

## **Federalism, Chinese Style: The Political Basis for Economic Success in China**

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### **1. Introduction**

The remarkable success of China's economic reforms – fostering economic growth averaging nine percent per year over the past fifteen years – seems to defy conventional wisdom. Consider:

- Economic reform appears to have been successfully pursued without any political reform.
- The Central Government seems to retain considerable political discretion, including the ability to reverse suddenly the reform process or to impose onerous exactions on successful enterprises.
- Finally, there has been little attempt to provide the central feature of private markets, a system of secure private property rights. Nor has an attempt been made to develop a commercial law (e.g., property and contract law) or an independent court system for adjudication.

Each of these factors bodes ill for economic reform. Without political reform, economic returns remain at the mercy of political predation. Political discretion, in turn, implies that there are no impediments to the government reversing the reforms. In this context, leadership turnover would not only allow the new government to reverse the reforms, but to confiscate

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considerable wealth and to punish those who were successful under the reforms. Alternatively, problems may occur during unexpectedly hard times. With severe budget problems and a population clamoring for "solutions, now," the immediate need for revenue produces powerful pressure for a partial or wholesale reversal of the reforms. This type of discretion typically kills the prospects of any reform program.<sup>1</sup> Because economic agents know in advance that political discretion affords no protection for their economic success, they are unlikely to put their effort and wealth into undertakings that put them at risk, and hence the reforms will fail. These problems are seemingly further exacerbated in China by the lack of a system of private property rights, a clear necessary condition for a successful market system. All these factors point toward poor performance for Chinese economic reform.

The actual performance of the Chinese reforms provides a striking contrast to these expectations. Over the past fifteen years, China's performance potentially places it among that of the other high-growth East Asian economies. The juxtaposition between the conventional wisdom and experience demands an explanation.

The purpose of this paper is to provide such an explanation. We argue that the problem with the conventional wisdom is several-fold. First, it provides too narrow a definition of political reform. Second, although it asks the right question about political discretion, the inappropriate definition of political reform leads it to the wrong conclusion. Third, though much is wrong with the system of property rights in China, looking for a system of such rights as exists in the West has confused many analysts. Rights are not as secure in China as they could be, and the absence of a law of property and contracts along with a judicial system to enforce it remains a significant lacuna in the reform process. And yet, property rights are not completely insecure and without political foundations. Indeed, political reform in China has provided considerable limits on the discretion of the central government. These limits, in turn, provide the beginnings of a strong and credible political foundation for many market-oriented enterprises throughout the successful regions of China.

To understand the basis for these claims, we begin with the notion of political reform. In the common parlance, political reform focuses on democratization and hence the separation of the Chinese Communist Party (CCP) from the state.<sup>2</sup> And, on this important component of

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<sup>1</sup> See McKinnon, Ronald I. "Financial Control in the Transition from Classical Socialism to a Market Economy," *Journal of Economic Perspectives* (1991) 5: 107-22; North Douglass C. *Structure and Change in Economic History*. New York: Cambridge University Press. 1981; and North, Douglass C. *Institutions, Institutional Change, and Economic Performance*. New York: Cambridge University Press. 1990; Root, Hilton. [Madagascar MS.]1993; Weingast, Barry R. "The Economic Role of Political Institutions: Market-Preserving Federalism and Economic Growth." *Journal of Law, Economics, and Organization* (forthcoming, 1995).

<sup>2</sup> Hartford, Katherine, "Socialist Agriculture is Dead; Long Live Socialist Agriculture! Organizational Transformation in China, pp. 31-61 in Perry, E. & C. Wong, eds. *The Political Economy of Reform in Post-Mao China*. Cambridge, MA: The Council on East Asian Studies/Harvard University. 1985; Saich, T. "Much Ado About Nothing: Party Reform in the 1980s" in Gordon White, ed. *The Chinese State in the Era of Economic Reform*. London: Macmillan Professional and Academic Ltd. 1991.

reform, China has made little progress. Nearly all the formal aspects of democracy are absent, notably, individual rights of free speech and political participation, a viable system of competition for political office and a set of constitutional limits on the state. As democracy is one of the most central aspects of political freedom, China's record speaks for itself.

And yet, democratization does not encompass all aspects of political reform. So what has changed? We emphasize three principal factors. First, political decentralization has not only enhanced the powers of local government, it has altered center-local government relations in several critical ways that are difficult – though not impossible – to reverse.<sup>3</sup> Second, a major shift in ideology underpins the reforms, with the CCP moving from a dogmatic emphasis on the Maoist version of Marxist-Leninism to a pragmatic, market-oriented approach. Although the rhetoric of socialism has been retained (e.g., the recent emphasis on the "socialist market economy"), the staunch anti-market, anti-private initiative, anti-private gain focus has been removed. Third, China has for the first time under the Communists opened its economy.

In our view, these changes have resulted in a new political system that we characterize as *federalism, Chinese style*. This system, in turn, provides considerable political protection for China's reforms, including limits on the central government. Viewed from the perspective of the individual, this system differs considerably from federalisms in the developed West.<sup>4</sup> Viewed from the perspective of the political relationships among the different levels of government, China's political decentralization shares much in common with Western federalisms. The modern Chinese system includes a division of authority between the central and local governments. The latter have primary control over economic matters within their jurisdiction. And, critically, there is an important degree of political durability built into the system.

As we argue, the Chinese system provides a partial basis for a special kind of federalism called *market-preserving federalism*.<sup>5</sup> Central to the success of market-preserving federalism is the element of political durability built into the arrangements, meaning that the decentralization of power is not merely at the discretion of the central political authorities. And here, conventional wisdom's focus on the relationship between the national government and the individual results in erroneous judgements, for this focus ignores the relationship between the central authorities and the provincial and lower governments. The latter relationships have not only changed dramatically, but in ways that are difficult to undo. They thus provide a degree of commitment.

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<sup>3</sup> Shirk, Susan L. *The Political Logic of Economic Reform in China*. Berkeley: University of California Press, 1993.

<sup>4</sup> Federalism in the West is nearly always associated with political freedom and the protection of individual rights. See Weingast, "The Economic Role of Political Institutions" for details of these federalisms, including a discussion of how federalism provided the important political foundations for the impressive growth of England in the 18th Century, and the United States in the 19th century.

<sup>5</sup> Weingast "The Economic Role of Political Institutions"; See also McKinnon, "Market-Preserving Fiscal Federalism."

Nonetheless, the new economy is not without its limitations. An understanding of how China's current system differs from a more complete system of market-preserving federalism provides some guide to both its current problems and solutions to them. First, China lacks an adequate mechanism for policing the internal common market. This absence explains in part why many local governments have focused on trade barriers and aggressive anti-market policies within their jurisdiction. Second, political decentralization has yet to be institutionalized to ensure its long-term stability. A third problem is the absence of private property rights and a commercial law, as many have noted. These limitations should not be seen as economically debilitating, but rather as problems that need to be addressed in the near future.

This paper proceeds as follows. The next section discusses the theory of federalism and is divided into two parts. The first examines the necessary political foundations of market-preserving federalism while the second examines the economic consequences of federalism. Sections 3 and 4 turn to federalism, Chinese style, paralleling the two parts of section 2. Section 3 discusses whether and how the conditions of market-preserving federalism hold in China; section 4 reveals the remarkable parallel between the predicted effects of market-preserving federalism and China's decentralization. This approach helps order the seemingly chaotic variety of behavior in the different provinces and localities. Much of this variation, especially the trends in behavior, policy, and economic outcomes, is as predicted by the theory of federalism. Several imperfections of the system are also noted. Our conclusions follow.

## 2. The Theory of Market-Preserving Federalism

### Political foundations of market-preserving federalism

The fundamental dilemma facing a government attempting to build and protect markets is this: It must not only be strong enough to enforce the legal rights and rules necessary to maintain the economy, but also strong enough to credibly commit itself to honoring such rules.<sup>6</sup> In the absence of credible limits on governmental behavior, nothing prevents the government from taking away wealth from the citizens for its own purposes. This may take many forms: an outright confiscation of wealth, onerous taxation, or inflationary financing by printing money. The absence of such a commitment, in turn, adversely affects the "positive incentives" of economic agents. Because rational actors understand that this political environment reduces their economic benefits *ex post*, they will withhold their efforts, investments, and information *ex ante*, thus jeopardizing economic growth.

