rather than higher officials. Fiscal decentralization is used in various ways, so we will try to interpret which meaning is implied by each particular argument. At a minimum, it would seem to require that subnational officials administer a significant share of state revenues. We distinguish all types of

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4 For recent discussions, see Rodden (2004) and Ebel and Yilmaz (2002). Federalism, in Riker’s (1964) definition, requires that subnational governments have the right to make policy autonomously in at least one area—i.e. the first aspect of what we call political decentralization. In Chinese, “decentralization” is often translated as fengquan, which means more broadly the abdication of planning powers by the government. By decentralization, we mean specifically a transfer of powers and/or autonomy to lower level governments.
decentralization from a mere weakening of the central state apparatus. A common perception in China is that the central authorities’ ability to control economic life has decreased since 1978. However, powers “lost” by Beijing are not necessarily gained by local governments. The increasing complexity of Chinese economy and society as the country modernizes has made monitoring and control by any level of government less comprehensive.

Applying these definitions, we consider China to have been administratively and politically highly centralized in 1978. Administrative decentralization increased considerably during the 1980s. Politically, however, the country remained extremely centralized. Although subnational officials make numerous decisions, especially on economic matters, they can always be overruled from above. If central leaders are divided, local officials can sometimes delay implementation. But if central authorities are united, they can crush local resistance. As for appointments, from the late 1980s village officials have been locally elected. In practice, all other subnational appointments have been made by higher authorities, with the center exercising ultimate control. If fiscal decentralization means the subnational share of budget spending, this increased from about 53 percent in 1978 to 73 percent in 1996, before falling back to 70 percent in 2003. The subnational share of revenues fell from 85 percent in 1978 to 62 percent in 1985, then rose to 78 percent in 1993, before falling to 45 percent in 2003. Tax system design has remained a prerogative of the central authorities.

2 The M-Form Economy

Qian and Xu (1993) and Xu and Zhuang (1998) argue that China’s economy as of 1978 was structured in a way particularly conducive to marketization, at least compared to its northern

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5 One might question whether this is, in fact, the case. Distance has always allowed for considerable non-compliance, as suggested by the old Chinese saying “Qiang zai wai jun ming you suo bu shou” [When the Emperor is far away, a general does not obey all his orders.]

communist neighbor. In the Soviet Union, regional economies were mutually dependent, specialized units, coordinated by the central planners, with different roles in the nationwide division of labor. In China, provincial economies were more self-sufficient and internally diversified. Fearing military invasion, Mao encouraged local self-sufficiency and devolved much planning and administration to provincial cadres (Qian and Weingast 1996). Whereas in the USSR, single plants often supplied the entire market, in China parallel enterprises in different provinces produced similar goods. Using the vocabulary of Chandler (1962) and Williamson (1975), Qian and Xu (1993) compare the Chinese economy to a multi-divisional (“M-form”)—and the Soviet Union to a unitary (“U-form”)—organization.

This inherited economic structure helped China when planning yielded to markets. Since different provinces and counties within them had relatively diversified economies, competition could emerge between rival producers of the same products. This deliberate redundancy left the system less vulnerable to transitional shocks, reducing the cost of disorganization. It also reduced the risk of disruption if the central government conducted localized experiments. Finally, M-form structure enabled central leaders to use yardstick competition to evaluate local officials’ success in supporting economic development (Maskin, Qian, and Xu 2000).

These arguments are quite compelling. However, they have little to do with either political or fiscal decentralization. They concern the Chinese economy’s structure at the start of transition—specifically, the lower industrial concentration and geographical specialization than in the Soviet Union. Low industrial concentration and diversified regional economies help make market systems more competitive and resilient. But this is true regardless how political authority and fiscal resources are shared between levels of government. The purported benefits of the M-form economy—competition between enterprises, alternative suppliers, less risky local experiments—are just as beneficial in a politically centralized market economy as in a politically decentralized one. That principals can use yardstick competition to evaluate local agents’ performance is equally valid whether the principals are local voters or central leaders. Political
decentralization in an M-form economy may indeed be less disruptive than in a U-form economy. But it does not follow that in an M-form economy like China’s, political decentralization necessarily outperforms centralization. To make this case, some other argument is needed.

3 Local policy experiments

China’s political decentralization is often said to have stimulated spontaneous local experiments that grew into nationwide reforms. In the West, the notion that political decentralization encourages policy innovation is often traced to Justice Brandeis’ remark that in a federal system states could serve as “laboratories”, testing novel policies without risk to the rest of the country. Although China’s political system is far from democratic, similar arguments have been made there. Cao, Qian and Weingast (1999, pp.123-4), quoting Brandeis, note that China has relied on “the ‘laboratory of the local governments’ to pursue reform.” According to Xu and Zhuang (1998, p.194), a major feature of Chinese reform is “its success in using local experiments and in adopting the ‘bottom-up’ approach.” The lesson China’s experience teaches, write Montinola et al. (1996, p.78), is that: “Experimentation, learning, and adaptation all follow from the inception of local political freedom over the economy.”

Did political decentralization in China stimulate policy innovation, and does this help to explain the country’s economic success? We dispute this for three reasons. First, that political decentralization leads to greater policy innovation is open to serious question. Second, even if political decentralization stimulates experimentation, this cannot explain China’s successes because the most important reforms were introduced when China was highly centralized.

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8 See Rose-Ackerman (1980), Cai and Treisman (2005). The risk for a local official of experimenting in his locality is greater than that for a central government experimenting in one of many localities. And the benefit of a given experiment for a local leader will be lower than that for a central leader who internalizes cross-regional informational externalities.
politically. Third, details of the Chinese reform process suggest political centralization actually helped in the identification, evaluation, and extension of successful experiments to other regions, sometimes against resistance by local conservatives. To illustrate, we briefly examine three of the most important reforms that fueled China’s economic takeoff.

