DEREGULATION, DECENTRALIZATION, AND CHINA’S GROWTH IN TRANSITION

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Abstract
In this paper, we show that China’s continued growth in the past three decades can be largely attributed to the deregulatory policies taken in different phases of transition that facilitated the utilization of China’s comparative advantage in labor-intensive sectors. We further argue that decentralization—and specifically, the fiscal contracting system adopted before the 1990s—could not be the fundamental source of China’s growth in transition. However, our interpretation of China’s transition does not downplay the active roles of local governments in economic development. Indeed, revenue-maximizing local governments did play an essential part in bringing about China’s fast growth, though changes in the central-local and state-business relationships have largely redefined local policy options and reshaped revenue-maximizing local government actions since the early transition period.
Introduction

China’s economic transition of the past three decades has been remarkable. China has transformed itself from a centrally planned economy to an emerging market economy while achieving an average annual growth rate of more than 9 percent. During this period, China’s per capita GDP has more than quadrupled and the living standard of ordinary Chinese people has improved markedly. Yet these impressive achievements have been accompanied by widening gaps between rich and poor and across regions, by serious environmental degradation, by poor working conditions, and by a lack of universal social security coverage. These problems have posed great challenges to the sustainability of its economic transition. A better understanding of the progress that has been made and the problems yet to be addressed in China’s transition is not only essential for China’s future, but also important to other developing countries, given the important implications of China’s development model to these countries.

An emerging consensus is being reached now in the literature that local governments have played very active roles in China’s “growth miracle” by building local infrastructure, encouraging local businesses, attracting investments, and even directly managing enterprises in the early transition period. Much of the literature that tries to explain the rapid growth in the 1980s and the early 1990s has emphasized the importance of fiscal decentralization. By providing revenue incentives for local authorities to benefit from the growth they could foster, according to this view, decentralization encouraged pro-business policies and stimulated economic growth
(Lin & Liu, 2000; Oi, 1992, 1999; Shirk, 1993; Wong, 1992; Montinola et al., 1995; Qian and Weingast, 1997). Some scholars go even further to claim that the Chinese economy has come under the thrall of a “market-preserving federalism with Chinese characteristics;” at least up until the mid-1990s (Montinola et al., 1995; Qian and Weingast, 1997). This line of argument contends that governments in developing and transition economies have often been the central barriers to development. Therefore, providing local governments with market-preserving incentives is critical to both spark and sustain development.

Other scholars have disputed this view of the positive impacts of fiscal decentralization in China. For example, Wong (1992) argues that decentralization and fiscal contracting have created a variety of microeconomic distortions. Naughton (1999), Young (2000) and Poncet (2003) hold that decentralization in China actually induced local governments to engage in over-investment, duplication, regional market protectionism, and even more local bureaucratic interventions. In addition, by reducing the central government’s ability to redistribute revenues, decentralization and fiscal contraction seems to have increased regional inequality (World Bank, 2002).

How can we reconcile these contradictory arguments? If China’s growth between the late 1970s and the mid-1990s was mainly driven by fiscal decentralization in the early reform period, why did earlier decentralization policies taken during the pre-reform period not yield similar progress in economic development and living standards? If the “market-preserving federalism with Chinese
characteristics” argument holds only for the first half of China’s three decades of transition, why has the Chinese economy continued to grow at a high (if not higher) rate since the fiscal recentralization reform adopted in the mid-1990s?

In this paper, we provide a framework for reconsidering China’s changing growth patterns both before and after China started its marketization reform and in different phases of economic transition. By examining the evolution of China’s institutional arrangements in regulation and inter-governmental relationship, we argue that the regulatory structure under the planned economy was endogenous to the overtaking development strategy adopted by the central government in that period, while the centralization-decentralization cycle in the pre-reform period was an inevitable outcome of information and control problems inherent in the planned economic system. We also argue that without micro-level deregulation during the reform period, decentralization alone would not have brought about sustained economic growth and improvements in living standards.

The rest of the paper proceeds as follows: We start with a discussion of the heavy industry development strategy pursued in China’s planned economy period and the centralization-decentralization cycle that ensued. The following section accounts for China’s growth in the early transition phase through an analysis of the deregulation and decentralization moves in this period. Next we evaluate the impacts of changing central-local and state-business relationships on China’s growth pattern since its recentralization period from the mid-1990s. The next section offers an alternative interpretation of China’s growth in transition, one that contrasts with the
view ascribing it to “fiscal federalism with Chinese characteristics.” The final section concludes with implications for further reforms that are necessary for China to realize sustainable development in economic transition.

Development strategy and (de)centralization cycle in the planned economy period

After the founding of the People’s Republic of China in 1949, the top leadership believed that rapid industrial development, especially in heavy industries, was essential to defend the new socialist system and to help the country catch up economically with the western industrial countries. Learning mainly from the Soviet experience, the Chinese government began in 1953 to formulate and implement the First Five-Year Plan, which gave priority to heavy industry development. The 156 central and backbone projects of industrial construction in the First Five-year Plan period were mostly heavy industrial projects implemented with financial and technical aid from the Soviet Union. Between 1953 and 1957, investment in heavy industries accounted for 85 percent of the total industrial investment and 72.9 percent of the total agricultural and industrial investment (Lin et al, 1999).

The development strategy of prioritizing heavy industry development was inconsistent with China’s capital-scarce and labor-abundant endowment structure, however. If the capital and labor markets had been allowed to operate freely, heavy industrial sectors would not have been viable, because investment would have flowed
to labor-intensive light industries (Lin and Tan, 1999). To mobilize resources for heavy industrial development, therefore, the state instituted a planned economic system. According to Lin et al (1998, 1999), this system had three essential characteristics (a) a distorted macro-policy environment that depressed interest rates, the exchange rate, and the prices of major industrial inputs; (b) a centralized resource allocation system to guarantee that essential resources flowed to the prioritized sectors (the heavy industries); (3) micro-management institutions depriving enterprises and rural communities of autonomy, so that resource allocation would not deviate from state plans. As a result, a large number of state-owned enterprises (SOEs) and People’s Communes were set up in urban and rural areas respectively; these were the micro-institutions whose purpose was to ensure that resources were allocated according to the central plan and to facilitate heavy industrial development.

