The Revenue Imperative and the Role of Local Government in China's Transition and Growth

Ran Tao and Dali L. Yang

Ran Tao is Senior Research Fellow, China Center of Agriculture Policy, Chinese Academy of Sciences; Dali Yang is Professor, Department of Political Science, University of Chicago and at the East Asia Institute, National University of Singapore

Paper prepared for presentation at conference on China's Reforms, University of Chicago, July 2008

1. Introduction

Given China's geographic size and substantial social and ethnic diversity, it is no surprise that local governments have figured prominently in China's long history (e.g. Min Tuki).[1] In this paper, we review the evolving role of local governments in China's remarkable economic transformation over the past three decades.

In examining the role of local governments, we engage a sizable literature that has emphasized the importance of fiscal decentralization for China's rapid growth in the 1980s and the early 1990s. On this account, fiscal decentralization served to provide the economic (revenue) incentives for local authorities to benefit from the growth they promoted.[2] With decentralizing reforms, officials in their quest for revenue as well as promotion were driven to adopt pro-growth policies by building infrastructure and attracting investment and, especially in the 1980s and early 1990s, by making business investments. Indeed, officials in China ranging from villages to provinces to central government ministries took the mantra of development to heart and became deeply engaged in bureaucratic, government or state entrepreneurship.[3] Some scholars have used "socialist corporatism" and, in the case of local governments, "local state corporatism" to describe this phenomenon.[4]

The evolving role of local governments in China's economic growth has also promoted much theorizing about central-local relations. It is believed that local government ownership in China helped curb central state predation.[5] Some scholars have gone even further to claim the emergence of a "market-preserving federalism with Chinese characteristics" (Montinola, Qian, and Weingast 1995; Jin, Qian, and Weingast 2007). Governments in many developing and transition economies have often been blamed for using their "grabbing hands" to become obstacles to economic development.[6] If the Chinese state with the Chinese Communist Party in command had already metamorphosized into some sort of "market-preserving federalism" by the early 1990s, then Montinola, Qian and Weingast have made an truly audacious claim and, if true, a highly consequential argument.

Yet other scholars have not been as sanguine about the impact of fiscal decentralization and highlighted the deleterious effects of rampant government involvement in the Chinese economy. In the words of Susan Shirk, "while local officials draped themselves in the mantle of market reform, what they meant by reform was, in fact, the perpetuation of the hybrid, partially reformed system, not a genuine market economy. They preferred to maintain their quasi-ownership rights over local factories and to exploit these rights to collect rents for themselves rather than playing only the role of referee in market competition."[7] The result, some commentators pointed out, was the worst of both worlds: local protectionism such as regional blockades, market segmentation[8] and "continuing bureaucratic management of industry."[9] Young (2000) and Poncet (2003), among others, found that there was serious duplication of industrial structure and growing dispersion of prices across regions, which signals serious interregional trade barriers in China. Moreover, decentralization and fiscal contracting seemed to have increased regional inequality due to the constraints on revenue redistribution by the central government (Hu and Wang, 2001 Yang, 1997, 2004).

In the rest of this paper we hope to shed light on the ongoing debate about the role of local governments in China's growth and transition by focusing on the revenue imperative facing local authorities. With the revenue imperative on our minds and on the basis of historical review and institutional analysis, we will examine how changing institutional arrangements have shaped and reshaped the incentives for local governments and by extension state-business relations. We see central-provincial (local) relations as an ongoing effort by central authorities to rationalize what the central leadership have seen as wayward behaviour by local authorities and also simultaneous efforts by local authorities to wiggle more room, particularly more discretionary fiscal power, for themselves. Rather than a Chinese-style market-preserving federalism, we believe the evolution of central-provincial (local) relations is far from having settled into equilibrium.

We divide the first three decades of the reform era into roughly two phases, demarked by the 1994 tax and fiscal reforms. We justify this division for two reasons. First, in the pre-1994 period the major drivers of China's growth in non-agricultural sectors were still government-owned enterprises including the state-owned enterprises (SOEs) and the township and village enterprises (TVEs). In contrast, the post-1994 period saw the acceleration of privatization; local government-owned enterprises have mostly been divested while the importance of the non-state sectors has steadily grown. Second, in 1994 China introduced a major tax and fiscal reform program known as tax assignment system to replace the discretionary fiscal contract system. This fiscal reform was a milestone in China's intergovernmental relations and has largely reshaped the incentives of local government in economic development. Taking into consideration these two major factors, namely the declining significance of local government-owned firms (and the corresponding rise in the importance of non-state businesses) and the rearrangement of intergovernmental fiscal relations, we see a major transformation, over time, of the local government's role in economic development from that of owner/shareholder to that of tax collector, with fundamental implications for China's transitional path in the future

2. Decentralization, Local Development, and Central-Provincial Relations: The First Phase (1978-1993)

China's reforms began in the rural areas in the late 1970s. As these reforms progressed, farmers gained the right to contract farmland from the collective on a household basis in what is known as the household responsibility system (HRS). The implication of HRS was far-reaching beyond raising agricultural productivity and farmers' income. Under the HRS, farmers gained the right to allocate their own labor and became the residual claimants of their production. The HRS thus also helped to liberate China's vast agricultural labor force from pure agricultural production and become available for non-agricultural employment, especially in township and village enterprises (TVEs).[10]

Household contracting (HRS) became the most prominent of a broader trend toward devolution of authority in China. Equally important was the introduction of fiscal conracting. As the formal government revenue system weakened in line with declining SOE profits, the central government introduced a fiscal responsibility system with the provincial-ranked local governments (hereafter provincial governments) to cope with fiscal decline.[11] Under this system, the Center signed fiscal contracts with provincial governments. Although the fiscal contracts varied both across regions and over time, generally the contracts specified the amount of revenue (or subsidy) a provincial government was to deliver to (or receive from) the center, with the remainder staying with the province.

Fiscal contracting was part of a broader administrative decentralization that gave the local authorities not simply more fiscal autonomy but also responsibilities for fiscal expenditures. Meanwhile, most state enterprises were also devolved to local governments (*qiye xiafang*) at the provincial, municipality, and county levels beginning in the early 1980s. 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 municipality governments controlled 45 percent and county governments another 35 percent (Qian and Xu, 1993). Under the director's responsibility system, local authorities generally entered into contracts with the factory directors.

Thus China's reform in the 1980s can be characterized as an evolutionary process of decentralizing at multiple levels: from central government to provincial governments, from local government to factory managers, from villages to households, and so on. Fiscal decentralization and the emphasis on responsibility provided powerful incentives for local authorities to seek revenue in order to pay for their expenditure responsibilities (Oi 1992, Walder 1995, Wong 1992).

By limiting the amount of tax deliveries to the central treasury and allowing local governments to keep most of new revenues, the fiscal contracting system made it possible for the local authorities to take up a growing share of the consolidated government budget over time. As a consequence, the central government's share of total government revenue declined steadily from a high of 40 percent in 1984 to 22 percent in 1993 (ZGTJZY 2003).

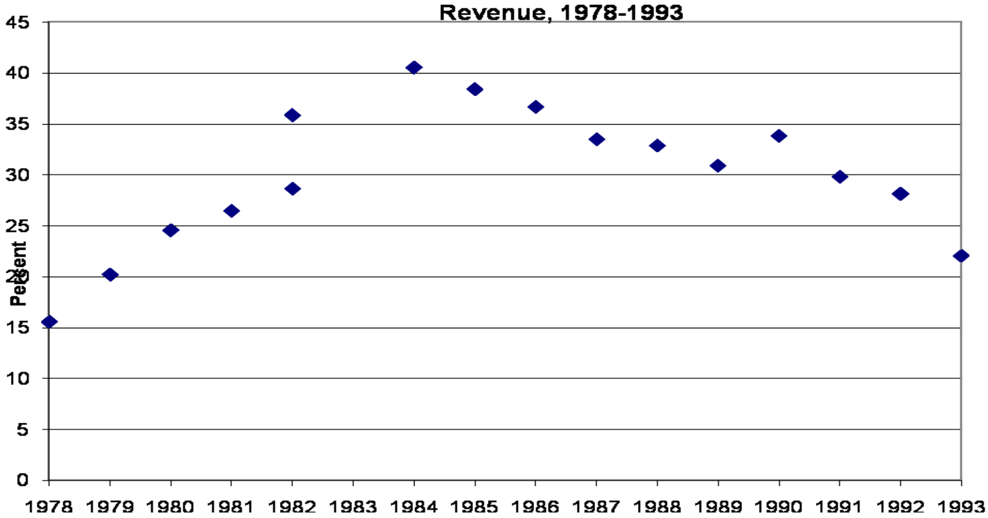


Figure. The Central Government's Share of Total Budgetary Revenue, 1978-1993

The local authorities not only enlarged their share of the formal government budget but also had access to growing amounts of “extra-budget revenues” (non-tax levies, charges, and fees). (Wong and Bird 2005) [ZGTJNJ data →figure for 1980 to 1992.

