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

Barry Weingast[1], Yingyi Qian[2] and Gabriella Montinola[3]

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

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The remarkable success of China's economic reform is built on a solid political foundation. That success has been made possible by a considerable degree of credible commitment to markets achieved through institutional reforms that we have called "federalism Chinese style." Because these reforms are endowed with a degree of political durability, they provide a significant amount of protection to the market from unwanted political intrusions. Political decentralization, in turn, has provided individuals and local governments with the incentives to pursue economic prosperity.

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

Gabriella Montinola, Yingyi Qian, and
Barry R. Weingast

Executive Summary

The remarkable success of China's economic reforms seems to defy conventional wisdom. Not only does economic reform appear to be successfully pursued without fundamental political reform, but 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. Without political reform, economic returns remain at the mercy of politics. 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.

The actual performance of the Chinese reforms provides a striking contrast to these expectations. 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, its concern with political discretion asks the right question. But an inappropriate definition of political reform leads to the wrong conclusion about political discretion. In fact, 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.

Along the important — and, to many, the paramount — dimension of political reform, democracy, China has made little progress. But along other political dimensions, China has made fundamental reform: First, political decentralization has not only enhanced the powers of local government, it has altered center-local government relations in several critical ways that would prove difficult — though not impossible — to reverse. Second, underpinning the reforms is a major shift in ideology, moving from a dogmatic focus on the Maoist version of Marxist-Leninism to a pragmatic, market-oriented approach. Although much of the rhetoric of socialism has been retained (for example, 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.

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 the economic reforms, including strong new limits on the central government. Viewed from the perspective of the individual, this system differs considerably from federalisms in the developed West. Federalism in the West is nearly always associated with political freedom and the protection of individual rights.

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. Importantly, the latter have gained primary control over economic matters within their jurisdiction. And, critically, there is an important degree of political durability built into the system that limits the ability of the central authorities to reverse these political reforms.

The Chinese system provides a partial basis for a special kind of federalism called *market-preserving federalism*. Two features are central to the success of market-preserving federalism. First, an important element of political durability is built into the arrangements, meaning that the decentralization of power inherent in the system of federalism is not merely at the discretion of the central political authorities. Second, the incentives created by political decentralization have fundamentally changed the relationship between all levels of government and the economy. At the national level, the government has greatly reduced the scope of the planned economy. At the local level, political reform provides governments with the incentive to foster the economic prosperity within their jurisdictions, a central feature of the Chinese economic success.

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 current problems and solutions to them. The absence of private property rights and a commercial law is one, as many have noted. So, too, is the absence of the appropriate political underpinnings of an internal common market. This, in turn, explains why a good deal of local governments have focused on trade barriers and aggressive anti-market policies within their jurisdiction. Finally, political decentralization has yet to be institutionalized to ensure its long-term stability. These limitations should not be seen as economically debilitating, but rather as problems that need to be addressed in the near future.

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

Gabriella Montinola, Yingyi Qian, and
Barry R. Weingast*

February 1994

> "The fundamental dilemma of economic development [is,] how does one get the state to behave like an impartial third party?" North (1990,58)

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.

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- 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 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 (McKinnon 1991, North 1981,1990, Root 1993, Weingast 1993). 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 (see, e.g., Hartford, 1985, and Saich, 1991). And, on this important component of 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. 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.[1] 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

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[1] Federalism in the West is nearly always associated with political freedom and the protection of individual rights. See Weingast's (1993a) for details of these federalisms, including a discussion of how federalism provided the important political foundations for the impressive economic growth of England in the 18th century, and the United States in the 19th century.

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* (Weingast 1993a; see also McKinnon 1993). 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.

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 economic theory of federalism and is divided into two parts. The first examines the necessary political foundations of federalism while the second examines the economic consequences of federalism. Section 3 turns to federalism, Chinese style, and describes China's political and economic decentralization in greater detail. It also examines what has and has not changed in China. Section 4 then turns to the effects of reform in China. Our approach reveals how considerable order can be made of 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. The final section 5 concludes with remarks on the direction of China's future reforms.