3.1 Agriculture: the household responsibility system

As Xu and Zhuang (1998) correctly note: “An example of experiment in the Chinese transition is land reform.” Local officials in some areas helped develop the so-called “household responsibility system” (HRS), which quickly undermined the role of the commune in Chinese agriculture. This experiment apparently began in 1978 when a group of peasants in drought-stricken Fengyang County, Anhui Province, risked imprisonment to divide their team’s land into separate plots for individual households to farm. Grain yields rose, and the province’s reformist first secretary, Wan Li, embraced the scheme, extending it to other locations. At first, conservative party leaders banned the practice. But its visible success helped strengthen the pragmatic faction of Deng Xiaoping, who allowed household farming to spread nationwide. By 1986, almost all peasants in China had adopted the HRS.  

The HRS was a major, extremely successful experiment. But it cannot be attributed to political decentralization. In fact, it was introduced at a time when China was one of the most centralized countries in the world—a communist autocracy, in which local officials were not only not allowed to decide policies, but knew they could go to jail for trying to do so. Admittedly, repression was not as extreme as during the Cultural Revolution. Still, officials were highly conscious of the danger of misjudging the political winds. An editorial in the People’s Daily in December 1978, just as agricultural reforms began, cataloged the fears that kept local officials from showing initiative: “The fear of being labeled as a ‘capitulationist’; the fear of being

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dismissed from one’s post; the fear of being expelled from the party; the fear of being divorced by one’s wife; the fear of serving a prison term; and the fear of being beheaded.”

Of course, central party rhetoric often exhorted local cadres to show initiative, as it had during Mao’s periodic attacks on bureaucratization. Reformists sought to change the climate of conformism and fear. But such campaigns were only beginning as of 1978. Local officials knew many who had heeded similar calls in the past had been punished rather than rewarded. In fact, rural reforms similar to the HRS had been started several times under Mao, but “each such attempt had been ruthlessly criticized, leaving many cadres fearful of supporting another round of decollectivization” (Fewsmith 1994, p.23). The official who supported the first household responsibility scheme, in Zhejiang Province in the 1950s, was later “named a ‘rightist element,’ expelled from the party, and sent down (xiao fang) for labor” (Ibid, p.24). The local risk-taking of peasants in Anhui and elsewhere is actually remarkable evidence of their desperation and entrepreneurial spirit despite a history of Leninist political centralization.11

In the Introduction, we defined “political decentralization” as either the local selection of local officials or the right of local officials to make policy decisions without being overruled. However one characterizes China in the 1980s and 1990s, neither of these existed as of the late 1970s. Until village-level elections were introduced in the late 1980s, selection of all subnational party and government personnel—even if formally carried out by local bodies—was controlled by higher levels. As for choosing policies autonomously, one can judge how free local officials felt from the precautions some took. The production team leader implicated in the Fengyang peasants’ scheme reportedly agreed only after the peasants pledged to raise his children until age 18 if he should be imprisoned (Chung 2000, p.90; Fewsmith 1994, p.28). In fact, even proponents of the decentralization argument claim that “federalism, Chinese style” emerged only in 1984-8


11 The memory of the catastrophic famine of the Great Leap period (1958-61) may also have emboldened peasants (Yang 1996).
(Qian and Weingast 1996, p.15). As of the late 1970s, the most one could say was that China was administratively and economically “decentralized in comparison with economies of the Soviet Union and Eastern Europe”—compared, that is, to other communist dictatorships (Ibid 1996, p.13).

The agricultural reforms—like others discussed below—did benefit from grass roots initiatives which violated higher level instructions. But there is a difference between initiatives from below and political decentralization. Grass roots initiatives occur in every system, including extremely centralized ones. Even under Stalin, Soviet enterprise managers spontaneously introduced experiments, which were sometimes extended by higher authorities, sometimes stamped out. In 1934, managers at the Menzhinskii Aviation Firm started paying workers premia for high quality production, in clear violation of their plan instructions. When this proved successful, the industrial ministry authorized the scheme for wider use (Granick 1954, pp.112-3). In 1935, “a group of engineers and economists of the Stalingrad Dzerzhinskii Tractor Plant drew up a plan for the total reorganization of the plant and its production, and presented the plan in the national industrial press.” In 1937, at the height of the purges, the Moscow Kuibyshev Electrical Combinat nevertheless “decided on its own to revise premium systems in order to give timeworkers greater incentives” (Ibid, p.116). Such initiatives actually resemble those in China in the early Deng period. If these were enough to render a country politically decentralized, it would be unclear what countries could be considered centralized.

China’s administrative system was a multi-tier hierarchy, linking the central authorities in Beijing to party and government bodies at the province, prefecture, county, and commune levels, with communes divided into brigades and production teams. Within this hierarchy, decollectivization did not result from autonomous decisions of local officials, or even from a

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12 Granick (1954, p.133) summarizes practice in the Stalinist 1930s: “It is in the plants that grass-roots ideas originate; they may later be taken up by higher bodies and spread to all industries or they may be condemned in official instructions. Nevertheless, it is here that they get their first test and hearing.”

13 Townships and villages have since largely replaced the communes and their subdivisions.
battle of local cadres against the center. Both pro-reform and anti-reform coalitions spanned the many levels of the state. In Anhui, support for the HRS united peasants and cadres in their brigades with the provincial governor and central reformists.\textsuperscript{14} Opposition united commune and county officials with central conservatives (Chung 2000; Fewsmith 1994). Elsewhere, local cadres also covertly opposed the reforms (Latham 1985). The government of neighboring Jiangsu Province installed huge posters on the border with Anhui criticizing the HRS (Luo 1994, p.131).