The Revenue Imperative and State-Business Relations in the First Phase (1978-1993)

The structure of fiscal incentives was coupled with a set of transitional economic characteristics to encourage Chinese authorities at all levels, especially local governments, to get involved in the business of business. The transitional characteristics included high pent-up demand arising from the traditional shortage of consumer goods typical of planned economies and relatively high prices for consumer products as well as dual-track pricing. As of the 1980s, there was relatively little business risk in making industrial investments. Besides helping with existing firms, governments at all levels also eagerly invested in new ventures, especially assembly lines for consumer goods such as bicycles, TVs, and motorcycles. Local governments used their regulatory power to limit entry by private businesses and protected their own firms from potential government predation.[12] And there was also cheap credit, lots of it, which governments at all levels allocated or sought from the state banking system for their firms.[13] In consequence, the bonds between state and enterprise strengthened (Naughton 1992a: 263-270; Yang 2004: chapter 2). By the early and mid-1990s, virtually all elements of the Chinese state, from the military, the armed police, to judiciary departments and the Party propaganda department had established and owned businesses to supplement their inadequate budgets (see Yang 2004, esp. Chapter 5).

The spectacular expansion of the township and village enterprises (TVEs) sector in this period is especially worth mentioning. Between 1979 and 1993 the number of TVEs grew to number 1.5 million in 1993 and provided employment for millions of rural residents liberated from the communes. They accounted for 36 percent of the national industrial output in 1993, up from 9 percent in 1978. Meanwhile, private enterprises got a relatively late start and accounted for less than 15 percent of the national industrial output.[14] [need to reconfirm these numbers]

Local governments had a variety of tool and policy instruments to assist local SOEs as well as TVEs. As long as the plan was in existence, local SOEs were included in local planning and thus local authorities secured various inputs, especially inputs, for these firms. As the economy gradually grew out of the plan (Naughton 1996), local authorities and the firms adapted. To begin with, local authorities could implement protective policies to support local SOEs and TVEs under their administration against competition from non-local enterprises (Bai, Du, Tao, and Tong 2003). There was much evidence that local governments in this period intentionally adopted and implemented restrictive policies for non-local products to restrict access to local markets and shield local firms and industries from interregional competition. As shown by Young (2000) and Poncet (2003) in the 1980s and early 1990s, there were duplication of industrial structure and growing dispersion of prices, which signals serious interregional trade barriers in China. To some extent, the duplication of industrial investments across the country would result in competition in the product markets and many of the local protectionist measures were thus paradoxically efforts by local authorities to resist the forces of market competition.[15]

Local governments also used their influence over local bank branches to help secure loans for local SOEs and TVEs (Brandt, Li, and Roberts 2005). This was feasible because China in the 1980s and early 1990s had a decentralized financial system in which local governments could exert much influence over bank lending. The local bank branches were under the "dual subordination" (双重领导shuangchong lingdao) principle, in that they were subordinated to the banking hierarchy as well as to the local government. Until the 1990s, local governments had a say in appointing the directors of local state bank branches. Local governments also held shares in many joint equity and commercial banks and had substantial influence over these institutions (Wong and Wong, 2001). Under this system, local governments could push local banks to provide subsidized credit to support local firms. Ex ante, they were directly involved in the credit plan formulation and might impose loans on specialized banks. Ex post, the local government had the authority to decide whether the enterprise should pay back the loan. A 1987 survey found most non-performing state bank loans had been made under pressure from local governments (Wang, 1994). In TVE development, local governments also played pivotal roles in securing loans from either the Agricultural Bank of China (ABC) or rural credit cooperatives (RCCs). Often the community governments provided loan guarantee for TVEs so that enterprises owned by the same local government (or community) became jointly liable for the loans to individual firms (Park and Shen, 2002).

As it is no surprise that local governments influenced the SOEs they owned, it is useful to take a look at the local governments' role in the development of the TVEs to illustrate the evolving relationship between government and business. The golden period in the rise of TVEs was in the 1980s. At that time, private entrepreneurs were uncertain about government policies, many of which discriminated again private businesses. Instead, township governments and village leaders took on much of the entrepreneurial role. They usually initiated internal fund raising to start up the community-owned enterprises. Although most TVEs enjoyed considerable operational autonomy, the community governments made strategic decisions in investment and finance, manager selection, and the use of after-tax profits (Byrd and Gelb 1990 and Oi 1995). Local officials also helped TVEs to tax advantages; in return, the TVEs generated funds for the community governments to use for the provision of local public goods and services. According to Oi (1999), who coined the term "local state corporatism", collectively-owned enterprises served both the political and the economic interests of local cadres during the initial stages of reform.

In general, local governments during this first phase of the reform era resorted to multiple instruments to support local government (community) owned firms and thus strengthen their revenue base. These instruments included tax exemptions as well as collusion with firms to hide revenue from central predation, influence on bank lending, free or subsidized inputs (such as land, electricity, water and other production inputs), and even the implementation of protectionist policies. As a matter of fact, local government then had little incentive to develop private enterprises since they could not control the cash flow of these enterprises and had difficulty collecting taxes from them.[16] Meanwhile, foreign direct investment (FDI) was during this phase concentrated in the Special Economic Zones (SEZs) and a handful of other cities.

3. Fiscal Reforms and the Evolving Role of Local Governments: From shareholder to tax collector (1994-present)

By the mid-1990s, the changing policy and economic environment had begun to drastically reshape the relations between local governments and firms. Broadly speaking, several major factors—growing competition, tax and fiscal reforms, and banking reforms, combined to decrease the benefits of government ownership of enterprises and helped persuade local authorities to divest firms they owned.[17]

To begin with, despite the incidence of local protectionism, the proliferation of firms, ranging from ones owned or controlled by governments at various levels as well as TVEs, to foreign-invested enterprises, and private businesses in the end helped to produce increased competition in most industrial sectors (Naughton 2003; Bai, Du, Tao and Tong, 2004). Amid the economic austerity that followed the political trauma of the 1989 crackdown, a buyers' market began to appear for various consumer products and over time such markets from textiles to consumer appliances would become the norm rather than the exception. The intense domestic competition has tended to spill into international markets; prior to 2007/2008, as Chinese manufacturers undercut each other in their quest for foreign sales, "the China price" became the potent signal of China's growing manufacturing prowess.[18]

Yet the growing domestic competition also proved fatal for many state-owned enterprises (SOEs), which were saddled with large social liabilities and poor management. According to National Bureau of Statistics data on state-owned industrial enterprises with independent accounting status, while the profitable enterprises had after-tax profits of 40.2 billion yuan in 1991, the money losers collectively lost 36.7 billion yuan, for a net profit of merely 5.3 billion yuan even if we leave aside government subsidies and creative accounting gimmicks.[19]

Data from the 1995 industrial census show the skewed distribution of state industrial enterprise profits by different levels of ownership.[20] The central government's 4,738 firms generated 33 billion yuan in net profits, compared with a mere 3 billion for the 83,167 state firms owned by the various local governments. Moreover, the local firms were more than twice as heavily indebted as the central government firms. Simply put, as of the mid-1990s most local governments had their investments in relatively small firms and in sectors with intense competition and low capacity utilization rates. Thus it was no surprise that local government officials and managers felt keenly that it had become exceedingly difficult to find new products and new projects with good prospects of making a profit. Already heavily indebted, the local SOEs also found their credit lines were increasingly tightened as central-government controlled state-owned commercial banks were forced to reform and thus strengthen risk management.[21]

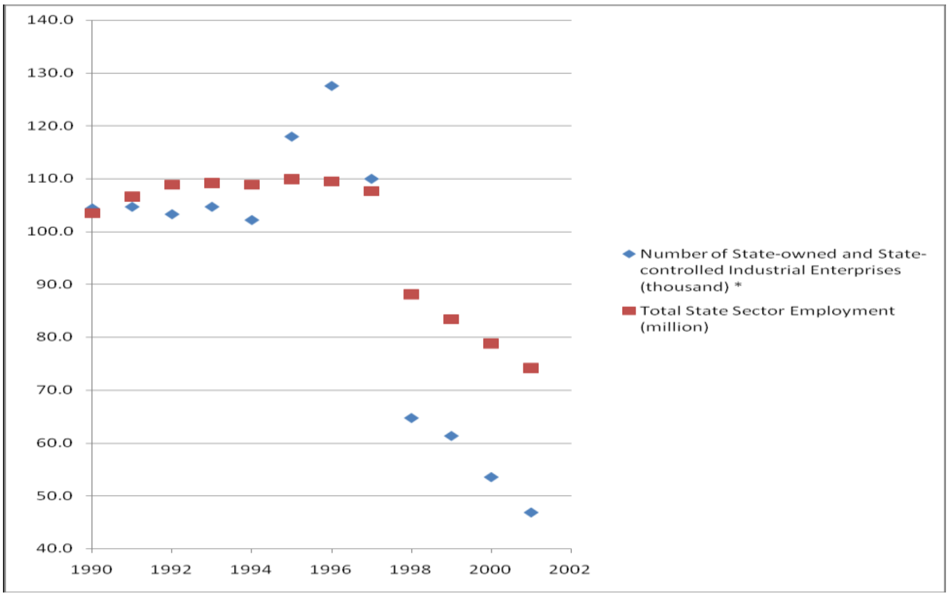
Under the pre-1994 tax system, SOEs were taxed at variable rates depending on the product they produced or businesses they engaged in. The product tax rates ranged 3 percent to 60 percent (Wong and Bird, 2005). In consequence, local governments would assess the value of a SOE based on the sum of profits and tax rates. A money-losing SOE paying a high product tax rate, such as cigarette manufacturers, might still be a profitable asset to the local government.