2. The Theory of Market-Preserving Federalism

Institutional foundations for credible commitment

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 (North 1990, Weingast 1993a). 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. This occurs when the government continues to bail out or subsidize troubled institutions and agents.[2] Lack of 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 (McKinnon 1993).

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 (Weingast 1993a).

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

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

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. These encompass a special set of institutional arrangements:

(1) There exists a *hierarchy* of governments, e.g., a national government and a set of subnational governments.

(2) A *delineated scope of authority* exists between the national and subnational governments so that each government is autonomous in its own sphere of authority.

(3) An institutionalized degree of *autonomy* imposes strong limits on the discretion of the national government so that credible mechanisms provide durability to this distribution of authority.

(4) The subnational governments have primary *responsibility over the economy* within their jurisdictions. Further, a common market ensures the mobility of goods and factors across regions.

(5) These governments face *hard budget constraints.*

These conditions represent an 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 (McKinnon 1993, Montinola, Qian, and Weingast 1994, Weingast, 1993a).

Conditions 1 and 2 are defining characteristics of federalism and thus the minimal necessary conditions for federalism. But this formalized type of decentralization alone does not generate federalism's market-preserving qualities. These require the addition of constraints 3 through 5.

Condition 3 provides for credible 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.

From the perspective of preserving market incentives, the authority of the national government is limited to policing the common market across regions (condition 4) and providing national public goods, which should not be left to the subnational level governments (like 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 4). Without condition 4, each subnational government would become a *de facto* "national government" in its jurisdiction, and its discretionary authority over the economy again deprives its ability in making credible commitment. Condition 3 thus enhances the value of condition 4. 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 3) to compromise the system of federalism and then to intervene.

The constraint of condition 5 has two parts, one for the national government and one for 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 positive 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.

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.

The effects of market-preserving federalism[3]

The most important effect of market-preserving federalism is the induced competition among jurisdictions. 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 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 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 (McKinnon 1993). 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 plays an important role in the political foundations to markets (Weingast 1993a). 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

[3] This section summarizes an extensive literature in economics, including the classic work of Tiebout and Oates. For a review of this literature, see Rubinfeld (1987).

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 imposed 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 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 (Krugman 1991). 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.[4] 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 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 over-grazes 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

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[4] For example, the common market in early 19th century United States could not have been sustained without the ever-vigilante 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 (Weingast 1993b). Similarly, such barriers are a major reason underlying the movement for economic and political union in Europe (Garrett 1993).

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, it 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 several levels of government. This says nothing about an explicit or constitutional basis nor whether it is designed to promote individual rights and political freedom.

These differences between Western and Chinese federalism 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 fiscal incentives, reliance on market mechanisms, and a new openness to international markets. These features generate far reaching consequences for political institutions and economic performance.[5]

General tendencies of decentralization. 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

[5] Qian and Xu (1993) 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.

industrial output of state-owned enterprises controlled by the central government was less than one-half of the national total (Wong, 1987). In the automobile industry, almost all enterprises in Eastern Europe and the Soviet Union were directly controlled by the central government, and the number of such enterprises was rather small. In China, by contrast, there were 58 enterprises making automobiles before the reform, most of which were controlled by the local governments (Wang and Chen, 1991). 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 (Qian and Xu, 1993). For example, there are more than 100 color television assembly lines, and every province has at least one. The number of enterprises making automobiles increased from 58 to 116 in 1987 (Wang and Chen, 1991).

Decentralization in the 1980s has consequences far beyond the simple delegation of control rights of existing state-owned firms to lower level governments. Unlike previous decentralizations which were carried out within the general framework of the planning system, 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. As table 1 reveals, the total foreign investment in China increased from $4.5 billion in 1985 to $19.2 billion in 1992. 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).

Governments in each region have assumed primary responsibility for economic development in that region, be it province, municipality, county, township or village. Many reform policies were delegated to provinces and local governments. Take the example of price reforms. China did not liberalize prices in one stroke. The dual price system is a common practice in China, 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.