After China adopted the heavy industry development strategy in the 1950s, it set up a highly centralized fiscal system, known as the “unified revenue and unified expenditure.” Under this system, the accounting of SOEs was incorporated into the central finance system. The Ministry of Finance was placed in charge of SOE cash flows, while the newly established State Planning Commission (SPC) was granted authority over the allocation of major industrial inputs, as well as the annual formulation of local revenue and expenditure plans. As a result, all government revenue and expenditures had to go through the center, with little budgetary autonomy left to the local governments.
In a country of China’s size, however, the task of formulating, administering, coordinating, and monitoring the local and SOE finance at the central level was inevitably overwhelming. It became even more so as the national economy grew and the structure of the planning economy became more complicated. For example, the number of enterprises subordinated to the central government increased from 2,800 in 1953 to 9,300 in 1957, and the number of items in material allocation under central planning increased from 55 in 1952 to 231 in 1957 (Qian and Weingast, 1996). Information asymmetries related to control and monitoring naturally emerged. As the economy developed further, with more projects initiated and more enterprises established, the highly centralized plan system became increasingly unmanageable. Because it granted little autonomy to the local and firm levels, this system dampened the incentives both of SOEs and of local governments.

By the end of the First Five-Year Plan Period, the central government had recognized this incentive problem and had launched a decentralization process to correct it. In 1957, the Center delegated many SOEs to the local level, reducing the share of industrial output produced by SOEs subordinate to the center from 40 percent to 14 percent of the national total. Furthermore, planning was largely shifted from the central level to the local level, with decisions on fixed investment now being made by provinces. Finally, revenue-sharing schemes between the central and the local were now fixed for five years, and the local share of government revenue rose from 25 percent to 50 percent.

This wave of decentralization coincided with the 1958 Great Leap Forward,
which called for rapid economic expansion. And local incentives did in fact respond quickly to the decentralization policies, as local small industries supported by the local governments grew quickly. This program did not succeed, however, because the radical decentralization caused serious coordination failures. Under soft budget constraints, local investment expanded excessively and economic over-heating soon emerged. The central government had to begin recentralization in 1959, and by 1963, all large and medium-sized industrial enterprises were again controlled by the center, with a concomitant rise in the central government share of revenue.

A second wave of decentralization was initiated in 1970 to meet the high growth target set in the Fourth Five-Year Plan, which reflected the central leadership’s perceived high likelihood of Soviet invasion. As in the first wave of decentralization, most large SOEs were again delegated to the provincial and the municipal level. The share of industrial output produced by SOEs under central control dropped from 50 percent in 1965 to 8 percent in the early 1970s (Lin et al, 1999). Local governments again obtained more authority over fixed capital investment and fiscal revenue. Once again, decentralization was followed by over-investment and overheating, which finally led to a recentralization in the middle 1970s.

In summary, the implementation of a heavy industry development strategy in a capital-scarce economy made it necessary to establish a distorted macro-policy environment, a centralized resource allocation system, and non-autonomous micro-institutions (the SOEs and the People’s Communes). In the initial period, a centralized fiscal system was also necessary to mobilize resources to the prioritized
sectors. But this system was highly inefficient, for two main reasons: because the
capital-intensive development strategy was incompatible with China’s endowment
structure, because central planners lacked the information, and because local
governments and SOEs lacked the incentives necessary to achieve greater efficiency.
The government then had to resort to both fiscal and administrative decentralization
by delegating more powers to local governments.

But without a change in the overall development strategy and the planning
resource allocation mechanism, decentralization always led to coordination failure.
Industrial linkages constructed under the centralized system broke down, and
interregional segmentation naturally followed. Under these circumstances, local
governments had strong incentives to become self-sufficient by establishing relatively
independent industrial systems. Under the typical soft-budget constraint of the
planned system, local governments naturally competed for scarce resources from the
central planner, while at the same time striving to increase the supply of these
resources by establishing small local enterprises such as steel plants, coal mines, and
machinery-building plants. As a result of over-investment and economic overheating,
the central government had to re-centralize.

Therefore, there are causal links all along the chain, from the heavy industrial
development strategy to the centralized planning system, to low efficiency stemming
from a lack of information and incentives, further to decentralization policies that led
to over-investment and economic overheating, and finally to re-centralization in the
planned system. As long as China stuck to its heavy-industry development strategy,
the planned system had to be left largely intact, and decentralization would not be sufficient to tackle the inefficiencies of the system. In fact, administrative/fiscal decentralization without marketization further distorted the socialist economic structure, because it aggravated economic shortages without addressing the problem of soft-budget constraint on local governments and enterprises. This pattern of decentralization-centralization even continued into the reform period, although under different environments and with different implications.

**Deregulation and decentralization in the early reform period**

*Deregulation through reform and opening up*

The Chinese central leadership recognized the inefficiency in the traditional centralized planning system as early as the 1960s, when the first round of decentralization policies was implemented. But it was not until 1978, two years after the ending of traumatic Cultural Revolution, that fundamental reforms took place. Though at that time the central leadership did not realize that the fundamental cause of China’s unsatisfactory development record under state planning was the heavy industry development strategy, policy makers did recognize the low production efficiency and lack of work incentives in the SOEs and the People’s Communes. This explains why China’s reforms started from micro-management institutions and focused on improving work incentives.
In rural areas, the Household Responsibility System (HRS) initiated in 1978 granted farmers land-use rights and the autonomy to allocate their own labor. As a result, farmers became the residual claimants of their production. Within just a few years, the HRS became the dominant form of microeconomic institutions in rural areas, resulting in the collapse of People’s Communes.

In cities, contemporaneous reforms in SOE management focused on power delegation and profit-sharing. To stimulate enterprises to increase production, various pilot reforms allocating more decision-making power to SOEs were carried out from 1979; these reforms included raising the retained share of profits and giving SOE managers more freedom to reward good work performance.

The reform policies taken in SOEs and agricultural sectors in this period can be viewed as gradual deregulatory moves out of the traditional planned system, although central leadership had yet to give up on the heavy industry development strategy. By granting the micro-units (the SOEs and rural households) more decision-making power in production and allowing them to share in profits or surpluses, these reforms induced rural households and SOEs to invest in labor-intensive industries that had been repressed before and were now extremely profitable due to the shortage of their products in the markets. As China’s rapid growth in the late 1970s and 1980s indicates, these policies not only improved the incentive mechanism in micro-institutions, but also helped, in an incremental way, to capitalize on China’s comparative advantage in labor-intensive sectors.