Once decollectivization proved successful, central officials promoted it vigorously (Hartford 1985, p.39). Provinces were required to report on implementation, and central officials and newspapers castigated those where the HRS was introduced too slowly. Local cadres who withheld loans or fertilizer, imposed levies, or refused to sign contracts at all were exposed, attacked, and “rectified” by teams sent from Beijing (Burns 1985, pp.619-21). Reformists Hu Yaobang and Zhao Ziyang toured sluggish provinces, scolding their leadership (Chung 2000, p.59). The Heilongjiang party leader, who had resisted the HRS, was removed (Fewsmith 1994, p.125). In short, the hierarchical nature of Chinese politics helped speed the spread of these innovations nationwide. The HRS was a grass roots initiative within a politically centralized authoritarian state that was quickly coopted by the rising faction in central politics, and extended across China’s regions.\textsuperscript{15}

3.2 Special economic zones

According to Montinola et al. (1996, p.61): “Decentralization of authority is particularly associated with the establishment of special economic zones, coastal open cities, and

\textsuperscript{14} A year before the Fengyang experiment began, provincial party secretary Wan Li had established liberal guidelines on rural economic policy, and these had been published nationwide in February 1978 in a front-page article in the \textit{People’s Daily}, apparently supported by Deng (Fewsmith 1994, p.21). Wan Li was an old friend of Deng (Baum 1994, p.68).

\textsuperscript{15} Demand from the population was also important in the system’s spread (Luo 1994).
development zones.” Such zones are often viewed as a major achievement of political decentralization in the mid-1980s. The first special economic zones (SEZs) were established in 1979 in four cities in Guangdong and Fujian Provinces. Later, many types of zones—“coastal open areas”, “coastal open cities”, “economic and technological development zones”, “hi-tech development zones”, “border open cities”, etc.—were designated, totalling around 3,000 by 1993 (Chung 2001, p.58). Zones enjoyed various privileges, from open trade, retention of foreign exchange earnings, and tax advantages, to the right to authorize small foreign investments.

If the SEZ’s were an experiment, they were clearly an experiment of the central authorities. Initial authorization came in a July 1979 directive of the central State Council (Stoltenberg 1984, p.639). Deng claimed the idea originated with leaders of Guangdong Province, and these leaders—two old comrades of Deng—were happy to take credit (Naughton 1993, p.509; Cheung 1998a, p.102). But without Deng’s support, nothing would have come of it. In fact, Deng was so dissatisfied with the Guangdong leaders’ slow implementation that he replaced them in late 1980 with more committed reformers (Cheung 1998a, pp.96-101). The zones’ host provinces helped work out detailed implementation; but central authorities regulated this process, set guidelines, monitored the results, and authorized extensions (Stoltenberg 1984, pp.640-41). Deng’s 1985 announcement that: “Shenzhen SEZ is an experiment… we hope it will succeed; but if it fails we can draw lessons from it,” left little doubt who would draw lessons and who would decide the experiment’s fate (Wong 1987, p.38).

In Fujian, the impetus for reform certainly did not come from provincial leaders. Both the governor and party first secretary were replaced in the early 1980s, after central authorities criticized them for delay in constructing the Xiamen SEZ. First secretary Liao, in particular, “distinguished himself by his lack of enthusiasm for reform” (Shieh 1998, p.309). Deng sent a

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16 In late 1993, Beijing reduced the number to about 500.
more dynamically instead. Again, the centralized authoritarianism of Chinese politics helped push forward reform.

Central control is also suggested by the way locations for the first four SEZ’s were chosen. To reduce risk of political or economic fallout, they were placed in relatively sparsely populated, underdeveloped provinces. Fujian, one of the least industrialized in China, “had no international airport, and its major ports and railroad system were inadequate for moving large volumes of freight and passengers” (Shieh 1998, p.305). Guangdong also “suffered from the lack of a strong industrial base as well as insufficient infrastructural facilities” (Cheung 1998a, p.122). In 1988 an additional SEZ was sited on the island of Hainan, in part because the “leaders of the CCP believed that Hainan was expendable” (Feng and Goodman 1997, pp.61-2). Locating the first experiments in peripheral areas, Beijing could then extend them if successful, for instance authorizing the less “expendable” city of Shanghai to liberalize.

Once the SEZ experiment was underway, other local leaders lobbied for similar privileges. But the undulating rhythm of China’s internationalization owed much more to the ongoing battles between reformers and conservatives in Beijing. As Zweig (2002, p.263) puts it: “Without Deng’s agency in 1978-79 and 1992, Zhao’s assertiveness in 1984-85 and 1987-88, and Zhu Rongji’s efforts in 1998-9, liberalization in each period would not have occurred…. Without the strategy of these pro-market leaders, which both motivated local elites and Chinese citizens to seek global opportunities and offered bureaucrats incentives not to oppose deregulation, domestic demand for global links would have remained stifled by internationalization’s opponents.”

3.3 Reform of State Owned Enterprises

From 1978, changes were introduced to the incentive systems of Chinese state owned enterprises. Parallel experiments started in two provinces—Sichuan and Hubei—and another began a year or two later in Shandong. All involved permitting enterprises to retain some profits. Although
subnational initiatives contributed to these reforms, the pilot projects were monitored, authorized, and sometimes ordered by central officials, who decided when and how they would be extended. Provincial leaders who supported them were taking a major risk that Deng’s faction would triumph against the more conservative Hua Guofeng.

In Sichuan, from 1978, six enterprises were allowed to keep a share of profits. This experiment is sometimes presented as a spontaneous initiative of the provincial party chief, Zhao Ziyang. But Lee argues that, even if the suggestion came from Zhao, the reforms were, in fact, authorized in advance by the central leadership: “circumstantial evidence suggests that in Sichuan the pilot schemes of enterprise autonomy policy were authorized by the State Economic Commission (SEC) and other related ministries within the State Council… With the broad principles and guidelines issued by the Central Party and government, Sichuan was given the authority to work out the concrete format of enterprise autonomy” (Lee 1986, p.57). The central Finance Minister monitored the new scheme closely, and the SEC held a conference in March 1979 to review its results. Shortly afterward, central ministries selected eight enterprises in Beijing, Tianjin, and Shanghai for similar experiments (Fewsmith 1994, p.74). Then in July, central authorities codified the experiments in five policy documents authorizing their extension (Lee 1986, Naughton 1985). In parallel, from 1979 a second experiment was implemented in Guangha County, Hubei Province (Naughton 1985). The Hubei experiment, known as “tax for profit”, replaced profit remittances with taxes and required payments for fixed capital (Ibid, pp.240-1). In 1981, a third reform building on the Sichuan experiments began in Shandong, known as “profit contracts”.