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.[6] 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 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 political authority to them that paralleled that granted earlier only to special economic zones. Similarly, many inland cities, which did not qualify as either special economic zones or coastal cities, established numerous "development zones" inside their region to enjoy part of the tax benefits and autonomy. 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.

The role of township and village governments. Nothing is more spectacular than the flourishing sector of township-village enterprises (TVEs), which are owned by township and village communities and controlled by township and village governments.[7] By the end of 1992, TVEs produced approximately one-quarter to one-third of the total industrial output in China. From the very beginning, TVEs have been outside the state planning sphere and are therefore market-oriented.

Several characteristics play a role in the remarkable success of TVEs all of which center on the incentives facing these firms (Qian and Xu, 1993). First, the structure of these firms afford residual claim rights to local governments (i.e., township and village governments). Second, two

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[6] Hainan was added as the largest special economic zone when it was organized as a separate province in 1987.

[7] A burgeoning literature focuses on this topic. See, e.g., Byrd and Lin (1990), Chang and Wang (1993), Nee (1991), Oi (1992), Qian and Xu (1993), Rozelle (1992), Walder (1993), and Weitzman and Xu (1993).

forms of limits are imposed upon the township and village governments and their firms. The first 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. The second limit is that these governments do not have the authority to enact protectionist policies. They cannot use political means to subsidize or protect their firms, for example, by erecting trade barriers to keep out competition.[8] This shows why TVEs and the SOEs of the central government are so different. Although both are "owned" by governments, their incentives and hence their behavior are far different.

We offer two pieces of evidence about these limits. Concerning the hard budget constraints, a large number of TVEs went bankrupt during the 1989-91 retrenchment. 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). Total credit going to the TVE sector was no more than 8 percent of the total outstanding loans, despite the fact this sector produced more than 25 percent of total industrial output (*Almanac of China's Finance and Banking*, 1992).

These observations suggest that township and village governments operate under a hard budget constraint and in absence of trade barriers. Both conditions were somewhat relaxed, however, for higher level governments in China during the 1980s and early 1990s.

Fiscal incentives: The fiscal contracting system. Starting in 1980, China implemented a fiscal revenue sharing system between any two adjacent levels of governments.[9] 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.[10]

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[8] In the Chinese organizational hierarchy, the county (which is above township) is the lowest level whose government has full-fledged authority to regulate the market through administrative methods. As a consequence, township and village governments have neither the authority nor the ability to erect trade barriers.

[9] See, e.g., Oi (1992), Oksenberg and Tong (1991), Wong (1992), and World Bank (1992).

[10] There were some attempts in the past to experiment with tax-for-profit schemes, but, with the revival of fiscal contracting schemes in 1988, the dominant form of fiscal system in China from early 1980 to the end of 1993 was the fiscal contracting system.

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 that had independent budget agreements with the center during 1988-1993 (Bahl and Wallich, 1992; see also Wong 1991,1992):

(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);
(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 most provinces and cities (29 of 35) they induce a 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 retention rate is regressive.

At the macro level, it is also interesting to note that during the reforms, the central fixed revenue (before sharing) increased from 21 percent of the total in 1981 to 39 percent in 1991. At the same time, the expenditure of the central government decreased from 54 percent of the total in 1981 to 40 percent in 1991 (*China Statistical Yearbook*, 1992). These changes yield three implications: first, local governments have assumed more responsibility; second, the net transfer from local to central governments has been reversed (local governments now subsidize the center); and third, the total net transfer has become relatively small.

By way of summary, these changes provide for substantial independence of the governments in China, from the provincial to the township. They not only possess significant fiscal autonomy from the central government, but 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 right to all residuals "earned" by producers, typically using this authority to take resources from those firms with positive earnings to bailout those with negative earnings. Under the modern Chinese system, all residuals earned by TVEs are retained by the local government.

4. Evidence and Interpretation

Our evidence and interpretations fall into five categories: durability and irreversibility; the effects of decentralization (competition among jurisdictions, experimentation, learning, and imitation); factor mobility; trends and momentum; and imperfections.