Micro-institution reform in SOEs and rural areas was far from the whole story
of China’s early transition period, however. Two other aspects that made China’s transitional experiences in the 1980s and the early 1990s a typical deregulatory process were the policy of opening up in the cities and the rise of township and village enterprises (TVEs) in the countryside. In July 1979, the center decided that Guangdong and Fujian, two southern provinces adjacent to Hong Kong and Taiwan, could pursue reform “one step ahead” of other regions by adopting “special policies” and implementing “flexible measures.” This marked the beginning of regional experimentation in China. In 1980, China set up four Special Economic Zones (SEZs)—Shenzhen, Zhuhai, and Shantou in Guangdong Province, and Xiamen in Fujian Province. The SEZs enjoyed not only lower tax rates, but also greater authority to make decisions for local development. While the rest of China was still largely dominated by the planning structure and public ownership, the SEZs were allowed to carry out market operations and to develop private ownership. In 1984, the central government declared another 14 coastal cities as “Coastal Open Cities,” and gave them authority paralleling the SEZs. To attract foreign capital and technology, each of these open cities was authorized to set up local “Development Zones” within its jurisdiction that could implement more liberal policies.

Another fundamental change in this period was the rise of TVEs in the countryside. The earlier agricultural reform through the Household Responsibility System contributed a great deal to rural TVE development, since it not only helped to liberate China’s huge rural labor surplus from pure agricultural production to non-agricultural employment in TVEs, but also accumulated the starting capital for
rural enterprises. Moreover, the second wave of decentralization in the early 1970s had generated a lot of local government-owned small industries, which laid a foundation for the rapid growth of TVEs in the 1980s. As a matter of fact, the 1980s also witnessed a large number of new local SOEs entering the labor-intensive light industrial sectors. Along with the booming TVEs, these local SOEs began to produce highly demanded consumption goods whose production had been depressed in the planning period. Therefore, one fundamental reason for the rapid growth of TVEs (and new SOEs) in the 1980s was that local governments were no longer restricted from establishing enterprises in most manufacturing sectors, as they had been during the planning period. Therefore, the key to rapid growth in this period was the deregulation of entry into labor-intensive sectors. This not only helped China to utilize its comparative advantage, but also filled the demand gap left by the traditional heavy-industry development strategy. Between 1983 and 1988, the total TVE output increased by more than fivefold (NBS, 2000).

Therefore, in contrast to the policy changes in the late 1950s and the early 1970s, the reforms and liberalization policies taken in the late 1970s and the 1980s were essentially deregulatory policies that turned out to be market-oriented. By 1985, a “dual-track price system”—under which the SOEs could make transactions at market-determined prices beyond the margin, as long as they had fulfilled the state planned production quotas—had been largely legitimized. At the same time, with the rapid entry and growth of new TVEs and SOEs, a more market-oriented track emerged. Booming labor-intensive sectors took advantage of China’s abundance of
cheap labor.

All in all, the reforms in micro-institutions can be viewed the first step in China’s reform sequencing. By relaxing control over micro-operational mechanisms, the government improved incentives, which produced new streams of resources. Part of the new resources under the control of profit-oriented TVEs and SOEs were then invested in the labor-intensive sectors that had been depressed in the planning period. This helped, in an incremental way, to adjust the distorted industrial structure inherited from the planned period. It also brought more market forces into play by inducing a partial marketization of key production inputs and outputs through the emergence of the “dual-track price system.” In other words, marketization was not an intended outcome of China’s reform strategy: At least early in the reform period, the Chinese government had no plan to adjust its heavy industry development strategy, but instead was trying only to improve micro-efficiency through better incentives.

**Decentralization in the first phase of China’s transition**

China’s reform and liberalization policies in the late 1970s and the early 1980s were facilitated by corresponding institutional changes in the central-local arrangements—that is, administrative and fiscal decentralization. In fact, the deregulatory policies, including micro-reforms in SOEs and Communes, regional experiments in SEZs and “Coastal Open Cities,” and promoting the development of rural TVEs, all necessitated administrative and fiscal decentralization to be supported
by the local governments.

China’s decentralization in the early period of transition can be characterized as an evolutionary process of decentralizing both administratively and fiscally. The administrative decentralization granted local government officials greater authority over local economic management, including the autonomy to set prices, to invest with self-raised funds, and more importantly, to restructure their firms and issue licenses to new firms. This change was evidenced by the diminishing role of the central State Planning Commission, from approving fixed-assets investment projects to managing only “key projects” (Qian and Wengast, 1997).

A second, perhaps no less important, component of administrative decentralization was the delegation of SOEs to local governments at the provincial, municipality, and county levels. This process began in the early 1980s, and by 1985, the state-owned industrial enterprises controlled by the center accounted for only 20 percent of the total industrial output at or above the township level, while provincial and municipal governments controlled 45 percent and county governments the remaining 35 percent (Qian and Xu, 1993). Fixed investment for local government-owned enterprises fell naturally on the shoulders of local governments. Since SOEs then also provided a wide range of social services to their employees, a higher share of local SOE ownership also meant that local governments now took primary and final responsibilities for these expenditures.

Administrative decentralization in the 1980s was also accompanied by a fiscal decentralization move known as the “Fiscal Contracting System” between adjacent
levels of governments. Between the center and the provinces, for example, this system worked as follows. First, revenues in any given province were divided between: “central fixed revenue,” all of which was to be remitted to the center; “local fixed revenue;” and “shared revenue” that was collected by local governments but was to be shared by the center. Although fiscal contracting schemes varied across regions and over time, the main idea was that provincial governments contracted with the central government on the amount of fiscal revenue to be remitted for the next year(s). Once local governments had fulfilled their fiscal obligations to the center, they were permitted to keep any additional revenue. This system remained in place until the end of 1993 (Montinola et al, 1995).

Compared to the “unified revenue and unified expenditure” system commonly found in the planned period, the new “Fiscal Contracting System” indeed granted local government much higher fiscal autonomy. A growing literature on China’s growth in transition argues that local governments in the reform period now had incentives to develop local enterprises and to step up their efforts to collect revenues under the fiscal contracting system. At the same time, because they now had the autonomy to invest with self-raised funds and to issue licenses, local governments were stimulated to establish state-owned enterprises, including TVEs.

However, an important complication arises with regard to the operation of the fiscal contracting system. Though this system granted local governments higher marginal retention rates in budget revenue, it was a highly unstable system: The central government could and did arbitrarily change the “rules of the game” and
adjust fiscal contracting arrangements in favor of itself. Though China’s fiscal system in the 1980s and the early 1990s is generally referred to as “fiscal contracting,” this system experienced quite a few significant changes initiated by the center between the late 1970s and the early 1990s. The 1980 fiscal system of “dividing revenue and expenditure with each level of government responsible for balancing its own budget” was introduced because the center found itself in deficit after the fiscal system of “linking expenditure to revenue and dividing extra revenue with fixed share,” adopted in 1978.