In 1994, the Chinese government began the implementation of sweeping tax and fiscal reforms that were designed to strengthen the central government's fiscal capacity. As part of the reforms, the highly variable product tax rates were replaced by a VAT for all manufacturing, repair, and assembly activities at the rate of 17 percent plus an exercise tax for alcohol, tobacco, and certain luxury goods. The VAT was shared between central and local governments (at the ratio of 75 versus 25 percent). According to Wong and Bird (2005), the package of tax and fiscal reforms drastically altered the incentives for government ownership of enterprises and "significantly diluted the linkage between enterprises and local revenues."

A third major factor, one that would become increasingly significant, was the tightening credit by the state-owned banking sector, which was then saddled with a rising portfolio of non-performing loans. Toward the end of the 1990s, the Chinese leadership restructured the People's Bank of China, the central bank, by replacing the PBOC's 32 provincial-level branches with nine regional branches and gained the right to directly appoint the heads of the regional branches. This reform as well as similar reforms in the state-owned commercial banks, were designed to curb local influences on bank lending and strengthen the institutional integrity of the banking system (Yang 2004, chapter 3). Facing the rising tide of NPLs and forced to save themselves, the state-owned commercial banks have steadily tightened lending standards and strengthened risk management. Over time, the financial reforms have gradually reduced the ability of local governments to exert influence on local bank branches and thus to lend to SOEs and TVEs.

The three factors enumerated above, declining SOE performance, tax and fiscal reforms, and financial tightening, explain why local governments increasingly saw the ownership of SOEs as liabilities. Since local governments had most of the smaller and money-losing state enterprises and felt more fiscal pressure to change than the central government, they led in reforming the state enterprise sector. Indeed, the Chinese leadership came up with an official strategy of "grasping the large [SOEs], unleashing the small (抓大放小)" and launched a large-scale restructuring of the government-owned enterprises (Li, Li and Zhang, 2000). By the end of June 2000, 76 percent of the small state enterprises nationwide had undergone some form of corporate reforms (改制), including reorganization, sale, joint venture, and leasing.[22] With the retrenchment in state ownership, state sector employment also declined. The TVEs, once hailed as a successful model of ambiguous property rights, were also not immune to the pressures facing the SOEs. Soon Jiangsu and other provinces that were famous their TVEs began to privatize the TVEs en masse.[23]

Table. State Sector Retrenchment (Number of State-owned Enterprises/Total State Sector Employment 1990-2001)



As they can no longer rely on profits and taxes from local SOEs and TVEs, local governments have naturally become more interested in attracting investments from other sources, especially manufacturing investment from overseas, to broaden the local tax base. In consequence, local authorities have tended to become more even-handed toward businesses not affiliated with the local governments (esp. foreign and private businesses). Indeed, these other business interests are more independent and more mobile than the SOEs and TVEs affiliated with local governments (communities) and thus call for efforts by the local governments to cultivate them. With the multiplicity of local governments competing for investors, regional competition for investments has become the norm.[24]

4. **The Revenue Imperative and the Game between Center and Localities**

Whereas Chinese local governments have had little formal budget autonomy, they have enjoyed much informal fiscal autonomy vis-à-vis the central government. In particular, their quest for revenue has not been confined to the formal budget. Instead, local leaders have generally paid special attention to extra-budget revenue, which are generally off the budget and thus more discretionary.

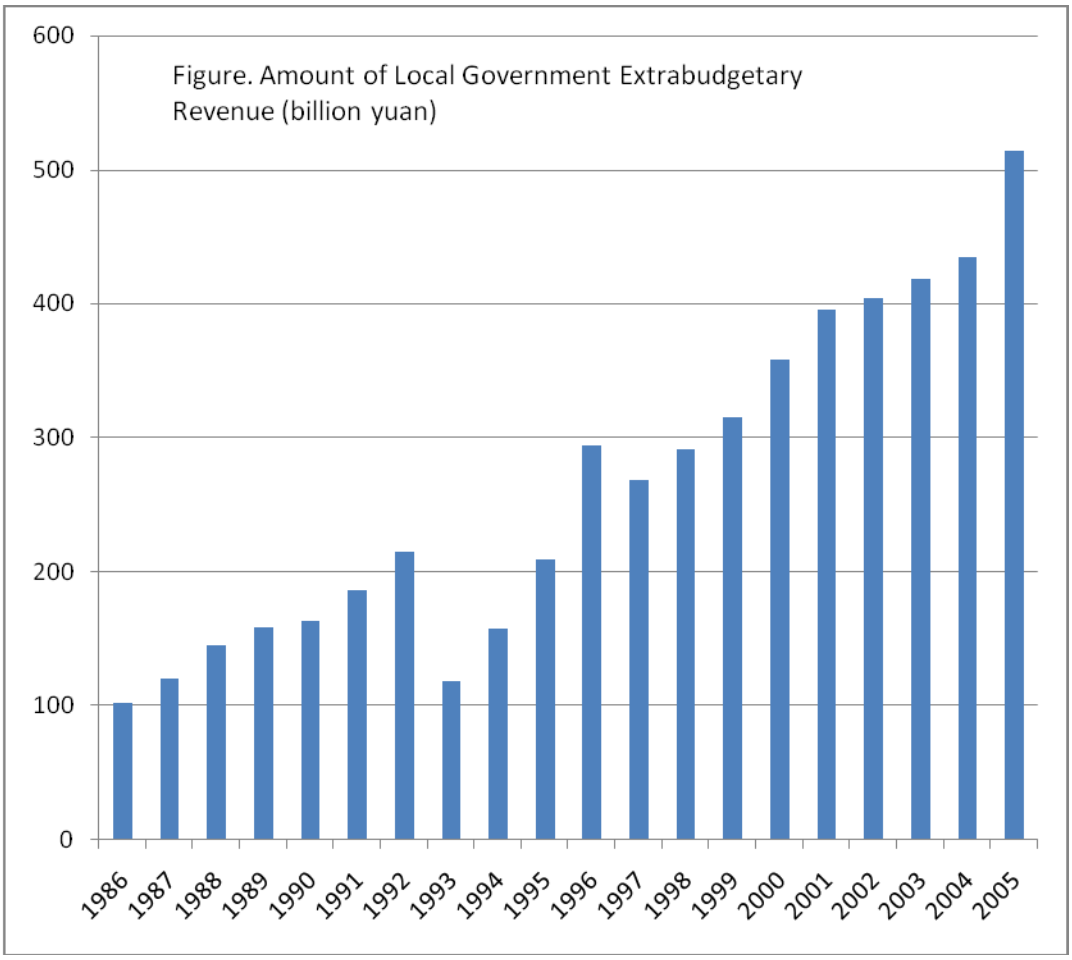
Even during the era of fiscal contracting, local authorities could not trust the central government to honor its words. From time to time, the fiscally-strapped central government "borrowed" funds from the provinces but would not bother to pay back. In this context, there was much concern about central government predation. Some of the wealthiest provinces were known to hide wealth among the people (藏富于民).

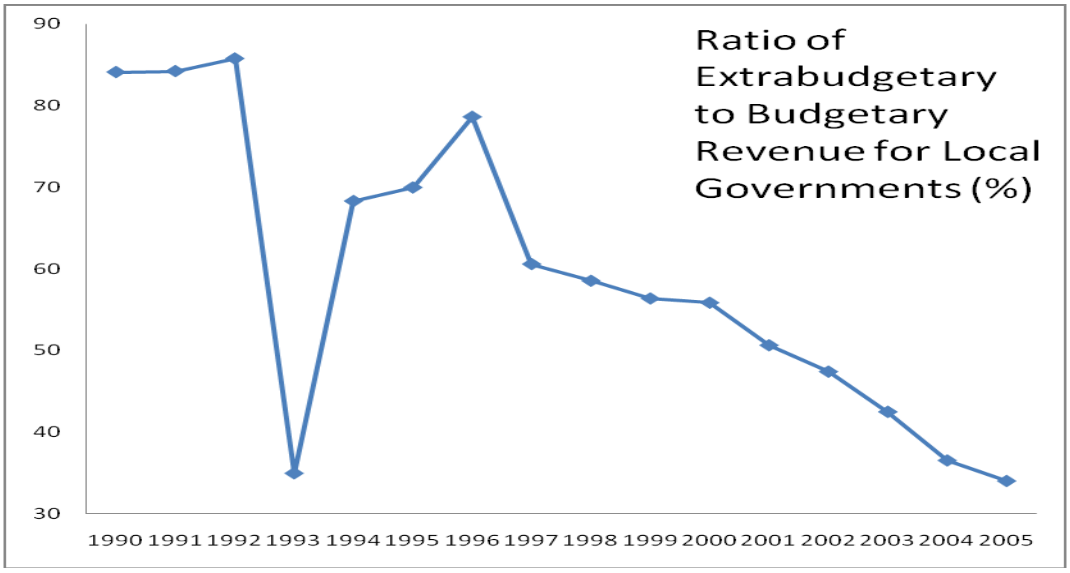
As was mentioned earlier, the Chinese leadership, in an urgent effort to bolster its severely weakened fiscal position, introduced a sweeping reform of the tax and fiscal systems in 1994. With this Tax Sharing (Assignment) System, each tax was assigned to either the central government or the local governments, or shared. This system, coupled with the establishment of separate tax administrations for the center and the localities, promised to institutionalize central-provincial fiscal relations.

