

Chinese Reform and Chinese Regional Decentralization

(preliminary and incomplete background paper)

29 November 2006

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Abstract

The Chinese economic reform has created world-record breaking prolonged fast growth and has reduced poverty at an unparalleled scale in world history. However, the Chinese institutions look notoriously weak. The Chinese reforms pose great challenges to economics. This paper explains Chinese reform strategies and outcomes by regional decentralization. Regional governments are major players to the bulk of the Chinese economy. Under the supervision of the central government they initiate, negotiate, implement, divert and resist reforms, policies, rules and laws. Chinese reform trajectories have been shaped by regional decentralization. Spectacular performance on the one hand grave problems on the other hand are all created or closely associated with this governance structure. Empirical evidence is provided to support theoretical arguments. In addition to explain the reforms this paper will also confront the problems and tradeoffs posed by the Chinese regional decentralization.

1. Introduction

The Chinese economic reform, which has undergone for nearly three decades, has transformed the world's largest developing country from a centrally planned economy into a mixed economy. This reform has created world-record breaking prolonged fast growth and has reduced poverty at an unparalleled scale (World Bank, 2002). During the reform period the Chinese per capita GDP has increased by almost eight-folds. China has turned from one of the poorest countries in the world¹ to a major economic power. Today's China is the world largest producer and consumer of many conventional industrial staples and high tech products, such as steel, TV sets, PCs and cell phones etc. (NSB, 2005) with the world's largest foreign reserves. The current size of the Chinese

¹ At the outset of the reform China's per capita GDP was about the same as that of Zambia, which was lower than an half of the Asian average or lower than two third of the African average; and its size was about one half of the Soviet Union (Maddison, 2003). Moreover, it had almost no trade with other countries.

economy, in terms of GDP, is larger than the sum of 83 countries in Eastern Europe, the former USSR and all of Africa (calculated based on Maddison, 2003).

In sharp contrast to the spectacular performance, it has been reported that from the view point of standard wisdom, such as Washington Consensus, the Chinese institutions in government, corporate governance, law and finance, look notoriously weak. Moreover, the Chinese reform policies often are unconventional and some times even look opposite to 'standard' policy suggestions (Weitzman and Xu, 1994; Rodrik, 2006).²

According to the conventional wisdom, the government should protect private property rights, enforce contracts and should be separated from business (North, 1981; Acemoglu and Johson, 2005; Rodrik, 2006). However, the Chinese government has deep involvements in business (Oi, 1999). There is no clear separation between government and business even in cases where firms are privately owned (Guo and Xu, 2006). Applying commonly accepted standards China is in general below average for rule of law or for governance quality (Allen et al., 2005; Pistor and Xu, 2005). Moreover, there had been no constitutional protection to private property rights until recently [the 2004 constitutional amendment].

The Chinese reforms pose great challenges to economics. Is the Chinese reform a miracle? Are the Chinese reforms explainable by economics? This paper will synthesise existing literature to tackle these challenges. We argue that the Chinese reforms are neither mysteries nor simple textbook applications. The Chinese reforms are coupled with regional decentralization and we will explain Chinese reform strategies and outcomes by regional decentralization.

Regional governments are major players to the bulk of the Chinese economy. Under the supervision of the central government they initiate, negotiate, implement, divert and resist reforms, policies, rules and laws. They drive, influence or hamper regional/national economic development, macro economic condition, environment, social stability, etc. That is, Chinese reform trajectories have been shaped by regional decentralization. Spectacular performance on the one hand grave problems on the other hand are all created or closely associated with this governance structure.

Chinese regional decentralization is a result evolved before and during the Chinese reforms. Regional governments have control rights over substantial amount of resources, such as land, firms, financial resources, energy, raw materials, etc. (Granick, 1990; Naughton, 1991, 1995; Qian and Xu, 1993; Shirk, 1993; Oi, 1999).³

² In comparing Chinese and Indian reforms with Washington Consensus policies, Rodrik (2006) said, "...their policies remained highly unconventional. With high levels of trade protection, lack of privatization, extensive industrial policies, and lax fiscal and financial policies through the 1990s, these two economies hardly looked like exemplars of the Washington Consensus. Indeed, had they been dismal failures instead of the successes they turned out to be, they would have arguably presented stronger evidence in support of Washington Consensus policies."

³ "In effect, it is the sub-national levels of Government that implement China's national development

In addition to explain the reforms this paper will also confront the problems and tradeoffs posed by the Chinese regional decentralization. The following major features of the Chinese governance structure have deep influences on the outcomes of the reforms. First, although regional decentralization has gone quite far in many aspects, the central government's control is always substantial that the Chinese governance structure is still hierarchical. The regional government officials are appointed. The appointment and promotion of regional government officials are served as instruments for the central government to induce regional officials to follow center's policy (Maskin, Qian and Xu, hereafter abbreviated as MQX, 2000; Naughton and Yang, 2004). This feature distinguishes the Chinese regional decentralization from federalism, where governors or mayors are elected and they suppose to represent and to be accountable to their constituents. The other feature is devolution and regional responsibility. The governance of the national economy is delegated to multi-levels of regional governments. Regional economies (from provincial level to county level) are relatively self-contained and regional governments have overall responsibilities to initiate/coordinate reforms (MQX, 2000; Qian, Roland and Xu, hereafter abbreviated as QRX, 2006a, 2006b), to provide public service, and to make/enforce law within their jurisdictions (Pistor and Xu, 2005). This feature differentiates the Chinese economy from a centrally planned economy.