Another form of the lack of commitment concerns governments that are unable to impose a "hard budget constraint" on themselves and other economic agents.<sup>7</sup> This occurs when the government continues to bail out or subsidize troubled institutions and agents.<sup>8</sup> Lack of

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<sup>6</sup> North, *Institutions.*; Weingast, "The Economic Role of Political Institutions."

<sup>7</sup> Kornai, Janos, *Economics of Shortage*, North-Holland, 1980.

<sup>8</sup> Although the most pervasive forms of the soft budget constraint are observed in the centrally planned economy where the government controls nearly everything, the problem is general in all modern economies. Indeed, the exploding savings and loan problem in the United

commitment in this form fails to provide "negative incentives" to economic institutions and agents, who rationally distort their efforts, typically leading to wasteful investment and low productivity. Put simply, the soft-budget constraint eliminates the need for sensible planning since mistakes are not costly to the decisionmakers.<sup>9</sup>

Reputation is often argued to be an important mechanism to achieve credible commitment, but it alone is hardly sufficient. Political institutions are also necessary because, in the appropriate form, they provide for a balance of power that can make commitment credible.<sup>10</sup>

An important set of political institutions that play this role are those surrounding federalism. Understanding the implications of federalism requires a clear understanding of how it is sustained, that is, of its political foundations. Most treatments simply take federalism as an exogenously specified system, focusing on its effects. For the purposes of studying the consequences of federalism in the developed West (e.g., in Switzerland or the United States), this often involves no great loss. For the purposes of implementing and perfecting a new system of federalism, however, an appreciation of its political foundations proves essential.

The most fundamental feature of federalism is decentralization. But not all systems of decentralization are federal. To understand federalism, we must identify its principal characteristics. As a special type of federalism, *market-preserving federalism* encompasses a set of conditions concerning the allocation of authorities and responsibilities among different levels of government:

- (F1) There exists a *hierarchy* of governments with a *delineated scope of authority* (for example, between the national and subnational governments) so that each government is autonomous in its own sphere of authority.
- (F2) The subnational governments have primary *authority over the economy* within their jurisdictions.
- (F3) The national government has the authority to police the *common market* and to ensure the mobility of goods and factors across subgovernment jurisdictions.
- (F4) Revenue sharing among governments is limited and borrowing by governments is constrained so that all governments face *hard budget constraints*.
- (F5) The allocation of authority and responsibility has an *institutionalized degree of durability* so that it cannot be altered by the national government either unilaterally or under the pressures from subnational governments.

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States resulted from a version of this problem. So, too, is the rampant inflation typical of many Latin American regimes.

<sup>9</sup> McKinnon, "Market-Preserving Fiscal Federalism."

<sup>10</sup> Weingast, "The Economic Role of Political Institutions."

These conditions represent an ideal type of institutional arrangement of a market-preserving federalism. The purpose of these institutions is in part to limit the degree to which a political system can encroach on markets.<sup>11</sup>

Condition 1 contains the defining characteristic of federalism. But formalized decentralization alone does not generate federalism's market-preserving qualities. These require the addition of conditions 2 through 5.

From the perspective of preserving market incentives, the authority of the national government over markets is limited to policing the common market across regions (condition 3) and providing national public goods, which should not be left to the subnational level governments (e.g., monetary policy).

The institutional arrangements of federalism recognize a critical difference between the national government and the subnational governments: there is only one of the former but many of the latter. The natural limits on the discretionary authority of the subnational level governments are induced by competition among jurisdictions. But this competition is beneficial only if there are no trade barriers and the entire nation becomes a common market (condition 3). Without condition 3, each subnational government would become something of a *de facto* "national government" in its jurisdiction, and its discretionary authority over the economy again deprives its ability in making credible commitment. Condition 2 thus enhances the effects of condition 3. If decentralization remained at the discretion of the national government, the latter could intervene in the economy first by using its discretion (in the absence of condition 2) to compromise the system of federalism and then to intervene.

The constraint of condition 4 has two parts, one for fiscal revenue transfers between levels of governments, and one for borrowing through the financial system. The hard budget constraint in the fiscal channel limits revenue sharing and equalization among governments, especially through soft grants. The hard budget constraint in the financial channel restricts open-ended access to capital markets, especially borrowing from the central bank. Condition 4 applies to both the national government and the subnational governments. A hard budget constraint for the latter is necessary because it directly ties local revenue to local economic prosperity. A local government's financial problems remain its own. This provides important incentives for local officials, for their government's fiscal health is directly related to local economic prosperity. If, in contrast, local governments were readily bailed out of their financial problems, they would have considerably fewer incentives to worry about the consequences of their choices. The constraint on the national government is necessary in part because a soft budget constraint would allow it to use monetary discretion to get around the constraints on its authority.

Condition 5 provides for credible commitment to the federal system and thus for limits on the national government's discretionary authority. Not only must there be decentralization, but that decentralization must not be under the discretionary control of the national government. Condition 5 concerns the enforcement problem and is critically important. But it is also likely

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<sup>11</sup> McKinnon, "Market-Preserving Fiscal Federalism"; Weingast, "The Economic Role of Political Institutions."

that each country, due to its own unique history and complicated social conditions, may resolve different arrangements.

Market-preserving federalism's balance of power between the national and subnational governments is superior to either a complete centralization with a unitary government or a complete decentralization with each region an independent state. In the latter two cases, the national government's authority is not limited through internal institutional arrangements, hence the potential danger exists for the discretionary authority to encroach on markets.

Before turning to the economic implications of market-preserving federalism, we pause to discuss the relationship between the conditions underlying market-preserving federalism and various systems of federalism throughout the world. Our approach shows that whether a nation calls itself federal – "de jure federalism" – is irrelevant.<sup>12</sup> What matters is whether the various conditions hold. Many de jure federalisms are nothing like market-preserving federalism, for example, in Argentina, Brazil, and India. In these cases, conditions 2 and 5 fail, and often condition 4. The failure of conditions 2 and 5 implies that the political discretion and authority retained by the central government in these systems greatly compromises their market-preserving qualities. As discussed later in this section, these conditions are a necessary component of federalism's market-preserving qualities.

The contrast between market-preserving federalism and the decentralization of the former Soviet Union is also instructive. That system was characterized by administrative decentralization without authority. Lower governments were largely administrative units of the central government with little autonomous political power, let alone power over their local economies. The center also carefully controlled factor mobility. Hence all but condition 1 failed in that system<sup>13</sup>

In sum, though many forms of political decentralization exist, only a narrow subset is characterized by market-preserving federalism.

### **The economic effects of market-preserving federalism**

The most important effect of market-preserving federalism is the induced competition among jurisdictions.<sup>14</sup> This has a number of salutatory effects. First, it means that no government has a monopoly of regulatory authority over the entire economy. Any subnational government which seeks to use its authority for purposes of monopolization or other political ends is at a considerable disadvantage because it cannot impose its will on the entire economy. When a particular jurisdiction imposes an onerous restriction on its firms, the latter face a

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<sup>12</sup> See Williamson, Oliver. "The Institutions and Governance of Economic Development and Reform," Unpublished WP, UC Berkeley, 1994.

<sup>13</sup> In contrast, 18th century England was characterized by market-preserving federalism, although the English did not call their system federal. See Weingast, "The Economic Role of Political Institutions."

<sup>14</sup> This section summarizes an extensive literature in economics, including the classic work of Tiebout and Oates. For a review of this literature see Rubinfeld, Daniel. "Economics of the Local Public Sector," *Handbook of Public Economics*, vol. II, A.J. Auerbach and M. Feldstein, eds. New York: Elsevier. 1987.

competitive disadvantage relative to competing firms from other jurisdictions that are not bound by the restriction. Producers outside the particular jurisdiction are not bound by these rules and hence their costs will be lower and they will outsell those firms bound by the restriction.

Second, competition among jurisdictions extends to factors of production, such as capital and labor. This induces jurisdictions to provide a hospitable environment for factors, typically through the provision of local public goods such as establishing a basis for secure rights of factor owners, the provision of infrastructure, utilities, access to markets, and so on. Those jurisdictions which fail to provide these goods find that factors move to other jurisdictions. Local economic activity and tax revenue decline as a consequence.