The 1980 central-provincial fiscal contracts were supposed to last five years. However, the central government started “borrowing” huge amounts of funds from the provinces to alleviate its fiscal problems in 1981 and 1982. These loans were never paid back. Instead, they were transformed into permanent transfers to the center (Tsui and Wong, 2004). In 1982 all the contracts were revised, except for those of Guangdong and Fujian, and the budgetary revenue was to be shared between the Center and the provinces based on the ratio of provincial expenditure to provincial revenue. A further adjustment was again introduced in 1985 by “changing profit remittances into taxes and dividing taxes into central, local and shared taxes” (Lin et al, 1999). Because central-provincial revenue-sharing arrangements were based on the budget balances of previous years, provinces with surpluses were expected to remit more revenues to the center while deficit provinces could retain more. This system was also intended to increase the central share and strengthen central fiscal controls (Tsui and Wang, 2004; Wong, 1992). Through this reform, the central government was
able to maintain a tight grip over those regions that were the most important sources of central revenue, including Shanghai, Beijing, Tianjin, Liaoning, Jiangsu, and Zhejiang. The revenues from these regions generally grew more slowly than the national average, since the high share of remittances dampened local enthusiasm for expanding the tax base. To mitigate this effect, the State Council adopted a new system in 1988 that introduced six types of central-provincial revenue-sharing methods, each applied to a number of provinces (Qian, 2000; Yang, 2006).

To sum it up, though under the fiscal contracting system local governments generally enjoyed a relatively high share of marginal revenue, the center did make a number of attempts and in fact eventually succeeded in increasing the scope of central fixed revenues. These moves shrank the revenue pool available for central-local sharing during the 1980s, from about 85 percent to about 60 percent of total budget revenue. Therefore, although under the fiscal contracting system the average marginal retention share of local governments in budget revenue grew from 68 percent in 1980 to close to 90 percent in 1990, local retained revenue as a share of total GDP fell from about 15 percent to 8 percent (Cai and Triesman, 2007).

Under the fiscal contracting system, the center resorted to various ad hoc mechanisms to influence revenue remittances from the local governments—for example, by revising fiscal contracts, arbitrarily shifting expenditure responsibilities to local governments, forcing local governments to purchase bonds at lower-than-market rates, and recentralizing locally-owned enterprises. These mechanisms led in many cases to perverse reactions from the local governments,
which were motivated to conceal their revenue capacities and to raise
“extra-budgetary” or “extra-system” funds, which are not considered a formal part of
China’s consolidated state budget. In the 1980s and early 1990s, revenue
concealment could be successful for two reasons. First, as owners of local SOEs and
TVEs, the local governments were able to control their cash flows, and to conceal tax
and profit from the center. The existence of local extra-budgetary and extra-system
funds associated with local government-owned enterprises further facilitated the
revenue transfer from the formal to the informal budget. Second, under the fiscal
contracting system the local governments were responsible for tax collection and had
control over the de facto tax rates and tax bases, despite the fact that they did not have
the authority to alter the statutory rates and bases (Ma, 1995). In fact, local
government frequently coordinated with local SOEs and TVEs to understate their
profits and to avoid central predation. Having to meet their own ends in expenditure
under fiscal contracting but with little bargaining power in rule-setting against the
center, the local governments as shareholders of local enterprises preferred to leave
the profits with the enterprises or channel them to local extra-budgetary and
off-budget accounts that were not subject to central control. 3

Figure 16.1 shows the central and local revenue and their shares in GDP
between 1982 and 1993. As shown in the figure, though both the central and local
revenues grew fast in absolute terms, China’s budgetary revenue as a share of GDP
decreased sharply in this period, falling from over 22 percent of GDP in the early 1980s
to 11.2 percent in 1994. Declining local tax efforts could explain at least part of this
Even when extra-budgetary revenues are included, total government revenue as a share of GDP dropped from 37.8 percent in 1982 to 27 percent in 1992. The share of central budget revenue in total budget revenue fell from a high of 43 percent in 1984 to 22 percent in 1993.

During this period, budgetary revenue grew much faster at the local level than at the center. In the case of extra-budgetary revenue, both central and local, grew rapidly, surging at an average annual rate of 29.9 percent between 1982 and 1992. By the end of that period, the total amount of extra-budgetary revenue was already 110.7 percent of the budgetary revenue. Local extra-budgetary revenue grew from RMB 53.2 billion to RMB 214.7 billion, registering a much higher growth than that of budget revenue. The dramatic increase in expenditure requirements of local governments—their share rose from around 45 percent in 1981 to over 70 percent by 1992—imposed tremendous fiscal pressure at the local level and encouraged the proliferation of extra-budgetary funds and self-raised funds that were not shared with the center, at the expense of budgetary revenues (Ma and Norregaard, 1998).

Protectionist local developmentalism
Besides concealing revenues from the center via extra-budgetary revenues and extra-system funds, local governments in the early reform period also had many other instruments to promote local SOE and TVE development. China in the 1980s and the early 1990s had a highly decentralized financial system in which the local governments could exert substantial influence over banks to provide subsidized credit to local state-owned firms. In the case of the TVEs, local governments went even further to explicitly or implicitly guarantee loans in lieu of collateral. As a result, these enterprises—which were owned by the same local government or community organization—became jointly liable for loans to individual enterprises (Park and Shen, 2003). The local governments also pressed state banks to lend to unprofitable SOEs in their jurisdictions. In other words, in the 1980s and early 1990s it was the decentralized financial system, rather than the fiscal system, that led to the soft-budget constraint for both SOEs and TVEs.

The unique roles played by county, township, and village governments in TVE development serve as the best illustration of local developmentalism. During the mid-1980s, when the TVEs saw their golden period of growth, local governments assumed an entrepreneurial role and initiated rural industrial development. Empirical research carried out by Oi (1995) showed that township governments and rural community organizations at the village level made strategic decisions about investment and finance, managerial selection, and the use of after-tax profits for public expenditure. Local officials in this period often spared no effort to circumvent government regulations and grant the maximum tax advantages and exemptions to
TVEs, thereby keeping more revenues within the locality and strengthening the competitive advantages of the TVEs. In return, the TVEs provided local governments with funds for locally needed public goods and services.

To promote and protect revenue bases, local governments then also had strong incentives to protect locally owned SOEs and TVEs under their administration against competition from non-local enterprises. Taxes, remittances, extra-budgetary and extra-system funds from these local enterprises often constituted a large share of local fiscal revenues (Tsui and Wong, 2004). There is a lot of evidence that local governments in this period intentionally closed local markets by implementing restrictive policies for non-local commodities, for example by choosing not to create transportation links with other regions (Naughton, 1999, Young; 2000; Poncet, 2003). These policies led in the 1980s and early 1990s to a serious duplication of industrial structure across regions and to growing price dispersion, both signaling substantial interregional trade barriers. Therefore, to the extent this period saw any “regional competition,” it came mostly in the form of regional protectionist policies aiming to protect local tax bases by shielding local firms and industries from any real interregional competition.