The regional decentralization governance structure paved roads for development of non state firms, which is the most important engine of China's growth during the reforms (Qian and Xu, 1993; Qian, 2003). In addition, given this institutional condition the central government delegated more autonomous power and provided stronger incentives to regional governments to encourage them in trying out reforms (MQX, 2000) and in promoting economic growth (Liu and Lin, 2000; Jin, Qian and Weingast, 2005; Li and Zhou, 2006). Indeed, compete to become rich quicker was a policy set by the central government. When a region has a higher growth rate than others, the head of the region will enjoy greater power and be more likely to get promotion.

In addition to incentives, the way reforms are coordinated also deeply affects reform performance. Chinese regional governments have had considerable responsibilities for regional coordination. Such decentralized coordination has important benefits. First, since regional governments are closer to sites they are better informed on local information than the central government. Second, communication and information processing locally is much easier than those between the centre and the regions. Thirdly, regionally based coordination makes economy-wide coordination failure less likely when there are external shocks. This also makes it easier to introduce institutional changes on an experimental scale, without causing disruption to the rest of the economy. Indeed almost all celebrated successful early reforms were introduced through experiments (QRX,

agenda. Nearly 70 percent of total public expenditure in China takes place at the sub-national level (i.e. provincial, prefecture, county, and township), of which more than 55 percent takes place at sub-provincial levels" (The World Bank, 2002).

2006a, 2006b).

Decentralization or centralization is relative to a given benchmark. There are two default benchmarks in our discussion of the Chinese regional decentralization in this paper. Given China was a centrally planned economy one benchmark we use is the ‘classical centrally planned economy’ (Kornai, 1994) or textbook version of command economy. The other default benchmark we use is the structure of a unitary state given China has never been a federation. This paper is also going to cover the debate on Chinese fiscal federalism (or simply federalism).

How to motivate regional governments whereas at the same time to coordinate or to control them? This subject has been debated by economists, political scientists, historians and sociologists etc. for decades both in general and in the context of China. However, they are scattered and very often they do not talk to each other. This paper will develop a coherent conceptual framework to put them together. We do not intend to provide an exhaustive literature survey. Instead, the purpose is for a deeper understanding of Chinese reform and economic development. By doing so, it may also deepen our understandings on legal, political, economic institutions; and on evolution of these institutions.

This paper will also address the following questions. What are general lessons that we can learn from the Chinese reforms? When Chinese ‘ignored’ standard advices, how did China avoid problems? Was the standard advice wrong or China simply come up with other policies that fit with its institutions better as substitutes? What are the key current economic problems in China, and how might these problems be best addressed given China’s institutions? Finally, does China’s growth sustainable under regional decentralization?

The rest of the proposal is organized as follows. The next section characterizes the Chinese regional decentralization and highlights its links with early successful reforms. A brief history of the evolution of the Chinese regional decentralization will be presented, which illustrates the path dependent feature of the evolution. Section three will explain how regional decentralization affects incentives of regional governments, which in turn deeply affect consequences of the reforms. Section four explains Chinese reform as regional experimentation. Section five discusses political economy of Chinese regional decentralization including debates on fiscal federalism. Section six discusses debates on a major negative side of regional decentralization, regional protectionism. Section seven discusses debates on another major negative side of the Chinese regional decentralization, regional disparity. The last section concludes by analyzing the tradeoffs of the two sides of the regional decentralization, summarizing policy options to go further in future reform, and lessons that may be useful for other countries.