Third, the hard budget constraint implies that local governments can go bankrupt. This provides them with incentives for proper fiscal management.<sup>15</sup> Local enterprises, local politicians, and citizens in particular areas hardly want their government to spend more money than is prudent. Bankruptcy would greatly hinder the ability of local governments to finance needed public goods, such as those needed to attract foreign capital and lower business costs.

Finally, market-preserving federalism provides the political foundations for markets.<sup>16</sup> By placing the authority over markets in the hands of lower governments, it induces them to foster local economic prosperity. By keeping the central government out of this activity, it prevents massive intervention of political goals that distort markets for other purposes. Once established, markets are difficult to alter since national political forces are deflected from this issue and since, at the local level, it is hard for a group with any particular goal to capture the lion's share of the local governments. That, in turn, implies that some governments are always likely to retain their pro-market focus. Market-preserving federalism there diminishes the prevalence of rent-seeking and patronage systems. The latter can only survive in areas with political protection from market forces, a phenomenon that market-preserving federalism is designed to eliminate.

**Predictions following the inception of market-preserving federalism.** Following the imposition of a system of federalism we should observe a diversity of policy choices and experiments. People in different political jurisdictions are likely to have markedly different interests, expectations, and capabilities. They may also appeal to markedly different theories and ideologies to make their decisions. We should therefore observe that they choose a range of policies to promote their goals.

As the results of these experiments and policies become known, individuals and policymakers will update their expectations about the effects of various policies. Thus, decentralization under market-preserving federalism results in an important degree of feedback that would not be present under a unitary system which imposes a single national experiment over all regions.

The competitive process among jurisdictions induces incentives for those which chose poor strategies to adopt variants of the strategies that appear to succeed elsewhere. To the extent that some jurisdictions are better at promoting markets, generating wealth, and caring for the

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<sup>15</sup> McKinnon, "Market-Preserving Fiscal Federalism."

<sup>16</sup> Weingast, "The Economic Role of Political Institutions."

needs of their citizens, their policies are likely to be imitated by others which have been less successful. Still, we do not expect the appearance of uniformity for several reasons. First, individuals and firms will sort themselves into jurisdictions. For example, to the extent that different industries require different types of public goods, they may locate in different areas. Second, resources and access to markets imply that a variety of economic and political differences will survive.<sup>17</sup> Finally, individuals are likely to vary in their tastes for public goods, as well as their ability to pay for them.

**Predictions when market-preserving federalism remains incomplete.** The set of predictions just noted will vary in systematic ways if particular components of market-preserving federalism are missing. For what follows, we discuss the implications of two limitations on market-preserving federalism. The first concerns the absence of a common market, allowing individual jurisdictions to erect trade barriers. The principal differences are that the common market is highly unlikely to be sustained without explicit protection from the central authorities.<sup>18</sup> This implies that some areas, particularly those not likely to perform well under competition with jurisdictions, are likely to erect trade barriers to firms and products from other areas. A federalism of this sort (one which is only incompletely market-preserving) will produce seemingly contradictory results. Some areas will be observed to promote markets while others will closely control their economy, especially from influence outside the jurisdiction.

We also expect this juxtaposition to be more pronounced just after a system of federalism is imposed than in a more mature system, especially for an economy like China's with only limited experience with markets. Limited exposure to markets naturally generates suspicion of them and of their potential dependence on outsiders. The feedback provided by multiple jurisdictions that conduct independent experiments is important for the next stage. As the market grows in those areas which commit themselves to it, the tendency of other jurisdictions toward protectionism will diminish. The experience with markets will reveal new information about how it allows local governments to provide for the needs of citizens. Even in the presence of strong trade barriers, fiscal pressures will push insulated areas to substitute market mechanisms for those activities that have been demonstrated elsewhere to be superior providers of particular goods and services.

The second explicit limit on market-preserving federalism concerns the absence of centralized control over the monetary system. To the extent that the authority over credit, for

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<sup>17</sup> See, e.g., Krugman, Paul. *Geography and Trade*. Cambridge, MA: M.I.T. Press. 1991.

<sup>18</sup> For example, the common market in early 19th century United States could not have been sustained without the ever-vigilant policing of the Supreme Court. Policing the market against encroachments by state governments proved a major use of its constitutional powers. These cases reveal the remarkable diversity and cleverness of the states in their efforts to erect such barriers. See Weingast, Barry R. "The Political Foundations of the Antebellum American Economy," Working Paper, Hoover Institution, Stanford University, 1993); Similarly, such barriers are a major reason underlying the movement for economic and political union in Europe. See Garrett, G. "The International Cooperation and Institutional Choice: The European Community's Internal Market." *International Organization* (1992) 46:535-62

example, is not centralized, but remains at least in part at the discretion of lower governments, several problems are likely to emerge. The most obvious is inflation as each government overgrazes the "commons," causing too much growth in the money supply. The second problem is a consequence of the first. Decentralized access to credit under these circumstances also softens the hard budget constraint as governments which increase their exposure can always borrow more in the short run. This induces moral hazard; for example, too much borrowing to finance too many investments, many of which would not be financed were it not for access to credit in this manner.

### 3. Federalism, Chinese Style

The decentralization in China differs from Western federalisms in several important respects. First, the latter virtually always root federalism in an explicit system for protecting individual rights. Second, Western federalism typically has strong, explicit constitutional foundations. Third, it is almost always associated with political freedom, representation, and democratization. None of these factors are present in China. Notice, however, that the definition of market-preserving federalism provided above in no way depends on these factors. Instead, it focuses on the political relationships among levels of government. This says nothing about an explicit or constitutional basis nor whether it is designed to promote individual rights and political freedom.

In this section, we present evidence from China on each of the five conditions, both positive and negative, underlying a market-preserving federalism. As we show, with some important qualifications, the conditions are satisfied.

The differences between Western and Chinese federalism noted above constitute the first aspect of what makes for federalism, Chinese style. The second aspect concerns the specific nature of the institutional changes of decentralization underpinning the reforms, the increased reliance on markets, and openness to the outside world. Perhaps the most significant reform steps taken by the Chinese central government were its decentralization of authority from the central to local governments and, to a lesser degree, the state-owned enterprises. The idea of decentralization in China is not new – it had two previous waves of "administrative decentralization," the Great Leap Forward in 1958 and the Cultural Revolution in 1970. Decentralization in the 1980s differs, however, in that it is combined with financial incentives, reliance on market mechanisms, increased control for lower governments over their economies, and a new openness to international markets. These features generate far reaching consequences for political institutions and economic performance.<sup>19</sup>

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<sup>19</sup> Qian and Xu provide a detailed analysis of how and why this happened in China. Based on this analysis, they also provide an institutional explanation of differences between economic reforms in China and in Eastern Europe and the Soviet Union. See Yingyi Qian and Chenggang Xu, "Why China's Economic Reforms Differ: The M-form Hierarchy and Entry/Expansion of the Non-State Sector," *The Economics of Transition*, 1(2), pp.135-170, June, 1993.

### Decentralization of Authority

Even before the current economic reform began in 1979, a large number of state-owned industrial enterprises in both light and heavy industries were controlled by local governments rather than the central government. In 1978, the share of industrial output of state-owned enterprises controlled by the central government was less than one-half of the national total.<sup>20</sup> In the early 1980s, as a result of the reforms, more state-owned enterprises controlled by the central government were delegated to local governments. By 1985, state-owned industrial enterprises controlled by the central government accounted for only 20 percent of the total industrial output from such enterprises at or above township level, while provincial and city governments controlled 45 percent and county governments 9 percent, and the rest came from township enterprises.<sup>21</sup>

Unlike previous decentralizations which were carried out within the framework of central planning, provincial and local governments under the market-oriented reforms enjoyed a wide range of authority within the market environment. More and more foreign capital, for example, flows into firms and projects that are not controlled by the central government. The total foreign investment in China increased from \$4.5 billion in 1985 to \$19.2 billion in 1992 (among the largest investors are Hong Kong, Taiwan, U.S. and Japan). At the same time, the share of foreign investment administered by provinces (rather than ministries of the central government) increased from 35 percent in 1985 to 68 percent in 1992 (*China Statistical Yearbook*, various issues).