The 1994 fiscal reforms have greatly strengthened the central government's control over the revenue stream, raising the center's share of government budgetary revenue from 22 percent in 1993 to over 50 percent after 1994. Indeed, wielding its political leverage over the provinces, the Center has come to dominate the fiscal system at the expense of the provinces. Since the late 1990s, the central government has taken control of several major taxes previously assigned to the localities exclusively, including the stamp tax revenue and the personal income tax, with hardly a murmur from the localities, let alone a veto. By 2003, the central government had started to claim 60 percent of the personal income tax revenue (above the 2001 base amount), leaving only 40 percent to the localities (Yang 2004; Yang 2006). It appears we have yet to reach the end of this recentralization cycle. Some recent proposals for fiscal reforms call for the central government to further tighten control of the fiscal system. The National Development and Reform Commission's Macroeconomic Academy has suggested that the central government claim the entire VAT while the Ministry of Finance's Institute of Fiscal Science has proposed that the central government take all of the income taxes but allow the localities to retain a higher proportion of the VAT.[25] In the fiscal cat and mouse game between center and localities, the cat has morphed into a tiger.

The central-local fiscal game is not limited to budgetary revenue but extends to control over informal revenue sources. One tactic local authorities have often used to gain greater fiscal autonomy from the central government is to shift some potential income from formal (budget) to informal (off-budget) categories. In the era of fiscal contracting, the amount of extra-budgetary revenues, levies, and charges came to rival the formal budget (Wong and Bird 2005). In connection with the 1994 fiscal reforms and again in the late 1990s, the central government reclassified some of the items included in the official statistics on extra-budgetary revenues, each time reducing the amount of revenues included in the extra-budget statistics. In general the central government has sought to bring more extra-budget funds into the formal budget. Even while the amount of local government extrabudgetary revenue has continued to rise in aggregate amount, the ratio of extrabudgetary to budgetary revenue has rapidly declined since the mid-1990s, thereby indicating greater central financial clout.

Figure. Extrabudgetary Revenue times series data





Despite the central government efforts to rein in the localities, local governments have never ceased in their efforts to pursue new extra-budget revenue sources. With the painful state sector restructuring, local authorities have had to simultaneously cope with the decline of traditional revenue sources, which was heavily dependent on the state sector, and come up with more funds to cover growing social liabilities and provide social services. Meanwhile, with the implementation of the 1994 fiscal reforms, the central government took a larger slice of the government revenue pie but left local authorities with the expenditure responsibilities. Worse yet for sub-provincial authorities, provincial governments responded to the reconfiguration of central-provincial fiscal relations by concentrating a larger share of local fiscal revenues in their own hands and transferring expenditure duties further downwards. Moreover, provincial authorities have not vigorously used fiscal transfers to promote fiscal equalisation at the subprovincial level, thereby compromising subprovincial authorities' ability to invest in infrastructure and provide for social services (World Bank, 2002).

In light of the above factors, local authorities continue to face pressures to generate extra-budgetary funds in spite of repeated central government efforts to include some extra-budgetary funds into the budget. In response to the central government's moves at fiscal rationalization, however, local authorities have to be entrepreneurial not only in collecting existing levies and charges but also in creating new extra-budgetary revenue opportunities. Since the late 1990s, the fiscally-strapped local authorities have increasingly turned to land because they are allowed to retain all proceeds from letting out land beginning in 1994 (Yang 2004: 208-213). Prompted by the Ministry of Land and Resources to comply with Land Management Law (which came into effect on January 1, 1999) and adopt public auctions for the use rights of land earmarked for commercial use, most cities have set up land banks or reserves. The land banks would requisition land from rural areas, prepare them for commercial use, and then auction off the land to commercial developers for profit.

In many regions, the revenue from land leasing, especially the fees from commercial and residential land leasing, have become the single most important source of local extra-budget revenue. Studies consistently show that land transfer fees account for some 30-50 percent of total sub-provincial government revenues and in some developed regions, it amounts to 50-60% of the total city revenue (World Bank 2002).

In 2007, local governments in China made 226,500 hectares of land available for commercial and industrial use. Of this land, a total of 115,300 hectares (公顷) of land (50.9 percent of the total land let, up 20.4 percentage points from 2006) were auctioned off (招拍挂出让土地). For the whole year, land sales generated close to one trillion yuan (913 billion for Jan-Nov period.), up from 767.7 billion in 2006 and only 49.2 billion yuan in 2001.[26] Simply put, local authorities have become hooked on land revenue as virtually a "second budget (第二财政)." It is no surprise, however, that the central government is seeking to put much of the revenue from land under formal budget supervision.

5. Assessing the Role of Local Governments

Heterogeneous local government behavior

As Frye and Shleifer (1997) have argued, local governments can be a "grabbing hand" or they can be a "helping hand". Whether local governments are predatory or developmental depends on their incentives under the given institutional arrangements and endowment conditions. As we have discussed in the previous sections, in China's transition these institutional arrangements include the state-business relationship and the central-local relationship. These evolving institutional arrangements have shaped local fiscal incentives and the involvement of local governments in the economy.

Because of the huge heterogeneity in local government behavior, it is inadequate to simply claim the "helping hand" argument for China's local governments. In the more developed coastal regions, local governments in the earlier reform period focused their developmental efforts on local TVEs and SOEs (Oi 1999, Bird and Lin

1990). But as these enterprises were privatized in the second half the 1990s and early 2000s, local governments began to encourage private business development and compete for investment from other regions and countries. To a large extent, local governments in these regions have limited their predatory behavior and have been much quicker in jettisoning local policies that had proved to be unsuccessful. Instead, local governments in these areas have worked hard to build a sound investment environment. Our fieldwork in recent years has found that in the wealthy Jiangsu, Zhejiang and Shandong provinces, even local governments at the township level have turned their attention to the provision of infrastructure to facilitate manufacturing investment. Township reforms have been carried out by rearranging and downsizing government bureaus and setting up administrative service centers.[27]

Yet local governments in many less developed and agriculture-based regions behave quite differently and have tended to be predatory, as findings from the Bird and Lin (1990) volume alerted us long ago. In these regions the local authorities face severe fiscal constraints and have very strong incentives to collect extra budget revenue in the form of various quasi-fiscal fees levied on local enterprises or illegitimate fees and charges on farmers, often with minimal oversight and little accountability. The salience of informal tax burdens on farmers between the mid-1990s and the early 2000s illustrates the vicious cycle that has tended to trap these communities. Under fiscal pressure, local governments in these rural areas imposed numerous informal fees and charges on farmers, aggravating the so-called "peasant burdens" (农民负担) and causing much grievance (Bernstein and Lu 2000; Kennedy 2006; Li 2004; Lin et al. 2007; Tsui and Wang 2004). It was estimated that the value of fees, charges, and levies in the less developed regions amounted to as much as 20-30 percent of farmers´ annual income, far above the 5 percent mandated by the central government (Lin et al. 2007). Indeed, there have been numerous farmer protests at the rapacious demands and the lack of accountability on the part of local officials (Bernstein and Lu 2000; Lin et al. 2007; Zweig 2003).

In an industrializing country like China, interregional differences in initial endowment and the level of economic development that ensues contribute significantly to differences in the quality of local governance practices. Localities along the coast have generally enjoyed better conditions for development and started market-oriented industrialization earlier than in the interior. Faced with greater factor mobility and rising competition, they have in turn been able improve the investment environment, attract more investments, and thus generate more revenue for further development (Yang 1990). In contrast, in less developed regions with poor local endowment and less favorable investment environment, there is also lower factor mobility (or where production factors, under market forces, are moving out to more prosperous areas) and local governments tended to be more short-sighted, focusing on meeting payroll rather than investing for the long-term (Yang 1997). When they do make investments, their performance has been subpar (Ong 2006).