2. Chinese Regional Decentralization and Early Reforms

2.1 Chinese Regional Decentralization: Basic Features

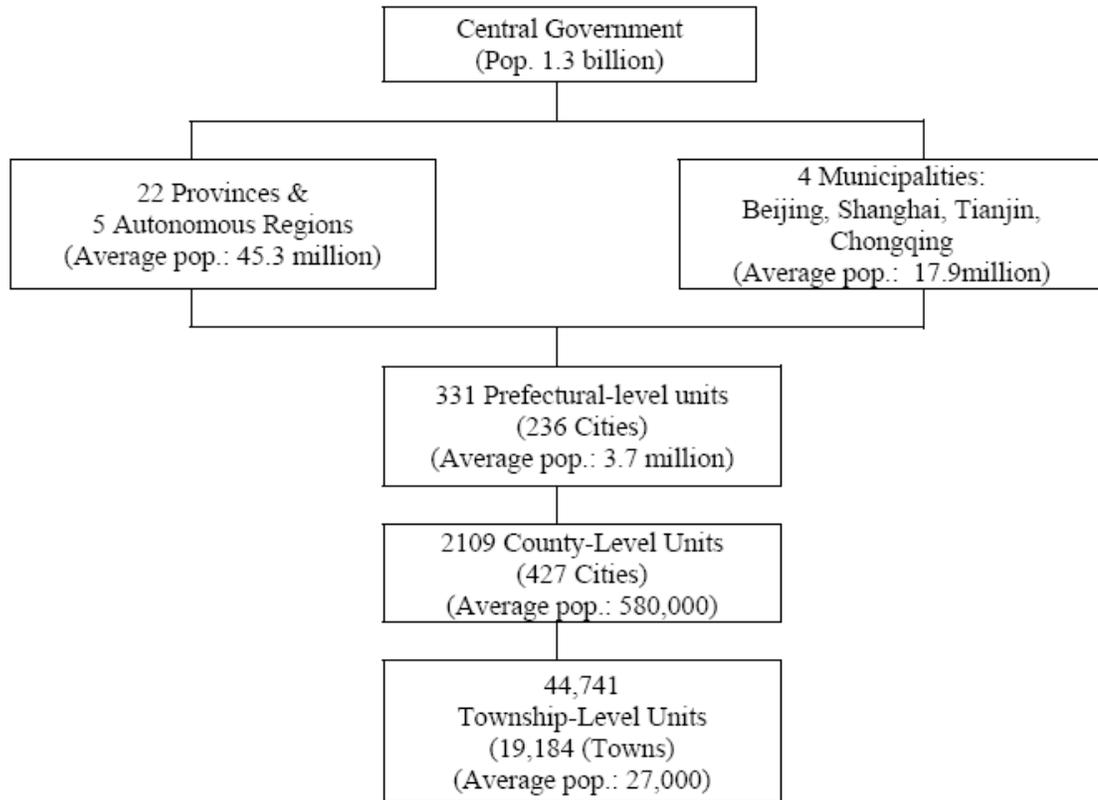
Deep involvement of all levels of the governments in the economy including firms is a salient feature of the Chinese reforms. The Chinese government consists of a region

based multi-level hierarchy. Below the central government, there are four levels of regional governments: provincial level, prefecture level, county level and township level. Most government functions are implemented by regional governments. Although by constitution China is not federal, in many important aspects Chinese regional governments are more 'powerful' than their counterparts in most federalist countries in the world. It is documented that in the early 2000s, the total expenditure of the Chinese regional governments was about 70% of the national level, which was far larger than that of the world largest federalist countries such as the U.S. (46%), Germany (40%) and Russia (38%) (Wong, 2006).⁴

The following figure depicts the Chinese government structure. The statistics in the figure reflects the situation in the early 2000s whereas the government structure has been similar throughout of the reforms.

Fig 1. Regional Governance Structure of Chinese Economy
[add number of firms and total employment and fixed assets of these firms at each level of regional government]

⁴ Using fiscal expenditure as a measurement for decentralization can be misleading and this be particularly problematic if our focus is more general than fiscal decentralization. We will discuss this issue in later parts of the paper.



Source: SNB, 2001.

The current Chinese governance structure is an outcome of institutional changes evolved before and during the reforms (Perkins, 1964, 1975, 1977; Wong, 1985; Granick, 1990; Qian and Xu, 1993; Naughton, 1991, 1995; Liu et al., 2006). Before the reforms there were two major political movements that lead to vast waves of decentralizations in the late 1950s (the Great Leap Forward (GLF)) and in the late 1960s (the Cultural Revolution) at extremely high costs (Qian and Xu, 1993; Shirk, 1993; Liu et al., 2006).⁵ The central government's bureaucracy was trimmed; supervision of most state-owned enterprises was delegated from the ministries to provinces and cities or even counties; and regional governments' responsibilities were substantially enlarged.

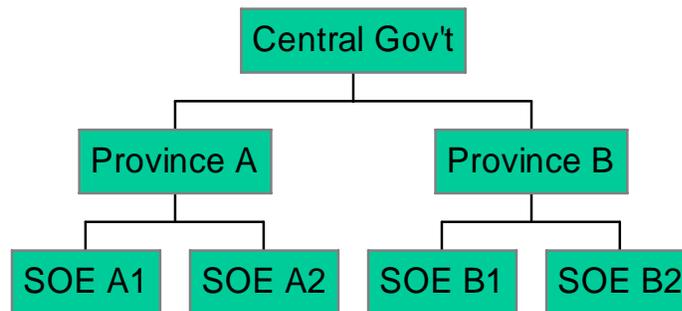
As an initial condition, outset of the reforms, almost all the two thousand counties in China had SOEs in producing agricultural machinery; 300 counties had steel plants, more than 20 provinces had SOEs producing automobiles or tractors. Small regional SOEs produced 69% of China's total fertilizer output and 59% of cement (Wang, 1986, pp.356-359). This is in a sharp contrast to all other formally centralized economies where specialization and monopoly is an outstanding feature. With greatly reduced responsibilities of the central government, the Chinese central government is much

⁵ For example, the GLF established the People's Commune, the Commune-Brigade Enterprises (the predecessor of the TVEs), and expanded local industries under state and collective ownership. However, the Great Famine was also caused by the GLF. For the Great Famine see Lin (1990) and Li and Yang (2005).

smaller than its counter parts in other centralized economies. Onset of the Chinese reforms, the number of products directly under the central plan in China was only 791 (the number was never more than one thousand in Chinese centrally planned system), and the number of ministries at the centre was less than 30 (Qian and Xu, 1993).⁶