Many reform policies were also delegated to provinces and local governments. Take the example of price reforms. China did not liberalize prices in one stroke. The dual price system was a common practice in China in 1980s, with one planned price and the other a market price. What is not well-known is that, for many goods, moving from a dual price system to a single price system was not completely carried out by the central government, but by local governments. Decisions about prices were largely delegated to lower level governments. (An exception to this generalization concerns some nationally important goods like energy and transportation services.) Many governments have extended their authority to pursue reform to liberalize the prices. In the case of grain prices, which should be controlled by the central government, Guangdong took the lead in 1992 to liberalize it, and many other provinces have since followed suit.

Decentralization of authority is particularly associated with establishment of special economic zones, coastal open cities, and development zones. In 1979, China established four special economic zones, Shenzhen, Zhuhai, and Shantou adjacent to Hong Kong in Guangdong Province and Xiamen in Fujian Province across the Taiwan strait.<sup>22</sup> Subsequently, Guangdong and Fujian gained substantial autonomy in developing their regions as the central government granted them authority to pursue reform "one step ahead." Not only did these areas enjoy

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<sup>20</sup> Wong, Christine, "Between Plan and Market: The Role of the Local Sector in Post-Mao China," *Journal of Comparative Economics*, 1987.

<sup>21</sup> Qian and Xu, "Why China's Economic Reforms Differ."

<sup>22</sup> Hainan was added as the largest special economic zone when it was organized as a separate province in 1988.

lower tax rates, but they gained more authority over economic development. For example, they have the authority to approve foreign investment projects up to \$30 million, while other regions' authority remained much lower.

In 1984, the central government declared 14 coastal cities as "coastal open cities," which conveyed new authority to them that paralleled that granted earlier only to special economic zones. In the early 1990s, treatment of special economic zones was extended to some inland regions. For example, some inland cities along the Yangtze River and border cities with Russia obtained similar authority as in those coastal cities. Further, many inland cities, which did not qualify for these special treatments as a whole, established numerous "development zones" inside their region to enjoy part of the tax benefits and autonomy.

### **Fiscal Incentives: The Fiscal Contracting System**

Starting in 1980, China implemented a fiscal revenue sharing system between any two adjacent levels of governments.<sup>23</sup> Although schemes vary both across regions and time, the basic idea is that a lower-level regional government contracts with the upper-level regional government on the total amount (or share) of tax and profit revenue (negative values imply a reverse flow of subsidies) to be remitted for the next several years, and the lower-level government keeps the rest. This system was maintained until the end of 1993 and a new fiscal system was introduced in the beginning of 1994.

Consider fiscal contracting schemes between the central and provincial governments (lower level fiscal contracting is similar). In the first step, revenue income in each province is divided between "central fixed revenue," all of which is remitted to the center, and "local revenue," which is subject to sharing. In the second step, a particular formula of sharing is determined. There are six basic types of sharing schemes for the thirty provinces and five cities during 1988-1993.<sup>24</sup>

- (1) **Fixed sharing:** A fixed proportion is remitted to the center (3 provinces/cities);
- (2) **Incremental sharing:** A certain proportion is retained up to a quota, and then a higher proportion is retained in excess of the quota (3 provinces/cities);
- (3) **Sharing up to a limit with growth adjustment:** The localities retain a specified proportion that is within a specific percentage of revenue from the previous year, and then retain all above that quota (10 provinces/cities);

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<sup>23</sup> See, e.g., Oi, Jean, "Fiscal Reform and the Economic Foundations of Local State Corporatism in China," *World Politics* (October 1992) 45:99-126; Oksenberg, Michael and James Tong, "The Evolution of Central-Provincial Fiscal Relations in China, 1971-1984: The Formal System," *The China Quarterly* (1991):1-32; and Wong, Christine, "Fiscal Reform and Local Industrialization," *Modern China*, vol. 18 no.2, April, 1992.

<sup>24</sup> The five cities are below the provincial level but have independent budget agreements with the center. The following is based on: Bahl, Roy and Christine Wallich, "Intergovernmental Fiscal Relations in China," Working Papers, Country Economics Department, World Bank, WPS 863, 1992; Wong, Christine, "Central-Local Relations in An Era of Fiscal Decline: The Paradox of Fiscal Decentralization in Post-Mao China," *The China Quarterly* (1991) 128:691-715; Wong, "Fiscal Reform and Local Industrialization."

- (4) **Fixed quota delivery:** A specified, nominal amount is remitted to the center (3 provinces/cities);
- (5) **Fixed quota with growth adjustment:** The fixed amount remitted to the center is increased at a contracted rate (2 provinces/cities);
- (6) **Fixed subsidies** (14 provinces/cities).

The importance of these new fiscal arrangements is that for all provinces and cities they induce a strong positive relationship between local revenue and local economic prosperity, thus providing local officials with an incentive to foster that prosperity. Schemes (4) to (6), which cover 19 out of 35 provinces or cities, at the margin allow local governments to retain 100 percent of local revenues. Scheme (3), which covers another 10 provinces and cities, has the same effect when the increased revenue limits for sharing are not a binding constraint. Even in scheme (2), the marginal remittance rate is regressive.

The fiscal contracting in budgetary revenue described above is only one aspect of fiscal decentralization; the other concerns the expansion of the so-called "extra-budgetary" funds (certain categories of revenues collected by the local governments and ministries, including some retained profits of state-owned enterprises). In the early 1990s, the extra-budgetary revenue reached about the same level as budgetary revenue. Unlike the budgetary revenue, which is subject to sharing with the higher governments, the extra-budgetary revenue is wholly retained by the local government. Moreover, the local government has complete authority over the determination of taxes or fees that fall into the categories of "extra budget." The decentralized nature of extra-budgetary revenues also increases local government security from predation by the central government, as extra-budgetary revenues are easier to hide from the higher governments. These funds are especially valuable to local governments as their use is more flexible than budgetary revenues.

By way of summary, these changes provide for substantial independence of the governments in China, from the provincial to the township, which ensures that governments in each region assume primary responsibility for economic development in that region. Hence, these governments possess both significant fiscal autonomy from the central government and considerable independent authority over their economies.

Notice the striking contrast between this system and that in the former communist system (including that of the former Soviet Union and Eastern Europe). In the latter, the central authorities retained the discretionary authority to the profits "earned" by producers, typically using this authority to take resources from those firms with positive earnings and to bail out those with negative earnings. This discretionary redistribution was described in the Soviet Union by the Russian word *uravnilovka*, which translates as "equalization" or "leveling off."<sup>25</sup>

### **The Common Market Condition**

In contrast to the decentralizations accompanying the Great Leap Forward and the Cultural Revolution, decentralization in the current reform is associated with increasing marketization.

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<sup>25</sup> For discussion of the Russian case, see Litwack, John, "Discretionary Behavior and Soviet Economic Reform," *Soviet Studies*, 1990; and Litwack, John, "Legality and Market Reform in Soviet-Type Economies," *Journal of Economic Perspectives* (1991) 5(4), pp.77-89.

The development process of goods and factors mobility across regions is considerable, but remains imperfect. On the one hand, there are clear signs of increased factor mobility over time, as evidenced by the huge "floating migrant" population and the foreign capital inflow. On the other hand, decentralization has also increased the incentives as well as the range of political means for local governments to erect trade barriers, resulting in the so-called "dukedom economies" phenomenon which worried the central government and economists. This form of protectionism has occurred most often in the markets of high profit-margin manufacturing goods (such as automobile, tobacco products and alcohol) and raw materials in short supply (such as cotton, silkworm cocoons, tobacco and aluminum).