The 1994 fiscal reforms, by centralizing revenue yet keeping expenditure responsibilities decentralized, have affected the localities differently (World Bank 2002). Local governments, notably sub-provincial governments, in richer areas have generally been able to meet their expenditure needs because they have a strong revenue base (non agricultural sectors) and can draw on additional incomes from the sale of rights to develop local land. However, local governments in many less developed areas have been hit hard and become more dependent on central government transfer payments. Faced with heightened revenue pressure, some of these local authorities have not only worked hard to compete for funds from upper levels of government but also tried to invest in revenue-generating industrial enterprises, lean hard on existing enterprises and farmers, and engage in protectionist practices. For example, local governments in many inland regions set up a lot of local TVEs with financing from formal and informal financial institutions - the Rural Credit Cooperatives (RCCs) and the Rural Cooperative Foundations (RCFs).[28] However, many of these TVEs failed in the late 1990s due to poor management, misuse of funds by local officials, corruption, and strong competition.[29] The township governments or village organizations that sponsored the TVEs were saddled with debt and, bereft of the firms that generated various quasi-fiscal fees, became more aggressive in raising funds from farmers, thus causing grievances and protests to rise (Saich 2001). The abolition of the state agricultural tax in the mid-2000s finally stopped this cycle but also weakened the financial base of many townships.

In spite of the vast heterogeneity in the quality of local governance, it is clear that all local authorities are driven by the revenue imperative. They adopt divergent approaches toward revenue generation largely in response to different local constraints. Even for local governments in more developed areas, the government's "helping hand" is too often offered to investors at the expense of farmers who tend to see their land requisitioned by local authorities with inadequate compensation. As Sargeson and Zhang' (1999) have shown, even in the more developed areas, local governments and their officials tended to put their own interests and objectives above not only those of the central government but also those of the local community. In this perspective, the notion of "local state corporatism" probably conflates the interests of local governments, individual officials and the members of local communities.

The revenue imperative and its adverse consequences

As adumbrated above, the local authorities' obsession with unbridled GDP growth and revenue raising has various adverse consequences, which generally fall under the rubric of maximizing short-term growth/revenue generation at the expense of long-term sustainable development. The most obvious is the local pursuit of growth at the expense of the environment.[30] In social terms, local authorities have tended to shift the cost of growth and revenue generation on farmers and migrant workers. The tens of millions of migrant laborers working on assembly lines and construction sites have generally been treated as an urban underclass and second-class citizens at best in their own country. Until recently, local government bureaus (Industry and Commerce; Labor) tended to help the new business elites to hold back labor demands for better working conditions and wages (Sargeson 1999; Solinger 1999). The sociologist Ching Kwan Lee (2002; 1999) argued that local officials and enterprise owners colluded to impose some sort of despotism on labor, especially migrant labor.

The patterns of adverse consequences are not static. Take the case of the mistreatment of migrant labor. In recent years, a variety of labor rights cases, from the beating to death of Sun Zhigang in 2003 to the discovery in 2007 of the existence of large numbers of slave labor working at brick kilns in Shanxi, captured public and elite attention. These cases prompted the authorities to abolish the notorious custody and repatriation regime for migrants in urban areas and to enact a new labor contract law. Meanwhile, soaring growth, improving policy treatment for rural areas, and changing demographics have resulted in a "dearth of migrant laborers".[31] These developments combined have begun to enhance the bargaining power of migrant workers vis-à-vis capital and led growing number of local authorities to become more attentive to the protection of migrant labor rights.

The conversion of agricultural land for non-agricultural purchases has been one of the most contentious issues in China's development (Ho and Lin 2004). As mentioned earlier, municipalities can requisition agricultural land from rural communities with (often inadequate) compensation. The municipalities can then make the land available to industrial investors (such as Intel) at relatively cheap prices. To make up for the cheap land offered to industrial investors and to generate extra-budget revenue for their own use, the municipalities have tended to seek high prices for land auctioned off to property developers. By varying the supply of land for commercial development, authorities can use the land banks as levers for adjusting housing prices indirectly and for maximizing land sale revenue. It is an understatement to say that many municipal governments, led by Shanghai, have become hooked on land revenue. Auctions of land use rights and rising property prices have reinforced each other, with local authorities being the major beneficiary.[32]

The requisitioning of land from rural communities for industrial and commercial development, especially in the thousands of development zones that have sprung up all over China is sometimes referred to as a contemporary version of the land enclosure that occurred in England and Wales in the eighteenth and nineteenth centuries, only on a much more massive scale. For Marxists, the land enclosure of commons in British history has special resonance in terms of property, violence, and bloodshed and especially in terms of the creation of a landless class as labor for the Industrial Revolution.

The massive land requisitioning in today's China has the backing of the Chinese Leviathan. The provisioning of cheap land as a policy instrument in regional competition for investment has contributed to the investment-driven growth in China in the past decade. When land as a key production input is under-priced, the overall investment, especially investment in the manufacturing sector, would be higher than socially optimal. [A tour through many of the development zones would quickly reveal the large plot size for many factories.] This would lead to an over-industrialized economy as well as relatively low returns in industrial investment. As Blanchard and Giavazzi (2005) observe, there are signs of too much investment in China's manufacturing for export, so investments on the margin have low returns. From 1990 to 2003, the manufacturing sector's share of China's GDP grew from 43% to 52%, while in 2003 this share was only 28% for the world average and the average share for all middle and high-income countries was 41%. Many economists studying China's macro-economy agree that after the middle 1990s China's high growth has been largely investment-driven. The contribution of TFP in overall economic growth has been declining since the middle-1990s which implies significant capital-deepening in the economy as a whole, as well as in manufacturing (Jefferson et al. 2003, Zheng and Bigstein, 2006).

The great Chinese land grab has especially soured urban-rural relations. A research report (Unirule 2007) estimates there were over 40 million dispossessed farmers due to urban expansion and transportation projects. For a host of reasons but primarily because local governments tend to underpay, especially in light of soaring urban land prices, farmers losing their land are often dissatisfied with the amount of compensation. Moreover, under-compensated farmers who have lost their land easily become unemployed but generally have limited access to urban welfare benefits.

A 17-province, 1,962-farmer survey conducted in China in 2005 shows that the number of land-related incidents increased more than 15 times during the past 10 years and appeared to be accelerating. As a matter of fact, land-related issues arising from state expropriations or acquisitions have become the top cause of rural grievances and protests (Zhu and Prosterman 2007). In the first nine months of 2006, China reported a total of 17,900 cases of "massive rural incidents" in which a total of 385,000 farmers protested against the government. Approximately 80 percent of these incidents were related to illegal land-takings.

In response to the growing rural protests, the central government has introduced various measures to improve the level of compensation to farmers since 2007. Meanwhile, the center has imposed stricter controls on land use, especially on the conversion of agricultural land into commercial/industrial land.[33] The stricter control over land zoning and the introduction of public tendering for land intended for industrial use and stricter enforcement of land auctions for commercial land have served to fuel rising land prices.

Soaring land prices have been a significant factor in rising property prices.[34] As a rising proportion of people, especially the growing number of recent college graduates, finding it harder to purchase housing, housing affordability has become one of the most salient public policy issues affecting political stability. Municipal leaders in some cities such as Guangzhou have made public pledges to stabilize and even bring down housing prices.

5. Local Government in China's Political Economy

While our discussion so far have focused on central-local relations and their impact for economic growth, the empirical evidence we have reviewed nonetheless has broader theoretical implications for our understanding of China's political economy.

5.1 Federalism with Chinese characteristics?

In accounting for China's strong growth in transition, scholars have argued that China's fiscal contracting system before 1994 served to align the interests of local governments with local business and thus helped turn local governments—albeit not all of them--into "helping hands" for local business (Lin & Liu 2000; Oi 1992, 1999; Shirk 1993; Wong 1992).

Qian, Weingast, and colleagues have gone further to claim the existence of a "market-preserving federalism (MPF)" with Chinese characteristics. In this system, there is a clear and durable division of authority and responsibility between central and local governments, with the local authorities assuming primary responsibility and control over their economies. While recognizing that the Chinese system differs "considerably from federalisms in the developed West," they contend that the Chinese-style federalism "provides considerable political protection for China's reforms, including limits on the central government (Montinola, Qian, and Weingast: 1995: 52)."

The main building block of the fiscal federalism argument is the central government's "commitment not to predate". Because China has a unitary political system dominated by the Communist Party, there is obviously no formal constitutional/political guarantee of such a commitment (Yang 2006). The only possibility for such a commitment to emerge in this system would be a de facto realignment of political interests and forces that curbs the center's predatory capacity. For Qian and others, the fiscal contracting system introduced in the 1980s tied the center and the provinces to long-term and stable fiscal arrangements, delimited their rights to tax revenue, and thus served to restrain central predation.

We note, however, that even in the 1980s there were various adjustments of the fiscal contracting system that allowed the center to raise the amount of revenue it received (Wong 1995). Moreover, the center "borrowed" money from the localities from time to time without bothering to repay. The tax and fiscal reforms of 1994 were another striking example of the center's ability to alter the prevailing fiscal arrangements.