The reforms took place almost right after the end of the Cultural Revolution when regional governments already de facto controlled a great deal of resources. For political and economic reasons granting more autonomous powers to regional governments is one of the major strategies in the first fifteen years of reforms (Qian and Xu, 1993; Shirk, 1993; Liu et al., 2006). Regional governments were given high fiscal incentives and were directly involved in managing or setting up firms, forming joint ventures with domestic or foreign investors, etc. (Qian and Xu, 1993; Oi, 1999). As a result, regional governments have de facto property rights to SOEs and collectively owned firms (COEs) within their jurisdictions (Granick, 1990), which count for most of the firms in the nation; become more important in all major regional affairs, from land allocation, business development, infrastructure construction, and fiscal matters to law making and law enforcement. In Qian and Xu (1993), MQX (2000) and QRX (2006a, 2006b), the Chinese regional decentralization is modeled as a stylized multi-regional governance form (M-form) in which every region is self-contained.⁷ The following figure depicts highly stylized Chinese regional governance structure where each region is self contained in both industry 1 and industry 2 – in contrast to specialized regions where each region is specialized in either industry 1 or industry 2 (e.g. in Russia).

Fig. 2. Regional Governance Structure



However, regional decentralization is not legally institutionalized in China (Shirk,

⁶ As a comparison, in Soviet Union the central planning system is based on the principle of functional specialization that the central government directly controls most of the state-owned enterprises (SOEs). In the late 1970s there were 62 ministries under the Gosplan in the Soviet Union responsible for 48,000 plan “positions” or 12 million products planned and coordinated by the Gosplan (Nove, 1983).

⁷ The term M-form was first used by Chandler (1967) and Williamson (197x; 199x) to characterize multi-divisional structure of large corporations, where divisions are self-contained and are granted autonomous power division chiefs are appointed by the headquarters.

1993) that there have been fluctuations for the central-regional relationship. Through personnel appointment and promotion/demotion the central government has kept considerable leverages in ‘building’ consensus with regional governments in order to push through policies that are in favor of the central government (Huang, 1996; Naughton and Yang, 2004). After one decade of dramatic decline of the share of the central government’s tax revenue, there is a fiscal recentralization since the mid 1990s (Tsui and Wang, 2004). The share of regional governments’ tax revenue in national tax revenue was reduced substantially (World Bank, 2002).⁸ Nevertheless, beyond fiscal sphere regional governments’ importance is almost intact. The central government still relies on regional governments to govern the bulk of the Chinese economy and regional governments still dominate regional economic affairs, such as allocating critical resources to firms, e.g. land, energy and credit (this part has declined dramatically recently), dealing with contract enforcement and property rights protection, etc. Furthermore, in the same period of ‘fiscal recentralization’ the regional governments gain more power on other aspects. Their de facto ownerships over regional SOEs and land have been transformed almost into de jure.⁹ This change paved road for regional governments to privatize SOEs and COEs and to sell land within their jurisdictions (Garnaut et al., 2005). The regional governments’ revenue created through privatization and selling land in the past years was comparable to the tax revenue [TBA]. Therefore, despite of a ‘recentralization’ in the formal tax system, it is likely that real fiscal revenues of many regional governments did not decline (Ping, 2006). More importantly, control rights over land gives regional governments important leverages in regional development, in regional industrial policy, in regional fiscal policy and in macro control of the region. In addition to resource control, regional governments have substantial lawmaking power and are responsible to most of law enforcements in the country (we will discuss this subject in details in later part of the paper).

To summarize, it is important to point out that Chinese regional governments are responsible for much broader regional matters than fiscal issues. Fiscal decentralization some times can be a good proxy for regional decentralization in empirical work. However, some times fiscal decentralization can be a misleading proxy when it does not go in the same direction as regional decentralization.

2.2 Regional Decentralization and Early Reform Strategies

The following celebrated Chinese early reforms, land reform (household responsibility system, hereafter abbreviated as HRS), development of non state sector,

⁸ Although their official tax revenue shares were reduced, rapid increase of other revenues may have well compensated regional governments that there may not be major change in fiscal terms (Ping, 2006).

⁹ In 2005, all the sub-national governments own about thirty one thousand SOEs and control xxx COEs (NSB, 2006) whereas the central government owns 166 firms (the State-Owned Assets Supervision and Administration Commission, or SASAC: http://www.sasac.gov.cn/gzwwgk/gzwwgk_jj.htm).

particularly township-village enterprises (TVEs), and setting up special economic zones (SEZ) are examples illustrating the decisive roles of regional decentralization in shaping up these reform strategies.

The essence of the 'Household Responsibility System' is to lease out land to rural households, who pay rent and taxes and enjoy the residual income and partial residual rights to the land. Thus rural households have both the incentive and responsibility to take risks and make efforts to improve the land 'allocated' to them. This reform started in the late 1970s in a couple of counties in Anhui Province and Sichuan Province, out of almost three thousand counties in the country. The experimenting county governments initiated these reforms and took risks. Moreover, given regional governments were assigned with resources and responsibilities over their jurisdiction, they were also responsible for coordinating the reforms. Following the success of the pioneering experiments, the scale of the experiments was expanded and many other regional governments implemented similar reform programs in later years (QRX, 2006a, 2006b). In 1980 about 14 percent of Chinese rural households became household farmers whereas the percentage was increased to 45 and 80 in 1981 and 1982 respectively. In 1984 when more than 98 percent of households became private farmers, the People's Commune system was officially abandoned by the Chinese central government (Naughton, 1995).