A. Durability and Irreversibility

Political decentralization began with the delegation of considerable economic authority to local governments. These governments assumed primary responsibility 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 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.

(1) After the Tiananmen Square, 1989-1991. The single best indication of 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 (Shirk 1993). 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.[11] 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. For example, when the government discriminated against TVEs during the austerity program in 1989-91, unemployment became a major issue, threatening social stability and the legitimacy of the regime. A substantial reversal of the reforms would raise these problems with a vengeance.

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.[12]

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 (Shirk 1993). 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

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[11] In 1990, there were even discussions among conservatives about the "recollectivization" of agriculture.

[12] 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.

promoted to the central government. The main reasons are, the lower the level of the government, the more autonomy the officials enjoy, 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 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, outside pressure puts additional limits on the central government. China's immediate reaction to the collapse of the communist regimes in Eastern Europe and the former Soviet Union was recentralization, but the Chinese government soon realized that its legitimacy could only be sustained by economic growth. Perhaps more central to government is the economic stake due to openness to the international market, in particular, pressure from the booming East Asian neighbors. 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.

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 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."[13] 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.

(3) Preparation for rationalization and institutionalization, 1993-94. 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.

Such a situation arose in the first half of 1993 when the economy seemed to become "overheated," facing problems of macroeconomic imbalance similar to those in 1988. Given the already decentralized economy, a mere return to the old planning instruments (say imposing credit quotas and exchange ceiling), even if feasible, would simply not be effective. The official press in this period was dominated by arguments from government officials about how to deepen reforms to solve these problems. First, a recentralization of monetary policy in July 1993 was followed immediately by a promise of banking system reforms à la the U.S. Federal Reserve System.

Second, amid a continuing decline of 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. The reason is that it is already impossible (too 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.

[13] 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.

Third, an attempt to regulate the exchange rate through administrative methods (by imposing a ceiling) failed in June of 1993. The exchange rate was later stabilized by market intervention in July 1993 (the central bank selling dollars rather than imposing ceilings), which was followed by discussions of possible trade account convertibility in the near future, another factor potentially limiting the discretion of the central government.

B. Competition among jurisdictions, experimentation, learning, and imitation.

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. First, as the results of the divergent policies became known, policies evolved. Failed experiments were discarded. 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, erecting trade barriers, preventing competition from firms from neighboring provinces. Moreover, there are widespread reports of over-competition. How are we to make sense of all this?

In what follows, we provide a series of cases revealing patterns consistent with the theory developed above.

(1) Heilongjaing's "Project 383."[14] 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 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 the

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[14] Source: "Heilongjiang Province implements Project 383 to control prices," *Price Theory and Practice*, July, 1990.

government's financial participation. 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, Heilongjaing 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.[15] 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.[16]

(3) Coordinating labor flows.[17] 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,

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[15] *Economic Daily*, 1991.11.25.

[16] 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).

[17] Sources: *Economic Daily*, 1991.5.15. and 1992.7.4; and *Outlook*, 1993.2.22.

such as water, food, sewage, transportation, security, and housing (see, e.g., Solinger 1991). In part, due to the congestion caused by these migrants, several provinces have begun to manage and coordinate these flows.[18]

For example, in early 1992, Guangdong, 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, should provide labor demand information to the other three provinces.[19]

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 last 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 Huangpu developmental zones. 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 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

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[18] Undoubtedly there are other factors underlying these policies, for example, keeping the 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.

[19] As another illustration, provinces such as Hunan, Sichuan, Henan and Jiangsu have established official labor relations with specific metropolitan construction and service industries. Some provinces and prefectures have set up organizations in large cities, such as Beijing, to manage labor exports from their areas.

market capacity has reached a certain scale in Guangdong so that organized labor markets will pay off.[20]

(4) Organized labor export and capital import in Sichuan Province. An interesting variant on the public goods story concerns labor export from Sichuan province.[21] Total labor exported from this province has reached 3 million per year. Remittances 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 backward local economies. It requires less capital and yields quick and high returns. Individuals leave with nothing and return with 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.