Central authorities repeatedly characterized these schemes as “experimental”, permitted them in a few selected enterprises, and monitored results closely. If pilot projects were judged successful, other enterprises were instructed to replicate them. When problems arose, central officials moved on to some other locally-tested scheme (Naughton 1985). Although some experiments began spontaneously, those that survived were quickly coopted by central
authorities. In sum, reform of incentives in state enterprises was a centrally-controlled process, in which local initiatives played a part, but in which the center coordinated to reduce redundancy and risk and speed the spread of successful innovations. The key experiments began before China could plausibly be said to have undergone political decentralization.

4 Resisting central abuses

One argument for decentralization is that powerful local governments can entrench liberal economic policies by coordinating to resist interventions by a predatory central state. Qian and Weingast (1996, 1997) contend that China’s provincial governors have defended economic reform against central hardliners. They point to the reformist governor of Guangdong, Ye Xuanping, who opposed attempts by Premier Li Peng in 1988-90 to recentralize budget revenues: “In China, … the central government tried to reverse local political authority underpinning market-oriented reform in the aftermath of Tiananmen Square in 1989. Led by the Governor of Guangdong, the governors of many provinces resisted so that the central government eventually backed down.”

This incident is worth examining. In 1988-90, conservative party leaders sought to rein in inflationary pressures and increase provincial tax remittances. Li Peng and his allies wished to replace the fiscal contracting system with one in which tax revenues would be more evenly shared. At several meetings in 1989-90, Ye, sometimes supported by other governors, criticized this. At one conference of provincial governors, his speech was reportedly met by “wild applause” (Gibney 1990). This might have seemed a serious challenge, coming from a popular provincial politician and the son of one of the country’s military leaders. Marshal Ye Jianying, Ye Xuanping’s father, had been one of the founders of Communist China. In 1977, after Mao’s

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17 Qian and Weingast (1997, p.90); see also Montinola et al. (1996), and Shirk (1993, chapter 9).
death, he had orchestrated the coup that deposed the Gang of Four, permitting Deng’s return (Sheng 2004, p.11; Baum 1994, pp.39-47).

This did not stop the central authorities from removing Ye Xuanping the following year, along with the Guangdong party secretary, whose term was ending. Two more junior officials, also reformist but somewhat more pliant, were appointed. In late 1993, the tax contracting system favored by Ye was scrapped and replaced by Li Peng’s preferred arrangement. Provincial governments no longer collected taxes for the center, and their share was cut drastically, although they received compensatory transfers. In preparation, the center also removed the party secretary of Jiangsu province, and other regional politicians were reportedly “dumped for rubbing up Beijing the wrong way” (Lam 1993, quoted in Yang 1997, p.103). To underline Beijing’s victory, Zhu Rongji even praised Guangdong’s government for serving as a “model for submission by the part to the whole” (Yang 1997, p.104). Ye’s resistance had delayed Li’s plans a little. But as an effort to block central interventions, it seems a rather limited success.

In fact, it is not clear the image of center-region conflict accurately captures what was going on. Ye’s “provincial rebellion” may actually have been instigated from Beijing. Deng was growing alarmed that Li Peng’s retrenchment would slow growth and undermine his achievements. On the eve of the September 1990 meeting at which Ye publicly challenged Li, Deng reportedly sent an old friend, President Yang Shangkun, to inform Ye that Deng would support resistance to Li (Fewsmith 2001, p.42). Li’s hesitations in responding may also have had as much to do with central politics as with provincial pressure. Maneuvering between factions, Li knew too vigorous an attack on the pioneering provinces would provoke a counterattack from central reformers, and very possibly Deng himself.

Central authorities had little trouble removing regional leaders on many other occasions. The Hainan governor, Liang Xiang, was summarily dismissed in late 1989, supposedly for corruption but more plausibly for being close to the disgraced Zhao Ziyang. In 1993, while

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18 Ye was reassigned to a ceremonial post in Beijing.
touring Heilongjiang, Vice Premier Zhu Rongji dismissed a provincial vice-governor on the spot for misdirecting credits. That year the center also removed both the party secretary and the new governor of Hainan (Feng and Goodman 1998). The average tenure of provincial leaders declined in the 1980s, as cadres were more quickly rotated, promoted, or demoted (Huang 1995).

Beijing did sometimes have temporary difficulty removing recalcitrant governors (as occurred with Ye). But this was not because provincial officials operated some corporate defense mechanism or coordinated to protest violations of some implicit constitution. Rather, individual governors exploited their vertical networks, enlisting protection of powerful patrons at the center (Huang 1995, p.61). Ye had excellent connections in the party via his father. As a child, he had camped out in the caves of Yan’an along with Mao, Deng Xiaoping, and the other early communists. His appointment in 1985 showed Deng’s commitment to reform in Guangdong (Cheung 1998b, p.27). This complicated Li Peng’s task, but did not save the Guangdong leadership.

China’s economic reforms have acquired greater credibility over time. This has to do with the sheer number of citizens and firms with a stake in their continuation and the increasing complexity of the Chinese economy, which makes a reimposition of tight state control harder to imagine. Provincial governors are important players in the games of Beijing politics, as they have almost always been. But the notion they can be relied on to coordinate to limit central interventions is not supported by much evidence.

5 Fiscal decentralization and incentives

Some scholars argue that fiscal decentralization gave Chinese local officials strong incentives to promote economic growth, contributing to high growth nationwide (Jin et al. 2005, Zhuravskaya 2000; Qian 2003). By fiscal decentralization, they mean assigning local governments a large share of marginal profit or income tax revenues. From 1980, the central authorities began signing
fiscal contracts with provincial governments over the division of tax revenues. Jin et al. (2005) argue that over time these gave provinces ever larger shares of marginal revenues, while becoming increasingly credible. By 1989, more than two thirds of provinces had the right to keep all marginal revenues. These scholars argue that letting local officials retain a larger share of marginal revenues should give them stronger incentives to “grow” the tax base by building infrastructure and reducing regulation and bribery. Jin et al. examined a panel of 29 provinces during 1980-92 and found that higher marginal retention rates were associated with faster employment growth in non-state enterprises and faster reform in state-owned enterprises.