The imperfect common market implies that some areas have used their political freedom to maintain considerable trade barriers.<sup>26</sup> We mention two examples. First, consider automobile assembly. Although the total production of automobiles in China was around 1.2 million in 1992, it had more than 126 assembly factories, with an average production of 10,000.<sup>27</sup> Almost all provinces have their own automobile factory. Such an inefficient scale can be maintained only in the presence of substantial government protection: tariffs at the national level and various trade barriers at the regional level.<sup>28</sup>

Second, in 1985 Jiangxi province liberalized hog procurement.<sup>29</sup> As a result of the large demand from rich neighboring provinces, such as Guangdong and Fujian, hog prices increased rapidly. To maintain the welfare of its urban constituents, the local governments of Jiangxi attempted to keep the urban retail pork price of local government-owned food companies at a low level. The local governments thus spent a large amount of their budgets subsidizing hog sales in local cities. As it was more profitable for rural households to sell hogs to neighboring rich provinces where hog prices were much higher, large numbers of hogs kept flowing out of the region. At the end of 1985, the Jiangxi provincial government reacted to this situation (in which the "Jiangxinese raise hogs and Cantonese consume pork") by establishing tax offices on the provincial border. Their purpose was to levy a so-called "hog development fund" on any

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<sup>26</sup> See Wong, "Central-Local Relations." In a recent comprehensive study of China's internal market, the World Bank concluded that "despite considerable progress in the substitution of allocation by the price mechanism, markets for both goods and factors of production (capital, labor and foreign exchange) are still regionally fragmented." "Links with the overseas exterior appear to have been easier to develop than links with other provinces, both in terms of the mobility of goods and some factors, particularly capital investment. There has been some tendency for individual provinces to behave as separate countries, rather than as parts of a single large country." World Bank, "China: Internal Market Development and Regulation," Country Operation Division, China and Mongolia Department, November 24, 1993.

<sup>27</sup> *People's Daily*, overseas edition, October 11, 1993, p. 2.

<sup>28</sup> For example, it is reported that one provincial government instructed its automobile registration department to refuse to issue license plates to unauthorized automobiles produced outside the province.

<sup>29</sup> Source: C. Wang, "Hog Production Problems in Jiangxi Province," *Economic Study*, May, 1988.

hogs sold out of the region. Since this hog development fund actually could be captured by any level of authorities that charged it, many county and even township governments in Jiangxi set up tax offices. In response, hog production decreased dramatically.<sup>30</sup>

As these examples suggest, the imperfect policing of the common market allows local governments to insulate themselves from competition by erecting trade barriers. These barriers also allow the emergence of corruption. In insulated regions beyond the reach of the central government, local officials can take advantage of their power for personal gain. In the presence of open competition, this type of corruption is harder to sustain because of market pressure.

### **The Hard Budget Constraint Condition**

At all levels of government, fiscal budget constraints are relatively hard due to the declining tax revenues and the limited inter-governmental budgetary transfers under the fiscal revenue sharing schemes. The one exception concerns the state banking system, which has become the most significant source of the soft budget constraint for governments at or above the county level.

China's state banking system features a central bank supervising four major state specialized banks. The banking institutions in China evolved from the planning era in which the central bank and each of the four specialized banks established a branch in every province, municipality and county. Under regional decentralization, the regional governments at provincial, municipality, and county levels also gained great influence over credit decisions through the regional branches of the central bank and specialized banks. The local bank branches were under the "dual subordination" principle (*shuangchong lingdao*): They were subordinated to the banking hierarchy as well as to the local government. As reform proceeded, the latter carried more weight. *Ex ante*, the local governments 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.

The absence of a unified monetary system has allowed local governments access to credit in a way that has expanded the money supply. When all local governments behave in this manner, the result is inflation. Yet not one of them has an incentive to stop, as each province claims that overheating is caused by the other provinces, not by itself. This has the structure of the "tragedy of the commons" and is the main reason that the monetary system is a national public good: it must be controlled by a single authority, and best by a national one.<sup>31</sup>

### **The Case for Township and Village Governments**

In the Chinese governmental hierarchy, central, prefecture, municipality and county governments all have full-fledged authority to regulate the market through administrative methods. But township and village governments have very limited authority because historically their responsibility was confined to agriculture and rural governance and they had no control over state-owned enterprises (SOEs) and had no access to the state banking system.

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<sup>30</sup> Though the details differ, this pattern was repeated in 1986 and 1987.

<sup>31</sup> This conclusion is standard in the fiscal federalism literature. See e.g., Oates, Wallace. *Fiscal Federalism*. New York: Harcourt, Brace, Jovanovich. 1972.

These institutional constraints have made the township and village governments somewhat different from the higher level governments: Township and village governments operate under a hard budget constraint and in the absence of trade barriers. Both conditions were somewhat relaxed, however, for higher level governments in China. In this sense, the Chinese federalism seems to better approximate a market-preserving one at the township and village level than at the higher level.

One result of China's reform is the spectacular growth of the market in the flourishing sector of township-village enterprises (TVEs), which are owned by township and village communities and controlled by township and village governments.<sup>32</sup> By the end of 1993, TVEs produced 30% of the total industrial output in China. This remarkable success of TVEs can be understood from the incentives facing these firms. First, the structure of these firms afford residual claim rights (in essence, the rights to profits) to township and village governments. Second, two forms of limits are imposed upon the township and village governments and their firms. The first limit is that these governments do not have the authority to enact protectionist policies. They cannot use political means to protect their firms, for example, by erecting trade barriers to keep out competition. The second limit is a hard budget constraint. Not only may they go bankrupt, but the local governments, in contrast to the central government which can print money, cannot endlessly bail them out. In 1989, for example, about three million TVEs went bankrupt or were taken over by other TVEs. In the same year almost all loss-making state-owned enterprises were bailed out by the state (*People's Daily*, Overseas Edition, March 23, 1990). Furthermore, total credit going to the TVE sector was no more than 8 percent of the total outstanding loans, despite the fact that this sector produced more than 25 percent of total industrial output at the time (*Almanac of China's Finance and Banking*, 1992). This shows why TVEs and SOEs are so different. Although both are "owned" by governments, their incentives and hence their behavior are far different.

### **Durability and Irreversibility of Federalism, Chinese Style**

Decentralization began with the delegation of considerable economic authority to local governments. These governments assumed primary authority over economic matters within their jurisdiction. We have also suggested that the reforms have provided considerable limits on the discretion of the central government. They are also often associated with the emergence

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<sup>32</sup> A burgeoning literature studies this topic. See, e.g., Byrd, William and Qingsong Lin, eds., *China's Rural Industry: Structure, Development and Reform*. Oxford University Press, 1990; Nee, Victor and Su Sijin, "Institutional Change and Economic Growth in China: The View from the Villages," *Journal of Asian Studies*, 1990.49; Oi, "Fiscal Reform"; Qian and Xu, "Why China's Economic Reforms Differ"; Weitzman, Martin and Chenggang Xu, "Chinese Township-Village Enterprises as Vaguely Defined Cooperatives," *Journal of Comparative Economics*, forthcoming 1994; Chang, Chun and Yijiang Wang, "The Nature of the Township Enterprise," forthcoming, *Journal of Comparative Economics*, 1994; Walder, Andrew, "The Varieties of Public Enterprises in China: An Institutional Analysis," mimeo, Harvard University 1994; Che, Jiahua and Yingyi Qian, "Boundaries of the firm and Governance: Understanding China's Township-Village Enterprises," mimeo, Stanford University, 1994.

of strong regional economic powers, such as Guangdong province. These limits seem to endow the reforms with a degree of durability, making reversal more costly, if not impossible. We show this by examining three events after the Tiananmen Square uprising in 1989.

**(1) After Tiananmen Square, 1989-1991.** The single best indication of the linkage between durability of reform and decentralization concerns the events following Tiananmen Square, especially between 1989 and 1991 under the austerity program. During that period, the conservatives gained the most political, ideological, and military power for a possible reversal. Li Peng tried to recentralize investment and financial powers from the provinces but failed. The governor of Guangdong refused, and many other governors followed.<sup>33</sup> But this is only a part of the story.

This incident suggests the striking new power of local governments to shape decisions by the central government. On several previous occasions when the economy faced difficulties (for example, in 1962 and in 1981), Chen Yun, an advocate for central planning, succeeded in compelling the provincial governments to "help the central government overcome the difficulties," that is, to turn over more revenue to the central budget. In contrast, Li Peng's attempt to do so following Tiananmen Square failed. This contrast illustrates our point: The limits on the discretion of the central government provides for the durability of reforms.