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[20] In the late 1980s, Guangdong experienced "blind" labor flows. At that time, the government tried to prevent local firms from hiring workers from other provinces. It ruled that firms were not allowed to hire workers from other provinces without government approval. The reasons for this attempt were twofold. First, there seemed abundant surplus labor within Guangdong; and second, Guangdong was short of food and millions of inflowing laborers would consume 750 million kg more rice. Moreover, in 1988, neighboring provinces blockaded their rice outflows, resulting in a marked rise in rice prices. Yet the attempt failed. Many firms claimed that they originally wanted to abide by the regulations. But they found that workers recruited from the inner areas of Guangdong tended to be of poor quality, had low literacy rates, and often demanded high wages. In contrast, workers from other provinces were cheaper, usually better educated and much more efficient. In the end, Guangdong firms agreed to hire some local workers, but also gained the ability to hire migrants. Moreover, the new labor coordination mechanisms allow smoother inflows and seem less likely to overwhelm local systems of public goods and social services.

[21] *Financial Times* 1993.3.9; *People's Daily*, 1993.1.2.

C. Factor mobility and competition among jurisdictions.

Competition among jurisdictions is evident in many forms. Several of the cases discussed above illustrate this. Jurisdictions initially chose different policies, the results became known, and those with inferior policies then adopted the superior policies. Beyond this type of experimentation and imitation, 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.

Evidence of labor mobility is striking. And though many types of restrictions remain on migration, the size of the floating labor pool is enormous by any standard (Solinger 1991). Labor moves from areas of surplus to areas of need.

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; and second, infrastructure (such as transportation and port facilities) and access to markets. 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.

Table 1 presents foreign capital inflows to China between 1985 and 1992. 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.[22] Under the efforts of different 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.[23] 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,

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[22] Sources: *People's Daily*, 1993.1.30; *South Weekend*, 1993.3.5; *Guangming Daily*, 1993.6.29.

[23] Among the new development zones, only 95 are approved by the the various departments of central government. Most development zones were established by different local authorities, from provincial governments down to township governments.

well-established facilities and other conditions that suit large amounts of capital investment. Further, once the investment to set up development zones is made by local governments, they often have little bargaining power with foreign capital holders, especially given the competition from other zones. As a result, terms have become extremely favorable for foreign investors. Large amounts of hoped for rents fail to materialize. It is reported that only 2 percent of development zones established last year have actually been utilized; others have remained idle and most of them are arable land.

D. Trends and Momentum

As the discussion in several previous subsections indicates, 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. Competition for factors imply 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.[24] 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 barriers to trade, including large numbers of tax offices across different counties and prefectures in the province. 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.

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[24] Source: *Financial Times*, 1992.4.1.

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.[25] 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 millon 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.

E. Imperfections

The limited institutional structure of China's central government results in two economic problems: the inability to supply or control the provision of certain critical national public goods, notably, the monetary system and a common market. As noted above, the absence of a unified monetary system has allowed provincial governments access to credit in a way that has expanded the money supply. When all provincial 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.[26]

The absence of a common market implies that some areas have used their political freedom to maintain considerable trade barriers (Wong 1991). Further, the absence of centralized authority in particular areas — for example, commercial and property law; and monetary policy — implies failures in the decentralized economy and, ultimately, limits on China's economic growth.

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

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[25] Source: *Economic Information Daily*, 1992.5.3.

[26] This is standard in the fiscal federalism literature (Oates 1972).

production of 10,000.[27] 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 region level.[28]

Second, in 1985 Jiangxi province liberalized hog procurement.[29] As a result of 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 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.[30]

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.

A final issue is worth raising under the heading of imperfections, in large part because it is often listed as a major consequence of "over-competition." Not every development zone can succeed, nor every new firm. The process of competition implies that large numbers of new firms may well fail to find a market niche. And given that large numbers of new

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[27] *People's Daily*, overseas edition, October 11, 1993, p. 2.

[28] 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.

[29] Source: C. Wang, "Hog Production Problems in Jiangxi Province," *Economic Study*, May, 1988.