On the surface, even though the 1994 reforms raised the center's share of budgetary revenue, the assignment of different taxes to the center and the localities respectively or as shared taxes did suggest the institutionalization of the central-provincial fiscal relations that had the inklings of a quasi-federal fiscal system. Yet over time the assignment of the taxes has proven to be far from stable. Instead, as mentioned earlier and discussed in more detail elsewhere (Yang 2006), the center has again and again unilaterally altered the tax arrangements to the extent that all major taxes are now shared between center and localities and in the center's favor. As a result, the separate tax administrations for center and localities respectively that were set up in the aftermath of the 1994 reforms are redundant. The central government has also taken repeated steps to rein in the extra-budget revenue and require more and more of it being included in the formal budget. In short, as far as intergovernmental fiscal relations are concerned, the center has come to dominate and whatever "limits on the central government" are clearly not significant as far as central-provincial fiscal relations are concerned.

A second building block of fiscal federalism is that inter-jurisdictional competition and factor mobility helped to limit local-state predation. However, in the early period of China's reform, local government-owned enterprises (local SOEs and TVEs) dominated in most localities. Capital mobility was inevitably low because these enterprises were tied to the local governments and central to the local revenue base; they were simply not free to move away. As a matter of fact, the dominance of local SOEs and TVEs in this period gave local government strong incentive to protect local enterprises by establishing inter-regional trade barriers to consolidate their revenue, which served to hinder the development of national market and interregional economic integration. At the same time, the amount of FDI was small in that period and was concentrated in a relatively small number of localities that enjoyed preferential policy treatment, especially the Special Economic Zones (SEZs) and Coastal Open Cities.

At the margins, there was some capital mobility and some scholars noted the effects of competitive liberalization among local governments in the pursuit of reforms (Yang 1997). Yet it would be a stretch to suggest that the feeble exit option for capital was then powerful enough to serve as a disciplining device against local predation prior to the mid-1990s. On the contrary, local governments had few incentives to predate because they were the shareholders of local enterprises. While such inter-jurisdictional competition for capital has become more intense since the 1990s, it alone does not make the Chinese economy federalist, de jure or de facto because the Chinese central government has evidently asserted its commanding position with the 1994 tax and fiscal reforms and the adjustments that have followed since.[35] While the Chinese media talk about the difficulty the center has in getting every policy implemented, especially in times of macroeconomic adjustment, there is virtually no talk about local authorities becoming strong enough to push back the center's recentralization efforts.

5.2 Political centralization and local initiatives

In their article, Montinola, Qian and Weingast (p. 81) warned about the "problems from a central government that is too strong, and this is the danger of recentralization per se." They argued that "Without further institutional constraints, a financially independent central government would pose potential dangers to the reform's progress over the past fifteen years, especially if run by leaders far less favorable to the reforms than Deng Xiaoping."

To be sure, political centralization per se doesn't contradict the federalism story. Blanchard and Shleifer (2001) propose that the Russian experience indicates that political centralization is a crucial ingredient for economic success. On this view, the central government has been in a strong position both to reward and to punish local administrations, reducing the risk of local capture and the scope of competition for rents. They note, echoing the theme first developed by Riker (1964), that for federalism to function and to endure, it must come with political centralization.

What makes the federalist argument hard to sustain in China is that China's economic growth accelerated in the 2000s to 10 percent per year even as the central government has dominated central-local relations and repeatedly underscored the subordinate nature of local power. The empirical facts are clearly contrary to the predictions of the Chinese-style Federalism model and we need to seek explanations for China's hyper-growth elsewhere.

With the various fiscal reforms since 1994, much recentralization has occurred and the central government has indeed become dominant vis-à-vis the provinces as far as fiscal relations are concerned. Yet at the same time, China's national leadership has not retreated from market-oriented reforms but has made many policies and decisions, including bringing China into the WTO, that have rendered China more market-friendly. In broad terms, much as had been the case in earlier growth stories in East Asia, China has married its authoritarian albeit stable and improving governance with space for local and private initiatives and has created an environment conducive to investment and thus growth (Yang 2006). Indeed, unlike in the earlier East Asia growth stories such as Japan and South Korea, foreign investment has found China under the rule of the Communist Party an especially attractive destination (Yasheng Huang 2003).

By disaggregating the contributions to growth among investment, consumption, and net export, economists are usually struck by China's high investment ratio, which soared above 50 percent in some years in the 2000s. As the investments are made one project at a time in different localities, it is evident that local governments haven't stopped their promotion of local economic development even as the fiscal system became more centralized. On the contrary, there has been intensifying regional competition for manufacturing investment in the past decade or so. In the 1990s and beyond, in particular, local governments across China have established a large number of industrial parks and economic development zones. Until the central government stepped in to discourage the practice, a "race to bottom" type of game emerged in which local governments competed to offer low-cost land and subsidized infrastructure to manufacturing investors so as to boost local economy. Considering the fact that the central government reaps most of the tax revenue from the manufacturing sectors after the 1994 fiscal reform, the strong local incentive in promoting industrial development is a puzzle that the federalism argument doesn't handle well.

This brings attention to another widely accepted explanation of China's growth in transition, which emphasizes the political and career incentives structure facing local officials in China and how such incentives have shaped the behavior of local officials. On this view, the readiness of the Chinese political hierarchy to reward and punish local officials on the basis of their economic performance motivates them to promote the local economy (Maskin et al 2000, Edin, 2003,Tsui and Wang, 2004, Li and Zhou, 2003). Employing the turnover data of top provincial leaders in China between 1979 and 1995, Li and Zhou (2004) find that the likelihood of promotion of provincial leaders increases with their economic performance, while the likelihood of termination decreases with their economic performance. They argue that this happened since economic performance of provincial leaders is a crucial indicator in personnel evaluations in China.

We note that not all localities have adopted a rigorous cadre evaluation system. In particular, as shown by Tsui and Wang (2004), a formal set of performance criteria emerged mainly at the sub-provincial level, especially from the county down to township governments and village organizations. This system did not get formalized until the mid-1990s. It is also worth noting that formally there is no such system linking growth (GDP or revenue) to officials' political career between the center and the province because provincial leaders are by nature multi-taskers who need to tend to a multitude of policy goals. As a matter of fact, officials in some richer provinces have deliberately hidden some revenue for fear of potential predation by upper levels of government.

Although the hypothesis linking growth and officials' career incentives is an elegant one, we believe it's superfluous. For that hypothesis ignores the fact that even officials who don't aspire to be promoted, especially many officials in prosperous coastal cities who do not wish to be given a higher rank but at a much poorer place, may also have strong incentives to develop the local economy. Instead we believe we have offered a simple but unified approach to understanding China's political economy. Put baldly, as has been shown in our earlier discussions, the impact of local fiscal incentives under changing rules of game (both between state-business and between central and local in terms of fiscal arrangements) is sufficient to account for China's growth pattern in transition, both for the earlier period of transition or after the middle 1990s.

We also submit that, under our explanatory framework, the formalization of cadre evaluation system at the local level can be endogeneized. One general imperative that emerges and cuts across more economically developed and more resource constrained localities after the 1994 fiscal reforms is the more acute need to generate one's own revenue as localities have faced mounting fiscal pressure arising from the 1994 fiscal reforms. Faced with tighter budget constraint and mandated expenditure targets, local governments at subprovincial levels have responded by strengthening the cadre evaluation system. Our fieldwork in different parts of China indeed show the cadre evaluation system began to be pushed upward from the county level to the prefectural city level in recent years. The strengthening of this system at the local level can help to push lower level to generate more revenue that could be shared as well as help to further decentralize expenditure to the lower level.

Conclusion

In discussing the role of local government in China's remarkable economic transformation, we build on a large existing literature that has emphasized the role of fiscal decentralization in providing the incentives for investment and thus growth. We share the conventional wisdom that Chinese local authorities have been vital players in investing for growth.

We differ from the existing literature in highlighting the differential impact of fiscal incentives on the behavior of local government with diverse resource endowments. We have also underscored how changes in fiscal incentives have had a profound impact on local government behavior, especially with the fiscal and tax reforms introduced in 1994.

In our view, the center has dominated central-provincial fiscal relations and, while there were some developments that were suggestive of federalist possibilities, used its political and financial leverage to remake the rules again and again in the center's favor. Our review of the changing fiscal regimes over time thus leads us to disagree with scholars who have claimed the existence of some sort of Chinese-style "market preserving federalism" in China. Meanwhile, we also discuss the utility of giving emphasis to the cadre evaluation system for understanding the local incentives for growth and conclude that such cadre incentives can be endogeneized into our analytical framework.

References

Bahl, R., 1998. “Central-Provincial-Local Fiscal Relations: The Revenue Side”. In: D.J.S. Brean, (ed.), *Taxation in Modern China*. Routledge: New York; London, 125-150.

Bai Chong-En, Yingjuan Du, Zhigang Tao, and Sarah Y. Tong, “Local Protectionism and Regional Specialization: Evidence from China’s Industries,” Journal of International Economics 63 (2004): 297-317.

Bernstein, Thomas and Lu, Xiaobo, 2000. “Taxation without Representation: Peasants, the Central and Local States in Reform China”. *China Quarterly*, 163, 742-763.

Bird, William and Lin Qingsong, eds. 1990. China’s Rural Industry: Structure, Development, and Reform. Oxford: Oxford University Press.