Five considerations support this claim. First, by this time, the price to be paid for recentralization had grown. In order to recentralize, the central government would have to undertake substantial new obligations by providing social safety net expenditures. A major retrenchment would increase the regime's financial obligations at precisely the time when the economy would be shrinking as firms successful under markets withered under the retrenchment. This raises immediate financial problems: how would these obligations be financed? Fiscal problems of this magnitude raise the specter of the former Soviet Union's failure, surely a possibility to be avoided. Further, a major retrenchment would risk considerable social problems.

Second, some regions have already accumulated sufficient wealth in a way that the central government can not easily take away because the regional governments followed a strategy of "storing wealth in people and in enterprises." The regional governments also have greater vested interest in continuing the reform.<sup>34</sup>

Third, incentive structures within the government and the Party have altered considerably. In advanced regions, many officials no longer care to be promoted to posts in the higher level government.<sup>35</sup> For example, in Guangdong province, township officials do not want to be promoted to the county level, municipal officials do not want to be promoted to the provincial level, and provincial officials don't want to be promoted to the central government. The main reasons are, the lower the level of the government, the more autonomy the officials enjoy,

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<sup>33</sup> Shirk, *Economic Reform in China*.

<sup>34</sup> Paralleling these problems is the substantially diminished reach of the central planning system. Put simply, the central government no longer has the administrative apparatus to monitor and plan the economy as necessary under the older system.

<sup>35</sup> Shirk, *Economic Reform in China*.

which also translates into the higher financial benefits. This strikingly contrasts with the earlier period in which promotion up the Party ladder was desired by most individuals.

This difference reflects an important change in political incentives. Local political officials are now far less beholden to the central authorities. In the past, central authorities retained a variety of incentives to control the behavior of lower officials: fiscal control of local government operations allowed them to manipulate local decisionmaking, and individuals were promoted for appropriate behavior and punished for behavior deemed inappropriate. Each of these has been weakened under the current arrangements. Although the central government retains control over the army and the appointment and dismissal of high level personnel, the power of these tools are weaker than when they were combined with the more micro-level incentives employed during previous eras.

Fourth, the fall of socialism in Eastern Europe and the former Soviet Union has had an important impact on China. China's immediate reaction to the collapse of these communist regimes was recentralization, but the Chinese government soon realized that its legitimacy could only be sustained by economic growth. A reversal of the reforms that cut off access to international markets would result in significant shrinking of domestic production and unemployment, thus dramatically increasing the demands on the central government. An outright reversal of the reforms would thus greatly expand the central government's fiscal commitments while dramatically contracting the economy, putting the regime at risk. Complementing this financial incentive is the economic stake due to openness to the international market, in particular, pressure from the booming East Asian neighbors. Further, the sheer growth of the market economy makes the imposition of a new round of central control of the economy difficult, if only because the central government no longer retains the capacity to monitor the vast new economy.

A final aspect of the reforms, as is often claimed, is that a majority of Chinese people have seemed to gain under the reforms, including farmers, workers, and even most bureaucrats. A widespread feeling that reforms have made people better off provides a large limit against any regime that would attempt to reverse them.

**(2) Deng's southern tour, 1992.** The above evidence suggests that the reforms were not reversed after the Tiananmen Square incident in part because of the increased political power of local governments. Amid the political deadlock within the central government at the end of 1991, Deng Xiaoping made his now famous southern tour to the province of Guangdong. Among his stops were several special economic zones. Using the regional support for continued reforms, Deng's visit tipped the political balance at the central government. This resulted in the central government's official declaration in October 1992 to build a "socialist market economy."<sup>36</sup> Ending the deadlock revealed two interrelated elements about the security of the reforms. First, it indicated that the immediate threat to the reforms after Tiananmen had failed. Second, the failure of the retrenchment revealed that the reforms were protected by a degree of durability.

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<sup>36</sup> It should be noted that reforms in many southern regions went ahead despite actions from the central government during the period of 1989 and 1991.

**(3) Rationalization and institutionalization, 1993-1994.** Further evidence for the durability of the reforms and decentralization is provided by the recent controversies over recentralization.

In the process of transition from a planned to a market economy, certain types of overshooting in decentralization have not been avoided. Several problems have thus emerged from the lack of central authority, raising calls for a recentralization. The crucial question is, will the central government use the occasion for centralization and reversal to the old system, or will it have to justify its action as an integrated part of more reforms, that is, a process of rationalization of market institutions? We provide two examples below indicating the latter path.

In the first half of 1993 the economy seemed to become "overheated," reflecting problems of macroeconomic imbalance similar to those experienced in 1988. This caused instability in the foreign exchange market. At first, the government attempted to control the exchange rate through administrative methods by imposing a ceiling, but this failed. The market exchange rate was later stabilized in July 1993 when the central bank sold dollars rather than imposing ceilings. This intervention was followed soon by the implementation of foreign exchange reform on January 1, 1994, which unified the previous official and market rates and essentially achieved trade account convertibility.

Second, amid the continuing decline of central government revenue as a proportion of GDP from 31 percent in 1978 to 15 percent in 1992 (within-budget consolidated revenue), the call for an increase of government revenue comes together with a proposal for enacting a more formal system of fiscal federalism, which was implemented in January 1994. The new fiscal system, which resembles that in the United States, establishes a two-tier tax administration system (national and local) that separates taxes into national, local, and shared taxes. It also simplifies tax rates and makes them more uniform. Furthermore, rule-based transfer formulae are being studied for possible implementation in the future. The reason for such a shift toward a formal fiscal federalism is that it appears impossible (prohibitively costly) to collect more revenue through methods of centralization, and fiscal federalism is the only alternative that will satisfy both central and local governments. Importantly, it holds the promise of resolving the problems of an overly weak central government without removing the beneficial effects of the decentralization. A direct recentralization, in contrast, would threaten to remove this essential political component underlying the success of the economic reforms.

**Summary.** A range of factors contribute to the durability of the reforms, limiting the discretion of the central government to attempt a reversal. First, as a result of the reforms, new, rival power centers have emerged in China. Local governments, particularly those in areas with the largest growth, now have substantial independent sources of revenue, authority, and political support. Second, although local officials are still appointed and dismissed by the central government, their authority is implied and enhanced by their access to and control of local information and resources (e.g., in the case of "extra-budgetary revenue"). Third, the gradual decline of the personal authority of national leaders and the rise of local governments has weakened the reach of the Chinese Communist Party into the lower levels of government, and many lower government officials now bestow their loyalty to localities, not the central government. Fourth, as the private market economy has expanded, the ability of the central

government to monitor and control local economic behavior has weakened enormously. Finally, as noted above, any attempt by the center at economic retrenchment would strain its financial capacity, raising the specter of the fall of the Soviet Union.

These changes have endowed the economic reforms with a degree of political durability. Each serves to raise the costs of a recentralization of political authority and an economic retrenchment, although this effect was often unintended. The short-lived attempt at recentralization following Tiananmen Square is consistent with this logic, as are the recent institutional and tax changes reflecting an attempt to correct for over-shooting in decentralization. Our argument does not imply that a retrenchment is impossible, but that it would be costly and might fail, thus making it less likely.

#### 4. The Effects of Federalism, Chinese Style

The economic approach to market-preserving federalism outlined in section 2 yields predictions about economic performance following the onset of federalism. We now turn to investigate some of the varied economic responses to federalism, Chinese style, over the past fifteen years.

Economic policymaking by provincial and local governments reveals a wide range of behavior over the past fifteen years. Many areas initially chose to remain unchanged. Others sought to reinforce the status quo. Still others, of course, chose the path of reform. Moreover, this pattern of policy choice has not remained stationary but has changed over time, in part reflecting the emerging evidence about the consequences of the different policies. Competition among jurisdictions is evident in many forms. Below we present some details.

##### **Competition Among Jurisdictions: Experimentation, Learning, and Imitation**

Following the predictions of the economic approach to federalism, jurisdictions in China initially chose different policies. As the results became known, those with inferior policies then adopted the superior ones. First, failed experiments were discarded while successful ones were expanded and imitated. Second, a large range of seemingly puzzling results have emerged that appear inconsistent with marketization. Many governments pursue strikingly interventionist policies, for example, by erecting trade barriers and preventing competition from firms from neighboring provinces. Moreover, there are widespread reports of over-competition. How are we to make sense of all this? The following series of cases reveal patterns consistent with the theory developed above.