This reform greatly improved agriculture productivity (McMillan, Whalley and Zhu, 1989; Lin, 1992). The average annual growth rate of agriculture increased from about 2% before the late 1970s to about 7% in the next five years after the reform. However, the major influence of the land reform may not be in agriculture sector per se. Agricultural output accounted for less than one third of Chinese GNP in the late 1970s. Moreover, the growth rate of agriculture has remained lower than that of aggregate GNP even in the best years of agriculture reform (Qian and Xu, 1993).

The greatest impact of the land reform lies in its interaction with the non-agriculture sector (Brandt, Hsieh and Zhu, 2006), particularly the township-village enterprise (TVE) sector. By abolishing collective farms, rural households were given greater freedom to re-allocate their resources. Moreover, improved productivity in agriculture further released labour and increased savings/investment for the development of TVEs. Finally, the abolition of the commune system shifted the focus of community governments to TVEs (Xu, 1995).

A TVE is a collectively-owned enterprise located in a township or a village. The community government is deeply involved in governing the TVE's operations (Weitzman and Xu, 1994; Chang and Wang, 1994; Li, 1996; Che and Qian, 1998). The development of the TVEs is a product of regional decentralization and it further strengthened regional decentralization during the reform.

Both the land reform and the early TVE development were initiated by some regional governments that they are un-intended local 'experiments' from the view point of the

central government¹⁰ (Qian and Xu, 1993; Naughton, 1995). In contrast, the special economic zone is a designed experimentation to be implemented by a few experimenting regional governments (Chung, 1999). A Special Economic Zone is a geographical region that has economic laws/governance different from the rest of the country with a goal of attracting foreign investments. The SEZ experiment started in 1980 in four cities. Followed the initial success, in 1984 the experiment was expanded into another 14 cities. With the steady expansion of the experiment in a dozen years the number of SEZs was increased to almost a hundred including all the capital cities of inland provinces and autonomous regions. Largely due to the development of the SEZs China becomes one of the largest FDI recipients and exporters in the world in about two decades.

Regional decentralization is vital for experimental approach being effective (QRX, 2006a); it is also vital for providing proper incentives to officials since reforms depend on their initiatives (MQX, 2000). However, the impacts of regional decentralization to the reforms and to the Chinese economy are not always rosy; regional decentralization alone is not sufficient to guarantee successful reforms [mention the debate on application of market-preserving federalism in China (e.g., Weingast, 1995; Qian and Weingast, 1997; Rodden and Rose-Ackerman, 1997; Cai and Treisman, 2004)]. Many grave problems and severe challenges China face today are associated with regional decentralization [literature TBA]. In the rest of the paper we are going to discuss the tradeoffs of the Chinese regional decentralization.

3. Regional Decentralization and Incentives for Reforms

One of the most important potential effects of regional decentralization is strong incentives provided to regional governments. This section analyse how regional decentralization associates with better institutional conditions for providing stronger incentives to regional governments and the tradeoffs of these incentives.

3.1 Regional Yard-stick Competition

Decades of fierce regional competition has contributed to China's high economic growth. However, it is also contended that this competition is responsible for growing inequalities, for environmental problems, for regional protections, for losing macro controls etc. [literature TBA]. The Chinese reforms started from an explicit policy to encourage regions to "get rich first" through interregional competition. Regions compete for per capita GDP growth and attracting FDI etc. fiercely. Regional ranking of these performances have been important part of evaluations for determining regional government officials' promotions (Li and Zhou, 2005). Government statistics and mass media regularly publish rankings of regional performances. Important questions to be addressed are the following. What are the conditions that regional competition leads to desirable outcomes? Why some times the same competition generate adverse effects?

MQX (2000) models Chinese economy as a multi level hierarchy that regional

¹⁰ Deng Xiaoping admitted in 1988 that the amazing growth of the township and village enterprises was completely unexpected and was one of most important achievement of the reforms so far.

governments are under incentive schemes of the central government. The condition that regional decentralization can work better through yard-stick competition is derived as following. If regional economies are alike that they are comparable to each other, then yard-stick regional competition will provide stronger managerial incentives, which will drive them to initiate reforms. The intuition is the following. Suppose that managers must be provided with incentives to carry out reforms. One way to do this is to reward them on the basis of reform performance. But performance is usually not perfectly correlated with their efforts. Thus, if the officer of a region shows a poor performance, he may try to blame the outcome on bad luck. This excuse will not be convincing, however, if all similar regions are prospering. Thus, it will, in general, be desirable to make the officer's reward, such as promotion, depend not only on absolute performance but also on performance relative to that in other regions, i.e. regional yard-stick competition. However, regional yard-stick competition will not work if regions are not comparable to each other. Russia with highly specialized regions is such an example.

Applying their theory, MQX find that Chinese regions are indeed 'alike' that regional yard-stick competition should work well for economic growth. They also find that the change of relative ranking in economic growth is significantly related to the change of relative ranking for the promotion chances of officials in that province. This reflects the use of regional yardstick competition. Consistent with this, more recently, based on a panel data from 1979 to 1994, Li and Zhou (2006) find that the likelihood of promotion of provincial leaders increases with their economic performance.