Blanchard, Oliver. , and Andrew Shleifer , 2001 , "Federalismwithand without Political Centralization : China vs.Russia" , IMF Staff Papers48 , 171-179.

Blanchard, Olivier J and Giavazzi, Francesco, Rebalancing Growth in China: A Three-Handed Approach. Discussion Papers, DP5403, Center for Economic Policy Research, January 2006

Brandt, Loren, Hongbin Li, Joanne K. Roberts. 2005. "Banks and Enterprise Privatization in China", *Journal of Law, Economics and Organization* 21 (2) (2005), 524–546.

Cai , Hongbin , and Daniel Treisman , 2007 , "Did Government Decentralization Cause China‘s Economic Miracle ? "World Politics , forthcoming.

Che, Jiahua; and Yingyi Qian. "Institutional Environment, Community Government, and Corporate Governance: Understanding China's Township-Village Enterprises." *Journal of Law, Economics, and Organization*, April 1998a, *14*(1), pp. 1-23.

Chen An. 2003. Rising-class politics and its impact on China's path to democracy. *Democratization*. 10 (2):141 -162

Jefferson, Gary H.; Rawski, Thomas G, Wang, Li, and Zheng, Yuxin. (2000) “Ownership, Productivity Change, and Financial Performance in Chinese Industry”, J*ournal of Comparative Economics,* 28(4): 786-813 .

Cartier, Carolyn. (2001) "Zone Fever', the Arable Land Debate, and Real Estate Speculation: China's evolving land use regime and its geographical contradictions”, *Journal of Contemporary China*, 10(28): 445 – 469.

Edin, M., 2003. “State Capacity and Local Agent Control in China: CCP Cadre Management from a Township Perspective”. *China Quarterly*, 173, 35-52.

Frye , Timothy , and Andrei Shleifer , 1997 , "The Invisible Hand andthe Grabbing Hand" , American Economic Review 87 , 354-358.

Ho, P.S. and Lin, C.S. (2004) “Converting land to nonagricultural use in China's coastal provinces”, *Modern China*, 30(1): 81-112.

Huang, Xiaohu, 2007, “Exploring the institutional foundations of land issues in China, China

Taxation (in Chinese), ” No. 2, 2007, pp. 46-47.

Jin ,Hehui . ,Yingyi Qian ,and Barry Weingast ,2005 ,"Regional Decentralization and Fiscal Incentives：Federalism，Chinese Style"，Journalof Public Economics 89：1719-1742.

Lee, Ching Kwan. 2002. From the specter of Mao to the spirit of the law: labor insurgency in China. *Theory and Society* 31(2):189-228

Lee CK. 1999. From organized dependence to disorganized despotism: changing labor regimes in Chinese factories. *China q.* 157:44-72

Li, Hongbin and Zhou, Lian.(2005) “Political Turnover and Economic Performance: the Incentive Role of Personnel Control in China”, *Journal of Public Economics*, 89 (9-10):1743– 1762.

Li Shaomin, Shuhe Li, and Weiying Zhang. (1998) "Cross-regional competition and privatization in China", MOCT-MOST: Economic Policy in Transitional Economies (Economics of Planning), 9(1): 75-88.

Li, X., 2004. “Rethinking the Peasant Burden: Evidence from a Chinese Village”. In: P. Ho, J. Eyferth and E.B. Vermeer, (eds.), *Rural Development in Transitional China: The New Agriculture*. London: Frank Cass, 45-75.

Litwack John M. and Yingyi Qian 1998 Balanced or Unbalanced Development: Special Economic Zones as Catalysts for Transition*1 Journal of Comparative Economics Volume 26, Issue 1, March 1998, Pages 117-141

Lin, Justin Yifu and Liu, Zhiqiang. (2000) “Fiscal Decentralization and Economic Growth in China”, *Economic Development and Cultural Change*, 49(1): 1-21.

Lin, J.Y., R. Tao, and Liu, M., 2007. “Rural Taxation and Local Governance Reform in China´s Economic Transition: Evolution Policy Responses and Remaining Challenges”. Stanford Center for International Development, Working Paper, No. 317, Available from: http://scid.stanford.edu/publications/china_PubsList.html

Maddison, Angus. (1998) *Chinese Economic Performance in the Long Run*. Paris and Washington D.C.: Organisation for Economic Co-operation and Development.

Maskin，Eric.，Yingyi Qian ，Chenggang Xu，2000，"Incentives ，Scale Economies ，and Organization Forms"，Review of Economic Studies 67，359-378.

Montinola, Gabriella, Yingyi Qian, and Barry Weingast. (1995) "Federalism, Chinese Style: The Political Basis for Economic Success in China", *World Politics*, 48(1): 50-81.

Naughton, Barry. 2003. “How Much Can Regional Integration do to Unify China’s Markets,” In *How Far Across the River? Chinese Policy Reform at the Millennium*. Edited by Nicholas C. Hope, Dennis Tao Yang, and Mu Yang Li. Stanford University Press, pp. 204-232.

Naughton, Barry. 1996. Growing Out of the Plan. Cambridge: Cambridge University Press.

Oi, Jean. 1992. Fiscal reform and the economic foundations of local state corporatism in China. World Polit. 45(1):99–126

Oi, Jean C., 1995. “The Role of the Local State in China’s Transitional Economy”. *China Quarterly*, 144, 1132-1149.

Oi, Jean C. (1999) *Rural China Takes Off: Institutional Foundations of Economic Reform*. University of California Press.

Ong, Lynette. 2006. “The Political Economy of Township Government Debt, Township Enterprises, Rural Financial Institutions in China”. *China Quarterly*, 186, 377-400.

Park, Albert, and Minggao Shen, 2003. “Joint Liability Lending and the Rise and Fall of China’s Township and Village Enterprises,” Journal of Development Economics, 71: 497-531.

Poncet, Sandra, 2003, “Measuring Chinese Domestic and International Integration,” China Economic Review, 14, 1, 1-21.

Qian Yingyi and Barry Weingast. (1996) “China's Transition to Markets: Market-Preserving Federalism, Chinese Style”, *Journal of Policy Reform*, 1(2): 149-185.

Qian, Yingyi; and Barry R. Weingast. (1997) "Federalism As a Commitment to Preserving Market Incentives", *Journal of Economic Perspectives*, 11(4): 83-92.

Qian, Yingyi. (1999), "The Institutional Foundations of China's Market Transition", Conference Paper, Annual Bank Conference on Development Economics, Washington, DC.

Qian ,Yingyi. (2000). "The Process of China's Market Transition (1978-98):The Evolutionary, Historical, and Comparative Perspectives", *Journal of Institutional and Theoretical Economics,* 156(1):151-171.

Ray Yep, ‘The Limitations of Corporatism for Understanding Reforming China’, Journal of Contemporary China, vol. 9, no. 25, 2000, pp. 547-66.

Rong Jingben et al, Reform of the Political System at the County and Township Levels, Beijing, Central Compilation & Translation Press, 1998, pp.371-384.

Saich Tong‘The Blind Man and the Elephant: Analysing the Local State in China’ in L. Tomba (Ed.), On the Roots of Growth and Crisis: Capitalism, State and Society in East Asia, Annale Feltinelli, 2002, pp. 75-99.

Sargeson Sally, 1999 Reworking China’s Proletariat (Houndmills: Macmillan, 1999).

Shane, Mathew and Gale, Fred, China: A Study of Dynamic Growth. Economic Research Service/USDA, WRS-04-08, October 2004.

Solinger Dorothy J. Contesting Citizenship in Urban China: Peasant Migrants, the State, and the Logic of the Market (Berkeley: University of California Press, 1999)

Shirk S. 1993. The Political Logic of Economic Reform in China. Berkeley: Univ. Calif. Press

Tsui, K-Y. and Wang, Y., 2004. “Between Separate Stoves and a Single Menu: Fiscal Decentralization in China”. *China Quarterly*, 177, 71-90.

Unirule, 2007, “Protection of land property rights in China’s urbanization”, Beijing Unirule Institute of Economics Research Report, July, 2007, Beijing Unirule Institute of Economics.

Wang,Shaoguang “Central-Local Fiscal Politics in China,” in Jia, Hao and Lin Zhimin, eds. 1994. Changing Central-Local Relations in China: Reform and State Capacity , Boulder: Westview.

Wang S, Hu A. 2001. The Chinese Economy in Crisis: State Capacity and Tax Reform. Armonk, NY: M.E. Sharpe

Wei, Lihua and Cong, Yanguo. (2005) “A Look at the Urbanization of the Pearl River Delta and the Performance of its Urban Planning through its ‘Zero Land Price’", *Planners* (in Chinese) , 21(4): 8-13.

Wong C. 1992. Fiscal reform and local industrialization: the problematic sequencing of reform in post-Mao China. Mod. China 18:197–227

Wong Christine P.W, Christopher Heady, and Wing T. Woo, Fiscal Management and Economic Reform in the People's Republic of China (New York: Oxford University Press, 1995), 86-7

Wong, C.P.W., (ed.), 1997. *Financing Local Government in the People's Republic of China*. Hong Kong; New York: Oxford University Press.