[30] Though the details differ, this pattern was repeated in 1986 and 1987.

provinces have recently joined the reform and development zone bandwagon, a wave of failures is likely to occur over the next few years. These failures will inevitably be accompanied by claims that the reforms have failed. Much of this will simply be the natural competition process in which a huge wave of new entrants appears at the same time, but which the market cannot sustain.[31]

5. China's Future

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 that system to limit itself to such tasks. The developed economies of the West learned to mitigate these problems 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 economic reforms in China — what we have called "federalism, Chinese style" — provides an important set of limits on the behavior of all levels of government. Decentralization directly limits the central government's control over the economy by design. It also induces competition among local governments, serving both to constrain the latters' 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 section 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

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[31] In this sense, the problems with building "too many" development zones have much in common with problems of building "too many" convention centers and shopping malls in the United States.

just the one conducting the experiment. These observations have changed expectations nation-wide. Yes, many individuals got rich, as some had warned. But so too did province, township and village. The unexpected but striking fiscal power plays no small a role in the comparisons that have been made, as several of the cases above illustrate. The remarkable ability of the reforms to generate resources for local governments 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 the reforms.

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.

In the remainder of this paper we discuss China's future: Where might it go from here? How can it alleviate some of the major problems that it currently faces?

Federalism, the third way: Beyond centralization vs. decentralization

China has benefitted greatly from decentralization during the 15 years reform, most notably in promoting incentives of individuals and local governments to pursue economic prosperity. This is made possible because of a considerable degree of credible commitment achieved through institutional reforms, what we have called federalism, Chinese style. These provide a degree of protection to the market from unwanted political intrusions, and thus the economy is no longer at mercy of a single politician's power.

Recently, however, growing regionalism and the loss of control by the central government has worried many policymakers, economists, and political scientists. Some have concluded that China's central government is too weak and that it should retake control over the economy to resolve these problems. Two Chinese scholars advance this perspective in a highly publicized recent report.[32] They argue that the decline of the ability of central government to raise revenue is the fundamental reason explaining two troubling phenomena: the decline in the central government's ability to regulate and promote the economy; and the gain by local governments of too much muscle, wielded at the expense of the central government.

In contrast to previous calls for recentralization, recent ones arise primarily from reformers truly committed to developing a market economy. They are concerned that the lack of central government control will prevent China from making a successful transition to a market economy and, in the worst case, will lead to economic collapse and the disintegration of the country.

Our paper provides a broader framework within which to analyze these problems. It suggests that the narrow focus on the issue of centralization versus decentralization is inappropriate. We argue that a third way, market-preserving federalism, is a better option for China. The fundamental issue for China concerns how to strike a balance between the central and local governments in a way that resolves some of the problems that have emerged without undoing the beneficial aspects of decentralization that have proved so critical to fostering market incentives and promoting growth.

Inefficiency from regionalism and the consequent formation of "dukedom economies" is not simply the result of local governments that are too powerful. It depends also on the lack of policing the common market across regions in combination with the failure to impose hard budget constraints upon local governments. The conventional wisdom, in contrast, holds that these phenomena result from too much authority held by the local governments. In one sense this is true — for the central authorities have chosen (or are unable) to enforce a policy of common market on China. And yet, recentralization per se is not the answer. Increasing central government revenue will have no effect on the two problems just noted. Instead, it will reintroduce the very incentive problems that decentralization has mitigated.

As the economy is moving away from a centrally planned system to a market system, the role of government in production, in the financing of investment, and in providing services must, of necessity, decline. Thus, the question is not how to prevent a precipitous decline in central government revenue — that is an obvious and desirable consequence of the

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[32] "State control is critical in drive to economic reform," by Wang Rong, *China Daily*, July 21, 1993, page 4.

move away from a centrally planned economy to a market-oriented one. The question instead concerns what categories of goods and services should the central government provide and how should it spend its money in ways that promote economic development and reform. In the case of China, the central government has perhaps not spent its money wisely. Money continues to pour into failing state owned enterprises and into new investments in manufacturing rather than in infrastructure.