(1) **Heilongjiang's "Project 383."**<sup>37</sup> Bordering Russia, Heilongjiang is China's most Northeastern province, and a conservative one. In an effort to demonstrate their dedication to the old system, Heilongjiang's officials announced "project 383" in 1989. This policy was designed to achieve a significant reduction in the rate of price increases (from 17 percent in the previous year to 13 percent) for the 383 goods in the official basket used to calculate the inflation index. The policy proved very costly and produced a political reaction in which many in the government (and the public) criticized it; for example, members of the financial

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<sup>37</sup> Source: "Heilongjiang Province implements Project 383 to control prices," *Price Theory and Practice*, July, 1990.

bureaucracy. The contrast with Guangdong was apparent to all. Guangdong had freed prices on the same set of goods. Due to reforms, prices had fallen. Guangdong's policies had thus achieved the same results but without significant financial participation by the government. Reports from economists suggest that project 383 has been abandoned.

This episode represents an important instance of the learning that takes place during the experimental process. Given its goals and expectations, Heilongjiang initiated project 383. It decided that the project was a failure, not because it changed its goals, but because market methods had proved more effective.

**(2) Two prefectures.** The process of choosing different strategies followed by comparing results, and the adoption of the superior strategy occurred in two similar prefectures just across the provincial border, Shaoguan in Guangdong and Binzhou in Hunan.<sup>38</sup> When reform was first adopted in Guangdong in 1980, many commodity prices in Guangdong rose above those in Binzhou since the reform was not carried out in Hunan. As a result, resources were attracted to Guangdong from Binzhou. The Binzhou government set up tax offices on the border in an attempt to stop this outflow. These attempts did not bring prosperity to Binzhou. Years later when the people in Binzhou compared themselves with their neighbor, Shaoguan, they found that, although both had similar initial economic conditions, Shaoguan had significantly benefitted from economic reform in Guangdong. People in Binzhou urged that they join the reform in Guangdong.

In 1988, the central government allowed Binzhou to adopt some reform measures. This enabled Binzhou to enjoy the benefits of opening markets to Guangdong. The prefecture government withdrew all its tax offices along the border with Guangdong. Soon the adjacent areas between Binzhou and Guangdong boomed and interregional trade reached a record level. Importantly, the Binzhou government obtained far more tax revenue from these businesses than from those border tax offices.<sup>39</sup>

**(3) Coordinating labor flows.**<sup>40</sup> China's floating labor population, estimated variously between 60 and 100 million workers, is so large that it can overwhelm the ability of local governments to provide basic services, such as water, food, sewage, transportation, security, and housing.<sup>41</sup> In part, due to the congestion caused by these migrants, several provinces have begun to manage and coordinate these flows.<sup>42</sup> For example, in early 1992, Guangdong,

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<sup>38</sup> *Economic Daily*, 1991.11.25.

<sup>39</sup> Stories of this type can be replicated manyfold. As an additional example, we note the comparison of Nanyang and Xiangfan, two cities in Henan and Hubei provinces, respectively. The latter made much faster progress, and when this was reported in the *Economic Daily* in 1984, the former designed a new set of developmental programs to learn from and imitate the advanced regions. Five years later, the city was ranked as one of the best among middle and small size cities within the nation (*Economic Daily*, December 6, 1991).

<sup>40</sup> Sources: *Economic Daily*, 1991.5.15. and 1992.7.4; and *Outlook*, 1993.2.22.

<sup>41</sup> See e.g., Solinger, Dorothy. "The Floating Population as a Form of Civil Society," Paper for 43rd Annual Meeting of the Association for Asian Studies, New Orleans, April 11-14, 1991.

<sup>42</sup> Undoubtedly there are other factors underlying these policies, for example, keeping the

Hunan, Guangxi, and Sichuan established an interregional labor coordination center to help coordinate labor movements among these four provinces. Under the new regulations, migrant workers in Guangdong must obtain approval from labor management organizations of their home province. Guangdong, in turn, agreed to provide labor demand information to the other three provinces.

A comparison of labor flow into Guangdong and Shanghai reveals the effect of these organizations. For both areas, the labor inflow of 1993 was the largest in history. Yet the two regions responded very differently. In Guangdong, transportation was much more in order than in previous years. The crime rate dropped sharply compared with the same period (spring) of the previous year. Many firms provide their own transportation for workers hired from other regions. Likewise some local governments of other provinces also provide transportation for workers from their regions. In contrast, large numbers of migrants flowed into Shanghai trying to find work in the recently established Pudong Developmental Zone. The development zone only needed approximately 500,000 to 600,000 workers. But the labor arriving in Shanghai on the two days of January 31 and February 1 more than doubled this figure. Many people were detained in the train station or on the streets. On January 31, the Shanghai municipal government sent an emergency request to neighboring provinces asking them to stop labor flowing to Shanghai. In the meantime, Shanghai started to deport those migrants who could not find jobs.

The difference between these two regions occurred in part because Guangdong had experienced the large amount of labor inflow much earlier than Shanghai. Therefore, Guangdong and its neighboring provinces have learned much more about the markets and what they can do about it. The market capacity appears to have reached a sufficient scale in Guangdong so that organized labor markets will pay off.

### **Competition Among Jurisdictions: Factor Mobility**

Beyond experimentation and imitation discussed above, there is a more explicit type of competition for resources, particularly labor and foreign capital. And here too localities with more efficient economies outcompete less efficient ones.

**(1) Organized labor export and capital import in Sichuan Province.** Evidence of labor mobility is striking. Although many restrictions remain on migration, the floating labor pool is enormous by any standard.<sup>43</sup> Labor moves from areas of surplus to areas of need. An interesting story concerns labor export from Sichuan province.<sup>44</sup> Total labor exported from this province has reached 3 million per year. Remittances from migrants have totaled as much as 3-5 billion yuan annually, accounting for ten percent of net farmer income in the province. Provincial authorities have attached great importance to labor export. The vice governor of Sichuan province pointed out that labor export has become an important means of developing

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benefits of local services (such as education) for local residents. Moreover, under other circumstances, these mechanisms could be used to cartelize labor markets, or for other political purposes.

<sup>43</sup> Solinger, "The Floating Population."

<sup>44</sup> *Financial Times* (China) 1993.3.9; *People's Daily*, 1993.1.2.

backward local economies. It requires less capital and yields quick and high returns. Individuals leave with nothing and return with what is, by local standards, a fortune. Their annual incomes are largely higher than 1000 yuan, and some have assets over 1 million. They bring back capital to invest in the local economies, promoting the local economy and township-village enterprises.

To foster the process of labor export and capital import, the Sichuan provincial government established a labor development office headed by the vice governor. Different levels of local government authorities established organizations that are responsible for managing labor exports and the provision of training to improve skills. Some counties established county-township-village hierarchical labor service systems, providing auditing, monitoring services, and coordination with tax bureau and financial institutions.

**(2) Competition for foreign capital.** There is also considerable competition among regions – provinces, townships, cities, special economic zones and developmental zones – for foreign capital. Two of the main ingredients in this competition are: First, the laws, regulations, and taxes that promote economic development, including secure property rights and private returns (known as the "software"); and second, infrastructure (such as transportation and port facilities) and access to markets (known as the "hardware"). There are now over 1000 zones designed to attract foreign capital. And there is considerable evidence that foreign capital flows toward those areas where a high return is likely.

As noted in Section 3, not only has foreign investment increased, but the share of regional control also increased dramatically. This is closely related to the recent trend which might be termed, "development zone" fever.<sup>45</sup> Under the efforts of several levels of local authorities, development zones mushroomed in the 1990s. According to the national bureau of land regulation, in 1991 there were only 117 development zones for the entire country. For 1992, it estimated the number to be 2,700.<sup>46</sup> In some cases, the cause for this development zone fever is that local governments try to attract foreign investment or business (so-called "building a nest to attract the phoenix"). In other cases, it is related to the emerging real estate business which is extremely profitable in China. This fever does not automatically turn on the flow of foreign investment, however. In many instances, there are not complementary, well-established facilities and other conditions that suit large amounts of capital investment. This puts pressure on the local governments to further improve infrastructure and complementary facilities.