Several points are worth noting. First, the argument is not really about decentralization at all. So long as local agents cannot be monitored perfectly, such incentives should increase growth under even the most centralized system. Extremely hierarchical corporations sometimes seek to motivate employees by paying bonuses linked to company profits.\(^{19}\) Second, a high retention rate of marginal tax revenues may not coincide with a high local share in total tax revenues, a more common measure of fiscal decentralization. Jin et al. try controlling for the province’s share in total tax revenues, and find this is not associated with faster economic reform. The argument might more accurately be characterized as one about agency contracts with strong incentives than as one about the distribution of power and revenues across levels of government.

In any case, a more specific reason exists to doubt the argument’s application to China. Formally, such arguments assume provincial officials maximize an objective function like the following:

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U = rstY(e) - C(e) \tag{1}
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where \(Y\) is the provincial tax base, which increases with provincial government effort, \(e\); \(C\) is the cost of exerting effort, also increasing in \(e\); \(t\) is the expected effective tax rate; \(s\) is the proportion of tax revenues that is shared between governments; and \(r\) is the province’s marginal share in

\(^{19}\) Indeed, Blanchard and Shleifer (2001) argue such fiscal incentives worked in China only because the center retained tight political control.
shared revenues. Given standard assumptions that $Y$ is concave and $C$ convex, the provincial government’s optimal effort increases with $rst$. If $s$ and $t$ are fixed, then optimal effort must also increase with $r$. This is the claim about incentives in China. As $r$ increased in the 1980s, this should have increased local officials’ incentive to support economic activity, generating higher output.

But, in this case, $s$ and $t$ were anything but fixed. First, $s$ fell in the 1980s as the central authorities changed the rules to increase their revenues. Under fiscal contracting, before revenues were shared certain “central fixed revenues” were reserved for the center. These included customs duties, some taxes, and remittances or profit taxes paid by the center’s “own” state-owned enterprises (Wong, Heady, and Woo 1995, pp.86-7). During the 1980s, the central government increased the scope of “central fixed revenues”, shrinking the pool available for sharing. Consequently, $s$ fell from about 85 percent of total budget revenues to about 60 percent (Ibid, p.90; see Table 1). At the same time, total budget revenues as a share of GDP, which might serve as a proxy for the effective tax rate, $t$, were also falling. Total budget revenues declined from about 28 percent of GDP in 1979 to about 16 percent in 1990, depleted by tax evasion, decline of the old state enterprises, and difficulties collecting from the new non-state sector. (The tax rate, $t$, is not the actual but the expected rate, so one might argue that only the formal rate matters. However, the steady drop in collections was obvious to provincial officials and must have influenced their expectations.)

We estimated the marginal retention rate, $r$, for 29 provinces in 1980-90, based on their existing fiscal contracts. Our measure of the average $r$ for these years is very close to that presented by Jin et al. (2005) in their Figure 1. This increased from around 68 percent in 1980 to a little below 90 percent in 1990. However, as shown in Table 1, the increase in $r$ was probably

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20 For a similar formalization, see Jin et al. (2005).

21 Another problem with this argument is that it ignores the central government’s potential to either support or impede economic activity (Treisman 2004).
more than offset by the simultaneous decreases in $s$ and $t$. The product $rst$, in our estimation, fell from about 15 to about 8 percent. If these figures are approximately correct, incentives to stimulate the economy deteriorated in the average province rather than improving. Although fiscal incentives might indeed explain why growth was faster in some provinces than others, it is unclear—given the fall in shared revenues as a proportion of GDP—how such incentives could explain rapid growth nationwide.

### Table 1: Estimating fiscal incentives, China 1979-1990

<table>
<thead>
<tr>
<th>Year</th>
<th>Estimated marginal retention rate (average for 29 provinces) $r$</th>
<th>Estimated percentage of tax revenues that was shared $s$</th>
<th>Total government revenues as percent of GDP $t$</th>
<th>$rst$</th>
</tr>
</thead>
<tbody>
<tr>
<td>1979</td>
<td>85.7</td>
<td>28.4</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1980</td>
<td>68.2</td>
<td>84.0</td>
<td>25.7</td>
<td>14.7</td>
</tr>
<tr>
<td>1981</td>
<td>69.4</td>
<td>79.4</td>
<td>24.2</td>
<td>13.3</td>
</tr>
<tr>
<td>1982</td>
<td>78.1</td>
<td>77.0</td>
<td>22.9</td>
<td>13.8</td>
</tr>
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<td>78.3</td>
<td>70.2</td>
<td>23.0</td>
<td>12.6</td>
</tr>
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<td>1984</td>
<td>78.3</td>
<td>65.1</td>
<td>22.9</td>
<td>11.7</td>
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<td>82.2</td>
<td>62.1</td>
<td>22.4</td>
<td>11.4</td>
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<td>84.7</td>
<td>59.5</td>
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<td>85.1</td>
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<td>88.7</td>
<td>62.5</td>
<td>15.8</td>
<td>8.8</td>
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<tr>
<td>1990</td>
<td>88.7</td>
<td>58.7</td>
<td>15.8</td>
<td>8.2</td>
</tr>
</tbody>
</table>


In another sense, the argument about marginal retention rates may miss the point. Throughout this period, local governments could set up various extrabudgetary and “off-budget” funds, all revenues of which they generally got to keep. Local governments usually had “complete authority over determination of tax rates and the amount of fees that fall into the categories of extra budget” (Qian and Weingast 1996, p.17). Subnational extrabudgetary fund revenues equaled 70 percent of subnational budget revenues in 1995 and 47 percent in 2002. On several occasions, central authorities tried to regain control over such flows, but with limited
success. For instance, from January 1983 Beijing imposed a 10 percent tax on extra-budgetary revenues, later increased to 15 percent (Oksenberg and Tong 1991, p.28). Such efforts prompted local governments to move money into off-budget funds, completely outside formal control (Ping 2000). Revenue from fees, most of which were paid into local off-budget funds, were estimated at 413 billion RMB in 1996, more than half the country’s total budgetary revenues (Ibid, p.21).