With the local economy being dominated by local state-owned enterprises, regional competition for mobile manufacturing capital, including the foreign direct investment (FDI), was not important in the 1980s and the early 1990s. For the entire 1980s, FDI in China was not only tiny, but also highly concentrated in a small number of large cities and pilot-reform provinces. Between 1983 and 1992, the two provinces
of Guangdong and Fujian and the three large cities directly under central control—Beijing, Shanghai, and Tianjin—took in over 70 percent percent of China’s FDI (NBS, various years). Other regions did little to compete for such investment.

In summary, in this period local governments had access to multiple instruments for supporting SOEs and TVEs, which the local governments owned. Besides tax concealment by hiding profits and/or channeling them extra-budgetarily or extra-system, local governments could also help to provide subsidized credit and free or subsidized inputs (such as land, electricity and other production inputs) and could even implement protectionist policies to support local TVEs and SOEs. Because they owned the enterprises that were their revenue bases, local governments in this period had strong incentives to protect these enterprises from both central predation and competition from non-local enterprises. As a matter of fact, local governments in this period had little incentive to develop private enterprises: ownership rights gave the government control over the financial accounts of firms, and it was easier to extract revenues from those firms than to tax private firms. For the same reason, when local governments controlled firms, it was also harder for the central government to extract revenue from them, and thus revenue was more likely to stay at the local level.

**Marketization, recentralization, and continued growth since the 1990s**

*Further marketization and privatization*
Starting from the 1990s, local government-owned enterprises, including the SOEs and TVEs, began to lose ground as both product markets and financial markets were liberalized. The accelerating market-oriented reforms after 1992 led to a fast-growing private sector, rapidly rising FDI flows, declining inter-regional trade barriers, and a much more integrated domestic market, intensifying product-market competition (Li et al, 1998; Bai et al, 2003; Naughton, 1998).

A financial centralization initiated by the central government in 1993 also gradually made it harder for local governments to support the SOEs and TVEs by pressuring local banks to lend. Before 1993, 70 percent of the central bank’s loans to state banks were made by the central bank’s local branches. But in 1993, the People’s Bank of China centralized its operation, and since then, local branches of the central bank have been supervised solely by the bank’s local headquarters. And in 1995, China passed the “Central Bank Law” to give the central bank the sole authority over monetary policy. These reforms gradually and substantially reduced the influence of local governments on monetary policy and credit allocation. Financial centralization was one of the major factors that led to the hardening of local budget constraints in the second phase of China’s transition (Lin et al, 1999).

As a result of these changes, by the mid-1990s both the SOEs and TVEs had begun to decline. Their problems were exacerbated by over-capacity in manufacturing caused by the duplication of industrial structure and excessive investment under the decentralized fiscal and financial system of the earlier period. As China’s product and financial markets became more liberalized, local governments were now losing
money from the SOEs and TVEs, so that enterprises that used to be assets for local
finance now became liabilities. Large-scale restructuring of SOEs and TVEs had to be
initiated in the mid-1990s. For example, by the end of 1996, 70 percent of small SOEs
had been privatized in pioneering provinces and half were restructured in other
provinces (Cao and Qian, 1999; Li et al, 2000). In 1978, nearly four-fifths of the total
industrial output in China came from SOEs; by 1997, the share had shrunk to slightly
more than a quarter. With the acceleration in SOE and TVE reform, about 25 million
employees of SOEs and TVEs were laid off in 1998–2002 (Qian, 2003).

Fiscal recentralization

Accompanying the decline of local SOEs and TVEs was a fiscal recentralization
initiated by the center in the mid-1990s. Under the earlier fiscal contracting system,
the center had seen its share of budget revenue continue to decline. Though the center
had worked very hard to increase its share by constantly revising fiscal contracting
schemes, local governments responded by lowering their tax collection efforts and
concealing revenue from central predation. Overall tax revenue was also declining as
a share of GDP (Bahl, 1998; Wong, 1997; Wong and Bird, 2005). In 1994, the central
government responded to these problems by introducing a new tax system, commonly
known as the “Tax Sharing System” (TSS hereafter). The center’s two major goals in
adopting the TSS were to raise its own revenue share in total revenue and also to
increase total government revenues as a share of GDP.
The TSS changed the way in which fiscal revenues were shared between the central and the provincial governments. It not only introduced several new taxes, but also made a clear distinction between central taxes (such as the consumption tax), local taxes (including the business tax and income tax) and shared taxes (the value added tax, or VAT). Revenues from the VAT, which became the most important tax under the TSS, were to be shared at a fixed rate of 75 percent for the center and 25 percent for sub-national governments. With these changes, the TSS successfully replaced the *ad hoc* contracting arrangements that had characterized China’s intergovernmental fiscal relations in the early reform period (Bahl, 1998; World Bank, 2002).

The TSS also significantly strengthened tax administration: It established separate central and local tax systems, with each responsible for its tax collections of non-shared taxes, and assigned to the Central Tax Bureau the responsibility for collecting the shared VAT (levied on the value added of manufacturing goods). Thus local governments are now only responsible for collecting local taxes such as the business tax (Wong and Bird, 2005; World Bank, 2002). These reforms make it very difficult for the local governments to collude with local manufacturing firms to avoid the central taxes and the shared taxes. As Bahl (1998) has pointed out, the changes also undermine at least some of the ability of the local governments to use “back door” approaches in revenue mobilization, by making it more difficult for them to transfer budgetary revenues into extra-budgetary or off-budget revenues. The tax instruments available to the local governments for supporting (or competing for)
manufacturing firms are now limited to the local share of the enterprise income tax, which constitutes only a very small part of the overall tax revenue. Our recent fieldwork in Zhejiang, Jiangsu, and Guangdong shows that local governments can at most exempt manufacturing firms from the local enterprise income tax entirely for three years and from half the tax for another two years. Further tax exemptions become extremely difficult.