A straightforward extension of the MQX theory can also shed lights to adverse outcomes of regional decentralization. Conditions that regional decentralization works are summarized as follows.¹¹ First, the central government must be able to induce regional governments to achieve its objectives via incentive schemes.¹² Second, the objectives that the central government intends to achieve through regional governments must be well defined and well measured. Third, regional economies should be more alike that they are comparable for the objectives that the central government intends to achieve.

The GDP growth rate of a region is well defined/measured and Chinese regions are alike. Thus, the Chinese central government has been successful in promoting regional competitions for growth. However, a competition for regional growth may lead to regional protectionism (Young, 2000); to the lack of scale economy (Lu and Tao, 2006); to deteriorated environments (TBA); and to worsen regional disparity (Kanbur and Zhang, 2005) etc. Technically it is possible to design incentives for regional governments to compete for every single issue and yard-stick regional competition can do well. However, combining all of these issues together in a coherent grand incentive scheme will be almost impossible. Internal conflicts among the multi objectives are inevitable due to the

¹¹ These conditions together shed lights on mixed results of cross country studies on federalism that federalism itself does not guarantee growth or welfare enhancing (TBA).

¹² Blanchard and Shleifer (2001) made a similar point as this condition.

inherent conflicting nature of the issues. When regional governments face multi tasks and some tasks are harder than others to measure, fierce regional yard-stick competition will induce regional governments focus on those tasks that are well defined/ measured and ignore others (Holmstrom and Milgrom, 1991; Dewatripont, Jewitt and Tirole, 2000). As a result, tasks related to social security, law enforcement, or environment protection etc. will be overlooked. Moreover, there are tradeoffs between different incentives for various tasks; tradeoffs between scale economy and competition; tradeoffs between dealing with externalities and competition. At an earlier stage of the reforms economic growth may be a commonly agreeable priority among the tradeoffs.¹³ But after an almost three decades of record setting high growth, priorities among the tradeoffs have been changed. Not only it is unclear now that growth always overwhelms other objectives, the sustainability of growth itself becomes not obvious if the tradeoffs are not dealt with properly. For some relatively simpler issues, the tradeoffs may be solvable by a division of labor between the central government and regional governments (Bai et al., 2000, 2006). However, for fundamental solutions deeper institutional changes are required to warrant that all levels of governments represent to and accountable for their constituents. Literatures on political, legal and economic changes in this direction and analyse on other policy choices will be covered in the later part of this paper.

3.2 Regional Decentralization and Hardens Budget Constraints

One fundamental problem with state-owned enterprises is soft budget constraints, which is a credibility problem in ex post implementation of ex ante contracts (Kornai, 1980; for recent surveys see Maskin and Xu, 2001; Kornai, Maskin and Roland, 2003). It has been observed that the Chinese regional decentralization seems to have worked in hardening budget constraints. Qian and Xu (1993) argue that by decentralizing financial resources, at bottom levels of the hierarchy, financial resources available to local branches of the state banks and rural credit cooperatives and to local governments are very limited, and non-state enterprises have less access to subsidies and credits as do state-owned enterprises. These limitations have prevented regional governments from bailing out many loss-making enterprises.

Qian and Roland (1998) argue that regional decentralization can help to harden budget constraints through regional competition. Under regional decentralization, the central government delegates most fiscal authority to local governments, who tax and spend only within their jurisdictions. Certain state enterprises will be profitable only if they undergo restructuring. But restructuring is costly to an enterprise's manager and so will be undertaken only if the enterprise would otherwise go bankrupt. Therefore, if the manager anticipates that he will be bailed out by the government, he will not restructure.

¹³ In 1990 when there were debates on the tradeoffs Deng, the architect of the reforms at early stages, put it, 'growth is the hard principle.' (TBA).

Whether or not a bailout occurs depends on the opportunity cost of the government's funds, in particular the marginal benefit of investing in infrastructure.

In the case of regional decentralization, the various local governments compete among themselves to attract outside capital to their non-state enterprises by investing in infrastructure. Infrastructure investment raises the marginal product of capital and therefore is a useful instrument in the competition for capital. Indeed, under regional decentralization, the private marginal benefit of investment will exceed its social marginal benefit (since a local government ignores the loss imposed on another jurisdiction when it lures capital away). But the bigger the infrastructure investment the higher is the opportunity cost of bailing out failing firms. Hence, this opportunity cost is higher under regional decentralization than under centralized fiscal authority (where infrastructure investment is efficient), and this implies that regional decentralization entails a harder budget constraint.

In studying the "fiscal contracting system" operating between the central and provincial governments from 1980-93 JQW find that the discrepancy between *ex ante* contracts and *ex post* implementation declined over time. They interpret this as credibility of fiscal contracts between the center and provinces. However, JQW also find that the central government was not able to keep commitment on disciplines to restrain from offering *ex post* subsidies to regional governments. Moreover, the substantial change of tax rules after 1993 creates doubts on the central government's credibility in keeping rules with regional governments (Tsui and Wang, 2004; Mertha, 2005).