Thus, both before and after the decentralizing reforms of the 1980s, local governments could collect revenues they did not have to share with anyone. If residual claimancy creates incentives to support growth, these incentives existed both before and after the introduction of fiscal contracts. Increases in subnational governments’ marginal retention rate for taxes might encourage subnational governments to shift revenues from extrabudgetary or off-budget funds into the formal tax system. It should also reduce incentives for local governments to help enterprises underreport output to evade taxes that would have to be shared with Beijing. This could increase reported output, but it is not clear why local governments would be more supportive of economic activity than they were before.

An alternative explanation for local officials’ increasing efforts to promote growth concerns precisely the system’s enduring centralization. Subnational officials in China undergo detailed performance reviews by their superiors, and are rewarded or penalized based on their success in achieving specific targets (Tsui and Wang 2004). Promotions, demotions, and job-related benefits all depend on such reviews, which have become increasingly formal. Criteria have varied over time. Under Mao, promotion depended, in part, on ideological conformity. But as reformers came to dominate in the 1980s, targets focused increasingly on economics. As of the mid-1990s, the system for evaluating provincial leaders assigned 60 out of 100 points to targets related to economic performance (Ibid, p.77). This focus is clear in the results. Li and

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22 Loosely regulated local extrabudgetary funds also existed in Russia in the 1990s, a country Jin et al. suggest grew more slowly because of poor fiscal incentives.

23 More recently, criteria have included environmental protection and worker safety.
Zhou (2005) examined careers of top officials in 28 provinces in 1979-1995, and found promotions were significantly more likely—and demotions less likely—in provinces with higher growth. Similarly, Maskin et al. (2000) found provincial officials were more often promoted to the Party’s Central Committee if their province’s relative growth rate increased. Career concerns create strong incentives to improve economic performance. This explains better than fiscal factors why the rise of market reformers in Beijing led to reforms and growth in the provinces.

6 Hard budget constraints

Qian and Roland (1996, 1998) argue that, when capital is mobile, decentralizing fiscal authority can harden budget constraints on state enterprises. They present a model in which enterprises lobby local—but not central—governments for financial aid. Local governments must divide their budget between building infrastructure—which increases local profitability, and so helps attract capital—and bailing out insolvent enterprises. Since reducing infrastructure investments results in an outflow of capital, local governments face a higher opportunity cost of spending on bailouts than a central government would (assuming capital is less mobile across national than regional borders). Thus, local governments should be less eager to provide subsidies than a central government. Qian and Roland contend that such effects have hardened budget constraints on state-owned enterprises in China.

The argument is elegant. But it is not clear it establishes that fiscal decentralization contributed to better economic performance in China, for two reasons. First, even if competition for capital hardened budget constraints on some state enterprises, it simultaneously softened them for those, whether private or state-owned, that partnered with external—especially foreign—investors. Second, there is little evidence that decentralization and competition for capital did harden budget constraints on state-owned enterprises. On the contrary, they appear to have
softened. Financial discipline was tightened in the late 1990s. But this reflected a reimposition of controls by the central government, not an increase in political or fiscal decentralization.

To take these points in turn, local governments can compete for mobile capital in various ways. Building infrastructure is only one, and not always the most cost-effective. Investors may be lured to a region precisely by the local government’s promises of soft credit, subsidies, or tax breaks. Provincial and municipal governments in China have made such offers quite explicit. The Jiangsu government pledged in a 1986 regulation that: “Problems concerning the funding of the investment of the Chinese party to a foreign investment enterprise will be fully resolved…. The various banks with which a foreign investment enterprise has opened an account will give priority when formulating loan targets to guaranteeing availability of working capital loans and short-term working funds for the foreign investment enterprise.” Qinhuangdao Municipal Government promised its development company would “be responsible for and partially or wholly handle the loans for short-term working funds needed for production and distribution, as well as for other needed credit of enterprises with foreign investment”. Xiamen, Heilongjiang, Guangdong and many other local units have made similar commitments.\textsuperscript{24} Foreign investors are often required to partner with a Chinese state-owned enterprise, whose budget constraints are softened by such privileges.

Subnational governments have often pressured local banks and state bank branches to finance favored businesses. A 1987 survey found most non-performing state bank loans had been made “under pressure from local governments” (Wang 1994, p.100). Until the late 1990s, local governments helped appoint and promote the directors of local state bank branches (OECD 2005, p.170; Lardy 2000, pp.22-3). Bank employees depended on local governments for water, electricity, housing, and schooling for their children (Jin and Zou 2003). Local governments also

held shares in many joint equity and commercial banks and continued to interfere in their operations (Wong and Wong 2001).

Provincial governments have often guaranteed foreign loans, explicitly or implicitly. Some set up financial trust companies to channel foreign loans—backed by government guarantees—to local projects. Many of these were infrastructure projects, consistent with Qian and Roland’s argument, but other loans went to state enterprises with dubious prospects, often connected to officials. By 1999, there were 242 financial trust companies in China (Sprague 1999). One, the Guangdong International Trust and Investment Corporation (GITIC), suffered a spectacular bankruptcy in 1999, having amassed a $1.8 billion net debt (Ibid). Provincial officials had been promising a bailout just months before (Laris 1999). Besides investing in local roads and telecommunications, GITIC had supported state-controlled enterprises manufacturing cement, glass, soft drinks, beer, and motorcycles. It lent about $82 million to one fabric manufacturer in Maoming, Guangdong, which later went bankrupt, defaulting on the entire loan (Fang 2002). Rather than disciplining local officials, foreign investment flows often provided a screen behind which officials could—sometimes corruptly—channel state funds to favored firms.