*Land developmentalism and continued strong growth after recentralization*

Interestingly, after the fiscal recentralization reform in 1994, the Chinese economy continued to grow as rapidly as during the early phase of transition. Fluctuations in China’s economic cycle complicate comparisons, but there is no evidence of a slowdown. For example, even as dwindling opportunities for reallocating labor were reducing China’s growth potential, the average annual growth rate in the seven years after the fiscal reform (1994-2000) was 8.1 percent, exactly the same as that for the previous seven years (1987-1993) (Cai and Triesman, 2007). The average growth rate rose in the past five years, to over 10 percent. Contrary to what the model of “fiscal federalism with Chinese characteristics” would predict, it seems that the incentives of local governments to promote development did not fade as the country’s fiscal system became more centralized. On the contrary, centralization had the effect of intensifying regional competition for manufacturing investment in the past decade or so, as a “race to bottom” emerged in which local governments in China competed to offer low-cost
land and subsidized infrastructure to manufacturing investors. In the 1990s, and perhaps even more since the early 2000s, local governments across China have established a large number of “industrial parks” and “development zones” by leasing land to industrial users at low prices or even for free.

Considering that after the 1994 fiscal reform, the center began to reap most of the tax revenue from the manufacturing sector, it is difficult to understand this behavior within the framework of decentralization-promoted growth. Why should local governments still have had a strong incentive to promote growth by setting up development zones and industrial parks over the past decade?

The explanation can be found in the fiscal pressures imposed by the fiscal centralization that was not accompanied by corresponding expenditure changes or adequate central transfers to local governments. With the introduction of the TSS, the central government was able to raise its share of revenue from less than 30 percent to over 56 percent after 1994. Yet the TSS has *de facto* maintained the decentralized structure of expenditure duties, to the disadvantage of the sub-national governments. In fact, local expenditure responsibilities became much heavier with the restructuring of state-owned sectors since the mid-1990s, as public service and social security responsibilities that had been taken care of by the SOEs themselves were passed to local governments without corresponding resources being set aside to meet them. In the late 1990s and the early 2000s the sub-national governments already accounted for more than 70 percent of total public expenditure, while receiving less than 50 percent of total government revenue. Spending on social services was decentralized all the
way down to the county level, with the sub-provincial tier financing 70 percent of public investment in social services, and provincial and central governments contributing only another 20 and 10 percent respectively (World Bank, 2002).

Facing mounting fiscal pressures, provincial governments in turn appear to have taken advantage of the vacuum left by the 1994 fiscal reforms, in the domain of intergovernmental fiscal relations at the sub-provincial level. They seem to have defined their fiscal relations with lower-level governments on the most favorable terms for them, that is, claiming a larger share of local fiscal revenues and transferring expenditure duties downwards, while playing a minor role in fiscal equalization at the sub-provincial level through fiscal transfers. This has seriously compromised the ability of sub-provincial levels of governments to carry out infrastructure investment and to provide for social security and public services (Wong and Bird, 2005).

Thus local governments after the 1994 fiscal reform were increasingly pressured to generate revenues on their own. These included both extra-budgetary revenues fully controlled by the local governments, and the formal tax revenues collected from manufacturing and service sectors. Since most of the SOEs and TVEs were already bankrupt or privatized by the late 1990s and early 2000s, the local governments had to generate extra-budgetary revenue from other sources. Collecting land lease revenue, levying administrative charges on firms and individuals, collecting penalty and confiscatory income charges, and in agriculture-based regions directly charging farmers can all be viewed as “entrepreneurial” ways for local governments to extract resources through informal taxation. In fact, these extra-budgetary revenue
sources have become essential for supplementing regular budgetary funds and financing infrastructure in urban expansion. In many regions, fees and other revenue from commercial and residential land leasing have become the single most important source of local extra-budgetary revenue. Studies consistently show that land transfer fees account for some 30 to 50 percent of total sub-provincial government revenues and in some developed regions they reach 50 to 60 percent of total city revenue (World Bank, 2005).

To maximize their own budgetary revenue, local governments promoted the development of local manufacturing and service sectors. After the 1994 fiscal reform, the business tax (levied on service sectors) and the income tax (on enterprise income and personal income) were assigned as purely local taxes, giving local governments a strong incentive to collect them in full. In fact, the incentive was so strong that for several years, revenues from these two sources grew much faster than overall tax revenue, which raised the local share of budget revenue from 44.3 percent in 1994 to 51.1 percent in 1997 (World Bank, 2002).

Local governments are also motivated to expand their tax bases by attracting manufacturing firms both from other regions and from abroad. Although local governments receive only one quarter of the VAT revenue levied on manufacturing sector, that share is better than nothing. Our fieldwork in Chinese provinces such as Zhejiang, Jiangsu, and Shandong indicates that local governments believe local service sectors cannot grow without a rapidly expanding local manufacturing sector. Local officials explicitly expressed their expectations of a demand spillover from
manufacturing investment to service sector development. These hopes have
intensified regional competition for mobile and mostly private manufacturing capital.
Because strengthened tax administration and financial commercialization have
reduced their ability to use tax exemptions and favorable bank lending as incentives,\textsuperscript{5}
however, local governments now rely on subsidized land and infrastructure as the key
instrument for attracting investment.

As a result, the period since the late 1990s has seen very rapid growth in
“development zones.” Local governments at the city, county, or even township level
acquire land at low cost from farmers and race to set up different types of
“development zones” or “industrial parks,” which offer basic infrastructure (water,
electricity and road) and other supporting facilities. By the end of 2003, the total
number of local “development zones” and “industrial parks” in China already reached
3,837. Among these, only 6 percent (232) had been approved by the national
government and 26.6 percent (1,019) by provincial governments. A majority of these
development zones (2,586) were set up by the city, county and township levels of
governments at their own initiatives. By 2006, the figure further jumped to an
astonishing 6,015. Because there are only 2,862 county-level administrative units in
China, this number implies that on average each county-level administration has at
least two development zones (Zhai et al, 2007).

By providing land and infrastructure at negotiated and usually subsidized
prices, local governments in China strive to attract industrial investors through
“site-clearing”-style packaged development. The land is prepared with infrastructure
and leased out for 50 years, usually at only a nominal price or even at a so-called “zero price.” Since local governments need to finance the land requisition costs (compensation to dispossessed farmers) and infrastructure preparation costs (costs in building roads and providing access to electricity, water, and heating) ex ante, leasing out industrial land this way inevitably means significant net costs to them.

The impacts of fiscal recentralization and local race-to-the-bottom competition on government revenue are shown in Figures 16.3 and 16.4. The figure presents the central and local revenue and their shares of GDP between 1993 and 2005. Although local budgetary revenue registered a decline immediately after the 1994 reform, it has grown rapidly since then, while central budgetary revenue has also been increasing since 1994. Extra-budgetary revenues have seen a divergence, however: Whereas central extra-budgetary revenue has more or less stabilized since 1994, local extra-budgetary revenue has grown significantly, despite a reclassification during this period that moved some extra-budgetary revenues onto the budget.