Finally, there are also observations and arguments that decentralization may soften budget constraints, may lead to losing macro control and inflation in China (Wang, 1991; Huang, 1995; Brandt and Zhu, 2000) and in general (Treisman, 2000) [details to be written].

3.3 Regional decentralization and corporate reform

The incentives provided to regional government through regional decentralization has profound impacts on corporate reforms since most firms are controlled by regional governments. To improve incentives and management, enterprises gained more autonomous from their superiors, regional governments, since the early 1980s [add details of regional experiments in enterprise reforms]. Before the mid 1990s regional governments were responsible for selecting SOE managers within their jurisdictions, they become much more performance-conscious in doing so (Groves et al., 1995). Associated with this, more managerial incentives were in place (Groves et al., 1994; Zhuang and Xu, 1996). These incentives and managerial labour markets have improved SOEs' productivities (Chen *et al* (1988); Groves et al., 1994, 1995; Woo *et al* (1994); Jefferson *et al* (1996); Li, 1997) [elaborate details of the evidence on what have been achieved and what are problems associated with regional decentralization].

Although the SOE reforms have improved performance, the surge of the Chinese economy in the first fifteen years' reform mainly came from the new entry and excellent

performance of the TVEs and other non-state-owned firms (Qian and Xu, 1993; Qian, 2003).

This sector was first developed under the people's commune system (called commune-brigade enterprises before the reform), which is the grass root level of the regional decentralized planning system (Byrd and Lin, 1984). The township-village enterprise (TVE) was the most important engine driving the unprecedented growth of the Chinese economy during the first 15 years of Chinese reforms. The Chinese regional decentralization provided suitable conditions for the growth of non state firms (Qian and Xu, 1993).

First, the regional decentralized governance structure provides strong incentives to regional governments to support the development of TVEs, eg for fiscal reasons (Qian and Xu, 1993; Che and Qian, 1998). Second, relatively self-contained regional economies gave TVEs opportunities to grow. There are broad ranges of products which the TVEs can produce to meet local demand, and often sufficient local products to supply to TVEs as inputs. Close links between TVEs and local SOEs often facilitated technology and management know how transfers (Xu and Zhuang, 1998).

To a large extent it is due to the fast development of the TVE sector China's remarkable economic growth occurred in the first fifteen years of reforms despite the lack of secure property rights (Weitzman and Xu, 1994; Li, 1996). The rise of this sector has caused the share of the state sector in GNP to shrink steadily. Regional decentralization not only provided suitable conditions for the growth of non state firms (Qian and Xu, 1993).

The TVE is owned by local citizens and controlled by the township-village government. How to explain the spectacular performance under vaguely defined property rights becomes a great challenge. Several complementary explanations are proposed in the literature. One explanation focuses on efficiency of informal contractual relationships between local governments and TVEs, or between TVE employees, when they have repeated interactions. This explanation is based on the fact that most TVE employees, managers and township-village officials lived in the same community for generations when there is almost no migration (Weitzman and Xu, 1994; Xu, 1995). However, this mechanism stopped working when large scale migration occurred that lots of TVE employees are migrant workers since the early 1990s. Other explanations emphasize the second best nature of the TVE governance structure when there is no legal protection of private property rights. Chang and Wang (1994) and Li (1996) argue that giving TVE's residual returns to citizens and township-village governments whereas giving TVE control rights to township-village governments will be more efficient and will be social welfare enhancing. That is because township-village governments had whereas ordinary citizens did not have access to resources when there was no constitutional protection to private property rights. Che and Qian (1998) argue that let township-village governments control TVEs is an organizational response to imperfect state institutions. They endogenize local government ownership as the second best institution and argue that

balancing power of governments at different levels can be efficiency enhancing. They also argue that community government ownership of TVEs can be more effective than private ownership in achieving the government's objectives. Closely related to the last point, Naughton (1994) argues that TVEs are vehicles for the community government to cash in the value of land under its control when asset markets are underdeveloped.

[add more on evidence and later developments of TVEs].

A common feature of the above explanations is that they all embedded with a transitional feature. They imply that the benefits of TVEs may disappear if protection of private property rights is improved, if asset markets are developed, and if large scale migration occurs.

There has been an evolution of the constitution and the laws that private properties being better protected gradually since the late 1980s, although Chinese constitution did not protect private property rights until 2004 (Clarke, Murrell and Whiting, 2006). Asset markets and domestic migration have grown rapidly since the early 1990s [add literature on these]. Under these changed conditions those theories would imply that ownership structure of TVEs may become sub-optimal.

Large scale privatization of TVEs, other collectively owned firms, and small SOEs started since the early 1990s often initiated by some regional governments (Garnaut et al., 2005; Guo and Xu, 2006). The central government gave the green light for a nationwide policy and law a few years later. To some extent the way the privatization took place echoed the roles of regional governments in the land reform in the late 1970s. Up to the early 2000s, most small firms in China have been privatized regardless of their original ownership structure (Cao, Qian and Weingast, 1999; Garnaut et al., 2001, 2005; Li, 2003; Yusuf, Nabershima and Perkins, 2006). [add details on regional governments' motivations for privatization; initiatives and strategies of privatization; problems associated with the role of local governments in privatization]

4. Regional decentralization and institutional experiments

It is documented that China's reforms have been carried out by an experimental approach. This is regarded as an explanation why China's reforms performed so differently than reforms in Eastern Europe (McMillan and Naughton (1992), Dewatripont and Roland (1997), Sachs and Woo, 1997). However, some experimental reforms were introduced as early as in the late 1960s in Eastern Europe (e.g. Hungary) and the Soviet Union in the 1980s but failed. Those failures led to discredit the experimental approach to reform and to the adoption of the big bang approach. Ironically, to a large extent, China followed many of the Eastern European gradual reforms in earlier stages of its reforms (QRX, 2006b). What makes China different in using the experimental reform strategy is the regional decentralized governance structure.