The second problem with this argument is that fiscal and administrative decentralization in the 1980s and early 1990s did not coincide with any noticeable hardening of state enterprise budget constraints. Some economic decisionmaking authority was decentralized to subnational governments in the mid-1980s just as competition for foreign capital was developing. One might therefore expect to see budget constraints harden in this period. Government subsidies to loss-making state enterprises did drop as a percentage of GDP (see Table 2.) But this source of soft finance was merely replaced by others. In part, loss-making enterprises kept afloat by accumulating arrears to suppliers, workers, or public utilities (Boardman 1999).

25 Similar, although smaller, cases occurred in Guangzhou and Dalian (see Kyodo News International, Asian Economic News, June 26, 2000).
But the most important source of funds was bank loans. Bank credit more than doubled as a share of GDP between 1978 and 1998, from 50 percent to an estimated 108 percent (Lardy 1999, p.20). Most went to state enterprises, which in 1996 were paying less than one third of interest due (Lardy 2000, p.24; Boardman 1999). Despite overstating profits—for instance, by counting unpaid interest on non-performing loans as income—the state banks reported sharply falling profitability.

Table 2: State subsidies to loss-making state-owned enterprises

<table>
<thead>
<tr>
<th>Year</th>
<th>Total (billion RMB)</th>
<th>% GDP</th>
<th>Central (billion RMB)</th>
<th>Local (billion RMB)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1985</td>
<td>50.7</td>
<td>5.7</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1986</td>
<td>32.5</td>
<td>3.2</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1987</td>
<td>37.6</td>
<td>3.1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1988</td>
<td>44.6</td>
<td>3.0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1989</td>
<td>59.9</td>
<td>3.5</td>
<td>22.7</td>
<td>37.1</td>
</tr>
<tr>
<td>1990</td>
<td>57.9</td>
<td>3.1</td>
<td>21.0</td>
<td>36.9</td>
</tr>
<tr>
<td>1991</td>
<td>51.0</td>
<td>2.4</td>
<td>23.6</td>
<td>27.4</td>
</tr>
<tr>
<td>1992</td>
<td>44.5</td>
<td>1.7</td>
<td>16.8</td>
<td>27.7</td>
</tr>
<tr>
<td>1993</td>
<td>41.1</td>
<td>1.2</td>
<td>10.2</td>
<td>30.9</td>
</tr>
<tr>
<td>1994</td>
<td>36.6</td>
<td>0.8</td>
<td>5.8</td>
<td>30.9</td>
</tr>
<tr>
<td>1995</td>
<td>32.8</td>
<td>0.6</td>
<td>5.9</td>
<td>26.9</td>
</tr>
<tr>
<td>1996</td>
<td>33.7</td>
<td>0.5</td>
<td>7.2</td>
<td>26.6</td>
</tr>
<tr>
<td>1997</td>
<td>36.8</td>
<td>0.5</td>
<td>9.6</td>
<td>27.3</td>
</tr>
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<td>1998</td>
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<td>0.4</td>
<td>7.5</td>
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<td>1999</td>
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<td>0.4</td>
<td>5.2</td>
<td>23.8</td>
</tr>
<tr>
<td>2000</td>
<td>27.9</td>
<td>0.3</td>
<td>4.9</td>
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</tr>
<tr>
<td>2001</td>
<td>30.0</td>
<td>0.3</td>
<td>3.8</td>
<td>26.2</td>
</tr>
<tr>
<td>2002</td>
<td>26.0</td>
<td>0.2</td>
<td>4.6</td>
<td>21.4</td>
</tr>
<tr>
<td>2003</td>
<td>22.6</td>
<td>0.2</td>
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<tr>
<td>2004</td>
<td>21.8</td>
<td>0.2</td>
<td>3.6</td>
<td>18.2</td>
</tr>
</tbody>
</table>


Data on non-performing loans have been only sporadically available. When they are, they are not always comparable (the method of classification changed in 2003), and are believed to greatly understate the problem (Lardy 1999, p.30). Announcements by monetary officials suggest the rate of non-performing loans was high and increasing in the 1990s, reaching more than one third of the value of outstanding loans in 1999 (see Table 3). The rate only began to decrease after the central government intervened to clean up banks’ balance sheets, as discussed below.
Table 3: Non performing loans of the four main state banks

<table>
<thead>
<tr>
<th></th>
<th>Old classification</th>
<th>5-category classification</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>% of total loans</td>
<td>Bn $ US</td>
</tr>
<tr>
<td>1994</td>
<td>20</td>
<td></td>
</tr>
<tr>
<td>1995</td>
<td>21.4</td>
<td>79</td>
</tr>
<tr>
<td>1996</td>
<td>24.0</td>
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<td>1997</td>
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<td>239</td>
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<td>1999</td>
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<td>266</td>
</tr>
<tr>
<td>2000</td>
<td>29.2</td>
<td>224</td>
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<tr>
<td>2001</td>
<td>25.4</td>
<td>213</td>
</tr>
<tr>
<td>2002</td>
<td>21.4</td>
<td>206</td>
</tr>
<tr>
<td>2003</td>
<td>16.9</td>
<td>192</td>
</tr>
<tr>
<td>2004</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>


If budget constraints were hardening, one might expect a decrease over time in the proportion of loss-making enterprises (since losses must be financed by subsidies or borrowing). This does not seem to have occurred. Directly comparable data for the entire period since 1978 were not available, but Table 4 shows the trends in two closely related series. The share of loss-making state-owned industrial enterprises did fall between 1976 and 1985. But then it rose dramatically, from 9.6 percent in 1985 to 47.4 percent in 1998. Total losses increased by more than 30 times, from 2.7 billion to 85 billion RMB. In 1996, the state-owned enterprise sector as a whole was in the red. Budget constraints do appear to have tightened somewhat in the late 1990s. Between 1998 and 2000, the share of loss-making state-owned or state-controlled industrial enterprises fell from 40.6 to 34.1 percent, before stabilizing around 35 percent. Did this reflect increasing competitive pressures on local governments as capital mobility intensified?