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<insert Ch16_Figure16.4>

In summary, once they were no longer able to extract resources from local SOEs and TVEs, local governments became keen on cultivating new tax bases by attracting private investment. As most local government-owned firms were privatized,
the role of local governments in economic development gradually shifted from
serving as shareholder in local state-owned enterprises to collecting taxes on
non-local government-owned and mostly private firms. Because these firms are
apparently much more mobile than the previous locally owned SOEs and TVEs,
genuine regional competition for private investment and new local tax bases began to
emerge.

Decentralization and deregulation in China’s transitional path

Fiscal federalism with Chinese characteristics?

In accounting for China’s strong growth in transition, Qian, Weingast, and their
colleagues have claimed the existence of a “market-preserving federalism” or “fiscal
federalism with Chinese characteristics.” It is argued that this market-preserving
federalism has two characteristics that cause Chinese local governments to lend a
helping hand to business. First, under the fiscal contracting system, local governments
signed durable contracts with the central government and thus enjoyed a relatively
stable and high share of budget revenue. Consequently, a “commitment effect”
prevented the center from appropriating local revenue and gave local governments
strong fiscal incentives to promote growth. Second, in a decentralized system like
China, fiscal competition across regions increased the opportunity costs of bailing out
insolvent firms. In addition, as competition among jurisdictions extended to factors of
production such as capital and labor, it induced jurisdictions to provide a hospitable environment for investment and prevented local governments from acting in a predatory manner toward enterprises. This too served as a commitment device (the competition effect) and allowed enterprises to grow (Montinola et al, 1995; Jin et al, 2005).

But from our discussions earlier, it is clear that the applicability of “fiscal federalism with Chinese characteristics” framework for China’s growth before the mid-1990s is highly dubious. Under the “fiscal contracting” system, the Chinese central government apparently did not demonstrate much, if any, commitment to upholding the fiscal arrangements that it had negotiated with (or imposed on) provincial governments. In fact, the center constantly took desperate and ad hoc measures and “nonstandard fiscal policy instruments in order to influence revenue remittance by the localities” (Tsai, 2004; Ma, 1995). As Wong et al (1995) and many others have shown, these instruments include “revenue-grabbing outside the (revenue-sharing) system by changing the scope of central fixed revenues, ‘borrowing’ etc. and unilaterally resetting contract terms in mid-course.” In addition, in this period the center also took over profitable enterprises from localities and coerced the latter into purchasing central government bonds. As expected, the ad hoc strategies reinforced the rationale for revenue concealment and further eroded trust between central and local governments (Tsai, 2004). Local governments in this period still had incentives to develop, however—not because they enjoyed a relatively high and stable share of marginal revenue, but because they could evade central predation.
by channeling resources to extra-budgetary and even off-budgetary accounts linked with local government-owned enterprises (the SOEs and TVEs).

Furthermore, precisely because China’s financial system was largely decentralized in this period, there could not have much “competition effect.” Nothing prevented local governments from bailing out the local state enterprises (the SOEs and TVEs), which dominated local economies in most regions. In this period, capital mobility was inevitably low, since these enterprises were essentially local revenue bases and could not be as mobile as private firms, which are assumed to seek best locations to develop. Therefore, regional competition for mobile capital could not possibly be the right story in this period. On the contrary, local governments had no incentives to predate these enterprises since they were the shareholders.

Contrary to the “fiscal federalism with Chinese characteristics” argument, which would predict that localities would have weaker incentives for promoting growth after the 1994 revenue-centralization reform, our analysis helps to account for the apparent continued (or even greater) strength of those incentives after the mid-1990s. Under the new fiscal system, which assigned them a lower tax share and higher expenditure responsibilities, local governments had no choice but to seek new tax bases by taking the new fiscal system as given. Since manufacturing capital is highly mobile and very sensitive to the change of local preferential policies, local governments have had to engage in a “race to the bottom” competition for manufacturing investment. This has helped to produce new tax revenue, because even though localities can take only a much lower share of tax revenue thus generated, that
share is preferable to receiving nothing. Moreover, success in competing manufacturing capital not only brings a relatively stable steam of VAT revenues for the foreseeable future, it may also boost local service-sector development and generate more revenue for local governments. Success in attracting manufacturing investment would further be translated into higher business tax revenue from service sectors, and perhaps higher extra-budgetary revenue from leasing land for commercial and residential purposes. Under such a circumstance, the “race to the bottom” competition we have witnessed in China since the mid-1990s can be explained from a fiscal perspective.

*Deregulation for growth and helping hand for revenue*

According to our view, the fundamental cause of China’s fast growth in transition can be found in the deregulatory moves that have allowed enterprises to make use of China’s comparative advantage in labor-intensive sectors. In the first phase of China’s transition, deregulation mainly involved removing barriers to entry in the industrial sector. This was to permit newly emerged SOEs and TVEs to utilize China’s cheap labor force and to enter labor-intensive sectors (and consumption goods production) that had been depressed in the planning period. A market track that included the SOEs, TVEs and foreign-funded enterprises developed outside the plan track. The growth of market elements was made possible by reforms in the farming system (adopting the Household Responsibility System), the SOE enterprise-management system
(delegating more autonomy to SOEs), the pricing system (adopting the dual-track pricing mechanism), and regional development (experimenting with the SEZs and the Coastal Open Cities). Gradually the coverage of the planned track was narrowed and market mechanisms began to dominate in resource allocation.

It is widely believed that the traditional planning system is inefficient since there is a lack of incentives at the micro-level. However, China’s growth in the early reform period came not only from efficiency gains from micro-institution reforms, but also from efficiency gains from overall resource allocation improvement (Lin et al, 1996, 1999). We argue that a more fundamental reason for China’s good performance in the early transition period is that government began to allow free entry of enterprises, regardless of their ownership, into labor-intensive sectors. As a matter of fact, not only were most of the TVEs local state-owned firms in the 1980s, but also the output of the SOE sectors continued to grow at an average annual rate of 7.8 percent between 1980 and 1992. The contribution of the SOEs to China’s total industrial output was well over 50 percent during that period.6 This is in sharp contrast with the transition experiences of the former Soviet Union and the Eastern European economies, where transition led to an immediate drop in output and serious unemployment (Lin et al, 1999).