What types of activities, goods, and services should the central government provide? As noted in section 3, it should focus on truly national public goods. And here we find a close parallel between the absence of central government activity and problems cited by the recentralizers, namely, protectionist local governments, and credit problems for local governments that lead to what some have called "overheating." Specifically, the central government should not recentralize per se, but should concentrate on increasing its authority in narrow but critical areas, namely, implementing a unified monetary policy (including limits on the access of local governments to credit) and policing the common market. Neither activity requires considerable revenue, but both are critical to the successful operation of federalism and a healthy market economy in China.

A third important component of the role of the central government at this stage of development in China is national infrastructure investment (or coordination of such investment) to reduce transaction costs in the common market. This will work against, though not resolve, regional disparities. The local governments should continue to have primary responsibility for regional development. When regional governments operate under a hard budget constraint and in a common market, competition among regions imposes limits on the behavior of local governments in a more effective way than the central government's direct regulation.

The three components of the central government authority, a unified monetary system, policing the common market, and investing in national infrastructure, together with continued economic growth, are the best guards against the disintegration of China. A disintegration would greatly hamper development, as each region has to solve its commitment problem individually and all regions have to sort out mechanisms for a common market. The difficulties involved in establishing the European Community and NAFTA are best contemporary examples of this problem.

Implications for China's reforms in the next stage

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 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.

Our analysis yields several implications for the next stage of China's reforms. First, as noted, it seems unwise to focus narrowly on increasing the share and centralization of government revenue. Not only may recentralization yield negative incentive effects, but there are more important things to do. A clearer division of authority between the central and local governments needs to be defined and provided with a stable and legal foundation. The central government should be constrained to concentrate only on national public goods, such as defense, infrastructure, and policing the common market, the latter two of which are in short supply at the present time. All other responsibility for the economy should be kept with lower level governments. This will not only gain popular support, but be beneficial to the reform. For these reasons, improving the system of federalism, Chinese style, that has begun to emerge in China, should be seen as a high priority.

Second, one practical step in the direction of institutionalization would be to increase and formalize the regional and local governments' participation in the decisionmaking process of the central government, perhaps in exchange for more revenue remittance to the center. For example, China might establish a formal decisionmaking body that includes the governors or other representatives from each province to voice their interests and to constrain the central government. The principal problem is to provide the central government with more revenue so that it can provide much needed national public goods and services, while restricting its ability to use these funds for purposes inconsistent with the reforms and marketization. Devising a formal process of input and constraint from the provinces is one obvious method. Historically, this raises interesting parallels with the development of representative institutions in Western Europe (see, e.g., Schumpeter 1919, Hoffman and Norberg 1993, North 1981).

Third, it might be feasible in the near future to start democratic reforms at the bottom level governments, that is, village, townships and county. This would increase the responsiveness of these governments to citizens within their jurisdiction. Indeed, this seems already to have happened to a certain degree. Although voting has not become a feature of China, the responsiveness of local governments to the needs and interests of their (permanent) residents has improved dramatically. Here too the early history of Europe is relevant. As the trading towns of Western Europe emerged, they provided institutions that at first responded largely to the interests of merchants (Pirenne 1925). As they grew richer and their "middle class" grew (e.g., independent artisans), representation was extended. The local institutions in China in no way parallel those of Europe, which relied far more on private firms and corporate entities of merchants. Nonetheless, the effect of both institutions raises important parallels.

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Table 1

Foreign Capital Utilization in China (Billion US$)

(1985-1992)

	Total	Regions	Ministries	Region/Total
1985	4.46	1.60	2.86	35.87%
1986	7.26	2.78	4.48	38.29%
1987	8.45	3.21	5.24	37.99%
1988	10.22	5.60	4.62	54.79%
1989	10.06	5.85	4.21	58.15%
1990	10.29	5.49	4.80	53.35%
1991	11.55	6.74	4.81	58.35%
1992	19.20	13.06	6.14	68.02%

Source: *China Statistical Yearbook*, various issues from 1986 to 1993.

Remark: Foreign capital in this table includes foreign investment and borrowing.