In fact, there is a simpler explanation. The central government intervened to reestablish control over state bank local branches and tighten credit administratively. In late 1998, the People’s Bank of China replaced its provincial branches with regional branches in nine cities. Local governments lost influence over appointments of bank personnel, now to be chosen and

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26 One might expect a temporary increase if discipline were increasing, but if the proportion continues to rise year after year, some source of financing must be covering the losses.
Table 4: Loss-making among state enterprises in Chinese industry, 1975-2004

<table>
<thead>
<tr>
<th>Year</th>
<th>Share of state industrial production enterprises that are loss making (%)</th>
<th>Losses of loss-making state industrial production enterprises (100m Yuan)</th>
<th>Share of state and state-controlled industrial enterprises that are loss making (%)</th>
<th>Losses of loss-making state and state-controlled industrial enterprises (100m Yuan)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1975</td>
<td>31.4</td>
<td>52.0</td>
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<td>27.4</td>
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<td></td>
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<td>1978</td>
<td>23.9</td>
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<td></td>
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<td>1989</td>
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<td>1990</td>
<td>30.3</td>
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<td>966.7</td>
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<td>752.2</td>
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<td>668.5</td>
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<td>680.0</td>
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<tr>
<td>2004</td>
<td></td>
<td></td>
<td>35.0</td>
<td>669.5</td>
</tr>
</tbody>
</table>


monitored by a vertical party committee system within the financial sector. Premier Zhu Rongji directed state banks to cut wages of managers who authorized bad loans or fire them (Shih 2005,
Simultaneously, Beijing launched a massive bailout, creating four asset management companies to take over bad loans, and providing 2,295 billion RMB ($277 billion) between 1998 and 2005 in emergency financing (OECD 2005, p.43). Some provincial investment companies were forced into bankruptcy.

Even local government subsidies to loss-making enterprises fell much more slowly than central ones (see Table 2), although this partly reflects the transfer of some unprofitable central enterprises to local subordination. Thus, hardening of budget constraints could be attributed more plausibly to centralization of authority in China, the continuing ability of Beijing to dictate subnational economic policy. Any additional effect of interregional capital competition is difficult to detect.

In fairness, Qian and Roland explicitly acknowledge most of these points. A key condition for fiscal competition to work in their model is that local governments cannot increase the money supply. They recognize this was not true during the period of fiscal decentralization in the 1980s and early 1990s, and do not argue budget constraints hardened until the late 1990s. They even associate this hardening with Beijing’s recentralization of monetary policy. Nevertheless, they conclude that: “China benefited greatly from regional decentralization in its first 15 years of reforms, and the Chinese experience shows that decentralization of fiscal authority has helped in advancing the reform” (Qian and Roland 1996, p.222). It is this conclusion that we question.

7 Conclusion

China’s remarkable growth in the 1980s and 1990s coincided with a decentralization of practical decisionmaking on various economic matters. It took place in a system in which a large share of expenditure and revenue collection occurred at subnational levels. Some scholars believe this decentralization facilitated market reforms and catalyzed the country’s economic development.
Although such arguments have been developed in a sophisticated and thought-provoking way and are quite widely endorsed both in China and in the West, they are not ultimately convincing.

Political decentralization could not have stimulated the main policy experiments that grew into China’s reforms since these experiments occurred in the late 1970s and early 1980s, before any political decentralization occurred. At this time, China was a centralized Leninist autocracy. Considerable administrative decentralization occurred later, but it did not create a credible check on central economic interventions; Beijing remained fully able to fire disobedient provincial governors and impose its policies. Those provincial governors that managed to delay central policies did so by exploiting vertical ties to patrons at the center rather than mobilizing horizontal organizations of other governors or coordinating a common response. Improved local fiscal incentives in the 1980s cannot explain higher growth because the increase in local shares of marginal revenues was offset by the rapid shrinking of the fiscal pie. Nor could fiscal decentralization have hardened budget constraints on state enterprises because budget constraints did not harden during the period of fiscal decentralization. Low industrial concentration and the relative self-sufficiency of China’s provinces may have rendered them less vulnerable to disruption. But this is a fact about the country’s inherited economic structure, not about political or fiscal decentralization.

Of course local actors were important in the story of Chinese reforms. But they were important as actors in a game directed from Beijing. The driving force was not political pressure from subnational officials, spontaneous innovation by them, or competition among them to attract capital. It was competition between central political factions of different ideological flavors, whose leaders sought to win support within the party by demonstrating the effectiveness of their favored policies. Central factions enlisted the aid of sympathizers at all levels of government, and built vertical networks. Grass roots initiatives, both of reformers and anti-reformers, aimed to win

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27 For an interpretation of agricultural reforms that emphasizes local initiatives, see Yang (1996)
the initiator favor and promotions from the relevant faction leaders. In short, this was the kind of
competition between vertical teams one would expect in a centralized, multi-tier system.

We do not mean to suggest centralization always leads to reform and rapid growth. Obviously this is not the case, as China’s history from 1945 to 1978 demonstrates. It was quite possible that pro-reform factions would lose or win only temporary victories, as had happened many times before. Nor did all the central reformers’ choices reflect an even-handed commitment to liberalization and growth: they played favorites, supporting some subnational units such as Guangdong and later Shanghai, at the expense of others.28 Since 1992, when the goal of marketization was essentially accepted by all, factional lines have reflected less fundamental divisions—geographical or institutional loyalties, personal ties, and more muted conflicts over the balance between liberalization and income redistribution.29 Nevertheless, factional competition continues to influence policy battles more decisively than competition between local and central interests.

Understanding the role of political and fiscal decentralization in China’s reforms is important since the country’s experience is often taken as an example for other countries. Those who praise China’s gradualist, incremental approach often associate this with decentralization (e.g. Chen 1993). Decentralization is sometimes presented as almost a functional equivalent of privatization, an alternative to more fundamental property rights reforms (e.g. Qian and Roland 1998, p.1156), or as a source of pluralism—perhaps accountability—even in the absence of democracy. If one accepts decentralization had little to do with the success of China’s reforms, one must seek other explanations for the country’s performance.


29 This is, of course, a matter of degree. Personal connections were always important in shaping the support group of the usually pragmatic Deng.
References