As China’s market-oriented reforms deepened over the past decade, high growth has been sustained despite the fact that there was a large-scale SOE and TVE restructuring in the late 1990s and the early 2000s. Even though “fiscal federalism with Chinese characteristics” could not be the fundamental cause of China’s growth in
its early transition, this does not mean local fiscal incentives have been unimportant in
China’s trajectory of growth. As shown above, the local governments in the early
transition period had strong fiscal incentives to promote local SOE and TVE
development with their controls over the cash flows of SOEs and TVEs. Since the
mid-1990s, changes in the central-local relationship and the state-business
relationship have worked together and redefined the choices faced by
revenue-maximizing local governments. Fiscal recentralization without corresponding
changes in expenditure assignment and sufficient compensating transfers has forced
local governments to seek new revenue sources, either from formal taxation on
industrial and commercial firms, or from extra-budgetary sources such as land leasing
fees (in more industrial regions) and direct taxes on farmers (in agriculture-based
regions). The decline of the SOEs/TVEs and the strengthened tax administration
during this period not only made it much more difficult for local government to
conceal taxes from the center, but also turned these local public enterprises from
assets to liabilities. Under these circumstances, local governments naturally resort to a
race to the bottom by grabbing land from farmers and providing subsidized land and
infrastructure to attract private manufacturing investment.

As Frye and Shleifer (1997) have argued, local governments can be a “grabbing hand”
or they can be a “helping hand” in economic development, depending on their
incentives under the given institutional arrangements and endowment conditions. As
shown in our previous discussion, on balance local governments have been a helping
hand to business throughout different phases of China’s transition. The pro-business
tendency of Chinese local governments became particularly obvious since the late 1990s, as local governments anxiously seek new revenue sources by engaging in fierce competition for investment. However, the government’s “helping hand” is too often offered to investors at the expense of farmers who tend to see their land requisitioned without adequate compensation, at the expense of workers who tend to face poor labor protection and social insurance coverage, and at the expense of the environment that has degraded seriously in the past decade.

Conclusions

In this paper, we argue that China’s continued growth in the past three decades can be largely attributed to deregulatory policies in different phases of transition. These policies have facilitated a better utilization of China’s comparative advantage in labor-intensive sectors. Though at the beginning of China’s transition the central leadership did not have a long-term blueprint for reform, deregulatory moves starting with micro-institutional reform have naturally reshaped resource allocation mechanisms. This in turn has helped to adjust the distorted macro policy environment inherited from the planning system. In an incremental way, the process of marketization led the way and a de facto change of development strategy followed.

We also argue that decentralization, in particular the “Fiscal Contracting System” adopted before the mid-1990s, could not be the fundamental source of China’s growth in transition. The “fiscal federalism with Chinese characteristics”
cannot explain the failure of decentralization moves in the planned economy period, nor can it account for China’s strong, if not stronger, growth after the 1994 fiscal recentralization.

Our interpretation of China’s growth story does not downplay the roles of local governments in transition, however. Indeed, revenue-maximizing local governments did play an essential role in bringing about China’s growth, both in the early transition period and in the second phase of transition. Particular attention needs to be paid to a new form of local developmentalism via offering subsidized land and infrastructure in regional competition after the mid-1990s. In fact, it might not be an overstatement to say that China’s growth record in the past decade is somewhat astonishing, partly because the country lacks both necessary regulations on labor and environmental protection and sufficient protection of farmers’ land property rights. Therefore, even if bringing in decent labor and environment regulations and strengthening property rights protection for farmers dispossessed by urban expansion may imply slower growth than China is now experiencing, these policies might be essential if China aims to achieve sustainable growth and development in its unfinished business of transition.
Notes

1 According to Lin et al (1999), many developing countries, including those socialist countries such as Russia, Eastern European countries and China, and even many Latin American countries and India that adopted import-substitution strategies, were actually adopting an overtaking and leaping-forward development strategy after World War II.

2 However, the decentralization in the 1970s did have some impact on the reforms starting from late 1970s. One result of this wave of decentralization was the rise of local small industries (the so-called “five small industries”). For example, more than 300 counties or municipalities set up small steel mills and about 90 percent of counties set up agricultural machinery repair factories. During that period, “mechanization in agriculture” was a catalyst for rural industry, which was the predecessor of township and village enterprises (TVEs) one decade later.

3 The 1988 new fiscal contracting system further raised the marginal revenue share retained by the local governments, particularly those that were major contributors to the central government's revenue. However, the contracts were not strictly adhered to and were revised repeatedly for some regions. In 1991, when the 1988-90 system was supposed to expire, the central government was unable to negotiate a satisfactory replacement; as a result, the 1988-90 system was extended until the end of 1993, when the center replaced the fiscal contracting with a new tax share in its favor.

4 As a matter of fact, the center’s move to raise the marginal retention rates can be largely viewed as the outcome of a bargaining game to compensate local governments for the center’s revenue grabbing through raising central fixed revenue.

5 Extra-budgetary funds (EBFs) date back to the early 1950s when local governments were permitted to levy nominal fees to finance activities outside of the formal state budget. However, they were minimal before the reform period and only started their dramatic growth during the 1980s. At the provincial and city/county levels, EBFs consisted of the retained earnings and depreciation of local state-owned enterprises (SOEs), as well as various user fees and public utility charges levied by agencies involved in the administration of SOEs. These latter fees generally remained with the levying agencies or departments rather than going to the local government’s treasury. Until 1993, the retained earnings of SOEs had a greater impact on local finance, since SOEs were known to collaborate with local officials in taxing the retained earnings or allocating the funds for local capital expenditures. The extra budgetary revenues or “little money lockers” (xiaojinku) include fees for specific public goods, profits from township and village enterprises (TVEs), and assorted surcharges and fines collected by townships and villages (Tsai, 2004; World Bank, 2002).

6 Even the local extra-budgetary revenue was not very secure. In the 1980s, the central government, under fiscal pressure, did make efforts to tap into local extra-budgetary accounts. The collection of the major energy and transportation projects fund and the state budget adjustment fund are examples. Therefore, when the central government found itself under deficit pressure, it changed the rules governing extra-budgetary revenues and tried to draw some fiscal revenues from local governments by rearranging its relationships with the local governments and the SOEs. In response, some local governments used their control of the cash flow of SOEs and TVEs to shift revenues out of both budgets and extra-budgetary accounts. Such efforts prompted local governments to move money into off-budget funds completely outside formal control.

7 In the early 1980s, as an effort to increase enterprise autonomy, the government permitted state-owned enterprises (SOEs) to retain some revenues. After the mid-1980s, SOEs’ profitability declined in the face of increased competition (Ma, 1997).
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Figure 16.1. **Central and Local Revenue 1982-1992**

![Graph showing central and local revenue from 1982 to 1992. The graph compares the central budget, local budget, central ex-budget, and local ex-budget over the years.](image-url)
Figure 16.2  Revenue as a share of GDP 1982-1992
Figure 16.3 Central and Local Revenue 1993-2005

Figure 16.4 Revenue as a share of GDP