### **Dynamics of Competition Among Jurisdictions: Trends and Momentum**

As discussed above, successful aspects of reform and marketization are being imitated in large numbers of areas in China. The divergence in success and prosperity of seemingly similar towns, cities, and regions fosters those who do worse to copy those who do better.

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<sup>45</sup> Sources: *People's Daily*, 1993.1.30; *South Weekend*, 1993.3.5; *Guangming Daily*, 1993.6.29.

<sup>46</sup> Among the new development zones, only 95 are approved by the various departments of central government. Most development zones were established by different local authorities, from provincial governments down to township governments.

Competition for factors implies that the various levels of government must provide secure promises to maintain reform and encourage investment.

To illustrate the trend in imitation of the successful areas, we discuss Shaanxi's learning from Guangdong's experience in opening trade.<sup>47</sup> The governor of Shaanxi province observed that the reason that Guangdong province achieved fast economic growth was that its markets were open and interregional trade was not blockaded. Shaanxi, in contrast, maintained considerable trade barriers, including large numbers of tax offices across its different counties and prefectures. In 1991, the provincial government released its control over 125 commodity prices and withdrew 12,289 tax offices. The commodity trade soon flourished. In the second half of 1991, the business tax of commerce increased by 20.1 percent over the same period of 1990.

The central government attached great importance to Shaanxi's experience. The State Council made copies of Shaanxi government's documents about its reform policy and sent them to other provincial governments. Many provinces, such as Gansu, Yunnan, Sichuan, Henan, Jilin, Ningxia, and Jiangsu, responded earnestly. Before long, Jiangsu established a "market guidance and coordination council"; Guizhou organized a "coordination team for market circulation reform." Many provinces have now incorporated the development of a market system into their socio-economic development plans.

As part of this effort, authorities from various regions are actively studying the political and economic arrangements within the most successful regions. For example, in 1991, Jiangsu province sent a group of 73 government officials to the southern part of Shaanxi province, which is a very poor area.<sup>48</sup> This is the first cross-province government official exchange. After one year, they helped many counties, organizations, and firms in that area establish cooperative connections with those in Jiangsu province. Due to their efforts, the southern part of Shaanxi has attracted more than 200 projects, including more than 10 million yuan and a range of different types of personnel from other regions. These officials also helped to train over 2200 local personnel; they provided information to local firms; and they helped promote these firms' sales on international markets. The official exchange enabled the rich province of Jiangsu to develop markets and resources in Shaanxi province.

## Summary

This section indicates that a range of behavior under the reforms is consistent with the predictions of market-preserving federalism. Experimentation, learning, and adaptation all follow from the inception of local political freedom over the economy. Local governments compete with one another for factors and in the international market for exports.

The illustrations provided in this section do not prove our hypothesis, for they are not a representative sample of behavior. They nonetheless provide a sufficient basis to establish the plausibility of our contentions.

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<sup>47</sup> Source: *Financial Times* (China), 1992.4.1.

<sup>48</sup> Source: *Economic Information Daily*, 1992.5.3.

## 5. Conclusions

The fundamental dilemma of an economic system is this: Not only does it depend on the political system for specifying and enforcing property rights and contracts, but it also depends on the political system to protect the market from political encroachment. The developed economies of the West learned to mitigate this problem long ago, and, for many purposes, economists can ignore them. But the same cannot be said for developing countries, particularly those with long histories of unconstrained government.

The central hypothesis of this paper is that the form of decentralization inherent in the reforms in China – what we have called "federalism, Chinese style" – provides an important set of limits on the behavior of all levels of government. By design, decentralization directly limits the central government's control over the economy. It also induces competition among local governments, serving both to constrain the latter's behavior and to provide them with a range of positive incentives to foster local economic prosperity.

The constraints of federalism, Chinese style, are especially important for China for a second reason. The other forms of credible limits on government typical of the developed west, notably, popular elections and a separation of powers, appear not to be politically feasible for China at this time. Consequently, federalism may be one of the few ways in which a large, non-democratic state can provide credible limits on its behavior.

The discussion in sections 3 and 4 reveals that a substantial range of economic behavior exhibited in China is consistent with our central hypothesis. These case studies illustrate the range of experimentation, learning, and imitation that has occurred in many areas of China. The observation of the results of particular experiments provides information to all provinces, not just the one conducting the experiment. These observations have changed expectations nation-wide. Yes, many individuals have gotten rich, as some had warned. But so too have many province, township, and village governments. This unexpected but striking fiscal power has played a significant role in the comparisons across jurisdictions, as several of the cases above illustrate. The remarkable ability of the reforms to generate resources for local governments has had substantial consequences. Not only did this allow them to provide for the welfare of its residents, often far better than nearby areas which had fought marketization, but it helped change the minds of many who were initially skeptical of reform.

The results of experiments have thus proved critical to the recent history of China. This in turn underscores the importance of the federalism with its institutionally created *absence* of a single government with monopoly control over the economy. When there is only one government and it claims that the market would fail to provide for citizen and social needs, who can credibly claim otherwise, especially in the presence of the obvious initial costs of marketization? In contrast, if many regions can choose policies for themselves, all can compare the results, including those which do not wish to initiate reform policies. The successive comparisons over the past fifteen years, in combination with other factors, such as the conservatives' failure in 1989-92, underpin the new push toward markets over much of China.

Our explanation overlaps with and departs from Shirk's important work. Like Shirk, we emphasize decentralization and the incentives of local governments in the success of economic

reform.<sup>49</sup> In comparison with our argument, Shirk places greater weight on the political organization of local governments and their control over the economy, arguing that local political officials should be viewed as creating systems of patronage and loyalty. We believe that there is considerable truth in Shirk's assertion. Because their approval is necessary for enterprises, and because their protection is part of the maintenance of enterprise property rights and contracts, local governments play a more central role in the economy than local governments in Western Europe or the United States.

Nonetheless, Shirk's argument about particularism and patronage requires qualification. As stated, it applies in broad form to the patronage systems common in Latin America and Africa. And yet those economies have performed, respectively, poorly and abysmally. Missing from Shirk's approach is an explanation of the limits on the degree of economic extraction of local governments in China, without which there would be no spectacular economic success.

Our approach suggests an answer: The system of federalism and the inherent jurisdictional competition places striking limits on this system of patronage and political spoils. So too does competition on the international market. Were particularism and patronage in a particular locality to place onerous restrictions or burdens on these firms, they simply could not succeed in international competition. China's striking economic success suggests that local government particularism differs significantly from that in Latin America and Africa. These issues are worth further research.

Before concluding, we briefly discuss some of the limits of our analysis. First, the evidence provided in sections 3 and 4 is intended to demonstrate the plausibility of our approach; it does not represent a systematic empirical test. The latter would require further analysis and more systematic data from an appropriately constructed sample of provinces, but no such data is available at this time. Second, although our approach does not rely on arguments about Chinese culture, we do not imply that Chinese culture is irrelevant. Undoubtedly culture is central to the ability of individuals and groups who have taken advantage of new opportunities under reform. Our argument emphasizes that Chinese economic success reflects in part institutional changes. A more complete approach would show how to integrate our institutional analysis with the relevant aspects of Chinese culture.

China's transition toward a market system is at a critical moment. The success of the past fifteen years' reform is a tremendous asset, not only in terms of economic benefits achieved, but also in terms of political institutions restructured. On the other hand, the institutional foundation underpinning a secure market system in China is far from rationalized and secure. We have discussed problems that arise from too weak a central government: internal trade barriers and soft budget constraints of various levels of government are just two phenomena that reflect such a problem. It is fortunate for China's economic success that both are less a

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<sup>49</sup> Shirk's more extensive discussions allow her to treat a much wider range of topics central to the reforms success, for example, the importance of gradualism, the initial role of agrarian reform, and the political mechanisms underpinning reform within the central government. See Shirk, *Economic Reform in China*, and Susan Shirk, *How China Opened Its Door*. Washington, DC: Brookings, 1994.

problem for the township and village levels of government in China. But there are also problems from a central government too strong. And this is the danger of recentralization *per se*. 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.