Wong, C.P.W. and Bird, R.M., 2005. "China's Fiscal System: A Work in Progress," Working Papers, No.0515, International Tax Program, Institute for International Business, Joseph L. Rotman School of Management, University of Toronto.

Wong Y.C. Richard and M.L Sonia Wong, 2001 "Competition in China's Domestic Banking Industry," Cato Journal 21 (Spring/Summer 2001).

World Bank. 2002 *China National Development and Sub-national Finance: A Review of Provincial Expenditures* .Washington, DC, 2002.

World Bank, 2005. China: Land Policy Reform for Sustainable Economic and Social Development. Washington D. C.,

Yang, Dali L. (1997) *Beyond Beijing: Liberalization and the Regions in China.* London and New York: Routledge, p. 57.

Yang, Dali L. 2004. Remaking the Chinese Leviathan: Market Transition and the Politics of Governance in China. Stanford, CA: Stanford Univ. Press

Yang, Dali 2006 ECONOMIC TRANSFORMATION AND ITS POLITICAL DISCONTENTS IN CHINA: Authoritarianism, Unequal Growth, and the Dilemmas of Political Development Annu. Rev. Polit. Sci. 2006. 9:143–64

Yang, Dali. 1990. Patterns of China's Regional Development Strategy. China Quarterly.??

Young, Alwyn, 2000, "The Razor's Edge: Distortions and Incremental Reform in the People's Republic of China," Quarterly Journal of Economics, Vol. CXV, pp.1091-1135.

Zweig, David., 2003. "To the Courts or to the Barricades: Can New Political Institutions Manage Rural Conflict?". In: E.J. Perry and M. Selden, (eds.), *Chinese Society: Change, Conflict and Resistance*. 2nd. ed. New York: RoutledgeCurzon, 113-135.

Zhai Nianxiang and Xiang Guangqing. (2007) "An Analysis of China's Current Land Acquisition System and Policy Implications ", China Administration (in Chinese), Issue 3.

Zheng, Jinghai and Bigsten, Arne and Hu, Angang. (2006) "Can China's Growth be Sustained? A Productivity Perspective", Working Paper, Department of Economics, Göteborg.

Zhu, Keliang, and Prosterman, Roy, 2007, "Securing land rights for Chinese farmers: a leap forward for stability and growth". Cato Development Policy Analysis Series, No. 3, October 15, 2007, SSRN (Social Science Research Network), [online; cited 2007 October]. Available from: http://ssrn.com/abstract=1066812.

---

[1] In this paper we use the term "local government" to refer to a range of authorities at provincial as well as sub-provincial (prefectural, county, township) levels. We also refer to the specific level of administrative authority as needed.

[2] Lin & Liu 2000; Oi 1992, 1999; Wong 1992; Montinola, Qian, and Weingast 1995; Qian and Weingast 1997; Jin, Qian, and Weingast 2005.

[3] Blecher and Shue 1996; Duckett 1998; Gore 1999; Nan Lin 1995; Nee and Su 1996; Oi 1992; for review of East Asia, see Wade 1993.

[4] Oi 1992, 1999; Pearson 1994; Unger and Chan 1995; Walder 1995; Wank 1995.

[5] Che and Qian 1998. The problem was that the local state can be just as predatory, though the degree of local state predation seems to vary spatially. We discuss this issue later.

[6] Robert Bates, *When Things Fell Apart: State Failure in Late-Century Africa*. Cambridge: Cambridge University Press, 2008; Andrei Shleifer and Robert Vishny, The Grabbing Hand: Government Pathologies and Their Cures. Cambridge, Mass.: Harvard University Press, 2002.

[7] Shirk 1993: 196.

[8] Lyons 1987; Shen Liren and Dai Yuanchen 1990.

[9] Wong 1992: 198.

[10] Dali Yang, Calamity and Reform in China, Stanford University Press, 1996; David Zweig, Freeing China's Farmers: Rural Restructuring in the Reform Era. Armonk, N.Y.: M.E. Sharpe, 1997.

[11] Michel Oksenberg and James Tong, "The Evolution of Central-Provincial Fiscal Relations in China, 1971-1984: The Formal System," *The China Quarterly*, No. 125 (Mar., 1991), pp. 1-32; Christine Wong, "Central-Local Relations in an Era of Fiscal Decline: The Paradox of Fiscal Decentralization in post-Mao China," China Quarterly (December 1991).

[12] Che, Jiahua, and Yingyi Qian. 1998. "Institutional Environment, Community Government, and Corporate Governance: Understanding China's Township-Village Enterprises." 14 *Journal of Law, Economics, & Organization* 1–23.

[13] Loren Brandt, Hongbin Li, and Joanne Roberts, "Banks and Enterprise Privatization in China," Journal of Law, Economics, and Organization 21(2) (2005): 524-546.

[14] Oi, 1999, Rural China Takes off; Qian and Xu, 1993; Qian, 1999. China Township Enterprises Statistical Yearbook, 1994 need double check.

[15] Dali Yang, Beyond Beijing, 1997.

16 As Che and Qian (1998) has argued, ownership rights give the government control over the firms' financial accounts and thus make it less costly to extract revenues from them than taxing private firms. For the same reason, when local governments control firms, it is also harder for the central government to extract revenue from them, and thus revenue is more likely to stay in the local areas. Here ownership and control make the difference.

[17] Portions of this section are drawn from Yang 2004, chapter 2.

[18] Pete Engardio and Dexter Roberts, "The China Price," *BusinessWeek*, December 6, 2004, at http://www.businessweek.com/magazine/content/04_49/b3911401.htm

[19] ZGTJNJ 1996: 429.

[20] This paragraph is from Yang 2004.

[21] Liu Shijin 1998.

[22] CCTV 2001-02-03; JJRB 2000-12-15.

[23] Loren Brandt, Hongbin Li, and Joanne Roberts, "Banks and Enterprise Privatization in China," Journal of Law, Economics, and Organization 21(2) (2005): 524-546

[24] As large numbers of investors have moved into China from overseas, some local governments such as Shenzhen and Suzhou have become more selective and taken care not to accept heavy polluters.

[25] 席斯，"财税体制改革新路径：大税种上收中央财政，" 经济观察报, May 2, 2008,

http://finance.sina.com.cn/g/20080502/02334824942.shtml

[26] 陈文雅, '土地出让金暴增六成 "大地主"坐收万亿', 经济观察报, April 19, 2008, http://finance.sina.com.cn/g/20080419/07154772093.shtml; **Ministry of Land and Resources, "2007 年中国国土资源公报," March 2008,** http://www.mlr.gov.cn/qt/gd1/200804/t20080416_101261.htm; 陈文雅, "去年前 11 个月全国土地出让收益上涨六成," 经济观察报, February 16, 2008, http://finance.sina.com.cn/g/20080216/09254510873.shtml

[27] For broader discussion, see Yang 2004, chapter 2.

[28] In an attempt to restructure the formal rural financial system, the central government separated the RCCs from the Agricultural Bank of China (ABC) in 1996. One year later, it established RCC unions at the county level to assume the role of managing township RCCs. As a result, township officials lost their power over the RCCs´ credit allocation decisions in their jurisdictions. The RCFs were established by the township and village economic organisations - effectively under the control of township and village cadres - for the purpose of amassing collective funds and households´ savings and channelling them into income-generating activities. In the late 1990s, the RCFs became the largest informal financial organisations in the country, with deposits reaching more than 100 billion yuan in 1996, compared to 800 billion yuan in the official and more established Rural Credit Cooperatives. The funds accumulated by RCFs were invested by rural cadres in township and village enterprises (TVEs), infrastructure, etc. and were even used to make up for shortfalls in local budgets.

[29] Following "bank runs" at some RCFs, the State Council ordered the closure of RCFs nationwide in 1999. This development clearly contributed to harden townships and villages´ budget constraints (Ong 2006).

[30] Elizabeth Economy, The River Runs Black.

[31] Dali L.Yang, "China's Looming labour shortage" in Far Eastern Economic Review, January/February 2005 Volume 168, No.2, pp. 19-24.

[32] 陈文雅, '土地出让金暴增六成 "大地主"坐收万亿', 经济观察报, April 19, 2008, http://finance.sina.com.cn/g/20080419/07154772093.shtml; **Ministry of Land and Resources, "2007 年中国国土资源公报," March 2008,** http://www.mlr.gov.cn/qt/gd1/200804/t20080416_101261.htm; 陈文雅, "去年前 11 个月全国土地出让收益上涨六成," 经济观察报, February 16, 2008, http://finance.sina.com.cn/g/20080216/09254510873.shtml

[33] To evade the stricter control, some sub-provincial authorities have adopted a variety of mechanisms, particularly by leasing rather than outright requisition of rural land for urban usage.

[34] Besides the revenue from land sales, the local authorities also get tax from the sale of housing and from the real estate companies.

[35] We recognize the Chinese fiscal system remains highly decentralized in terms of expenditure responsibilities (Wong and Bird 2005) but decentralization doesn't equate to federalism.