A reform often involves many programs that are highly complementary to each other; and they bear strong externalities; moreover reforms are vastly uncertain. Therefore,

government coordination is needed for those reforms even in developed market economies (Bolton and Farrell, 1990; Milgrom and Roberts, 1992; QRX, 2006a). In the case of reforms in developing economies are transition economies that many markets were missing, government's initiatives and coordination are vital. The question is which government and how the coordination is carried out. Given a typical Chinese region is relatively self-contained and a regional government is responsible for its jurisdiction, regional governments are in a good position to initiate and to coordinate regional experiments. Moreover, given interregional dependence is relatively weak in China when a regional experiment fails its impact to the rest of the national economy is more or less isolated (Qian and Xu, 1993; QRX, 2006a, 2006b).

The theory developed by QRX (2006a, 2006b) explains that regional decentralization creates conditions to ease coordination problems in reforms and to make reform strategies more flexible, although Chinese regional decentralization suffers from lack of scale economy. Reforms can proceed with local experiments, or parallel experiments, by regional governments, because coordination is established locally. [Elaborate the basic logic, predictions and intuition of the QRX theory]. QRX provides evidence that China repeatedly adopted successfully an experimental approach to reforms whereas plagued by coordination problems, many previous reform experiments in Eastern Europe and the former Soviet Union failed.¹⁴ [elaborate unitary-governance structure of FSU-CEE and explain why FSU-CEE experiment fail].

The discussion that regional decentralization facilitates policy experimentation corresponds well Justice Brandeis' legendary remark in 1932 that states in a federal system can serve as "laboratories" to test novel policies. It may also echo the famous claim that decentralization may result in greater experimentation and innovation in producing novel policies (Oates, 1999). Nevertheless, theoretically the point by Brandeis and Oates is indeterminate because inter-jurisdiction experimentation/competition may lead to a race either to the top or to the bottom. In the QRX model this indeterminacy problem is avoided since the benevolent central government in their model is responsible to make strategic decisions on experiments. In general, however, how to guarantee the central government is benevolent is an unsolved major challenge.

4.1 Successful experiments: Household responsibility system; Special Economic Zones

4.2 Unsuccessful or less successful experiments: social safety net; fiscal reform

¹⁴ An important feature of the Chinese regional decentralization, which makes the above arguments works, is that a typical region is relatively self-contained. In the case of Russia when regions are highly specialized that they depend to each other, simple devolution of powers to the regions, such as the devolution of authority to regional governments under Yeltsin in Russia after 1992, This is because when industries are regionally concentrated and cannot be moved around easily, regions cannot be self-contained units as in the case of China without major industrial investment will not work.

experiments ... (WB, 2002)

4.3 Dual track approach as experiments: dual track price system as large scale experiments (Lau, Qian and Roland, 2000; Fan and Wei, 2006); other dual track experiments, Che, 2006)

4.4 On going experiments: privatization

5. Political economy of regional decentralization

The Chinese government is trying to reform the country towards a more vibrant market economy without weakening the political supremacy of the Party. Obviously this objective is not fully consistent with the conventional wisdom and there has been no blueprint for this. This dilemma has led the Chinese authorities to experiment a variety of forms of governance from firms to markets that it has been likened to trying cautiously to feel for stepping stones across a river. These make the Chinese reforms fascinating.

With the control of the Party in the centre, although the economy has been highly decentralized to local regions, China is not a federal system. By constitution Chinese local regions have no inherent power, and local power is granted by the central authorities. The central government is empowered to delegate power to regions, and to renounce power from regions [quote constitution and law literature]. The Party is organized hierarchically, thus the vertical relationship between regional government and the central government is still imperative for certain issues. In some political aspects China still resemble reformed Eastern European countries (Kornai, 1986), although Chinese economy differs substantially.

5.1 Political Economy and Fiscal Decentralization

The role of the central government or the Party in the reform process has been an important subject under hot debates. On the one hand it is argued that the central government is controlling China effectively. Examples illustrating this point include Beijing's relative success in containing periodic provincial economic overheating etc. (Naughton and Yang, 2004). This is because through the Party the central government has increased its political and administrative control over provincial government leaders, and continues to co-ordinate economic policy-making and implementation (Huang, 1996b). On the other hand, Wang and Hu (2001) argue that central state capacity has been severely undermined by decentralization and economic reforms in the reform era. However, there is a consensus in the debate. That is, the Party or the central government is important; moreover, the power of the Party or the central government is endogenous.

Shirk (1993) argues that much more decentralized Chinese political and economic authority itself is a result of delegating power from the Party, due to Mao since the late 1950s and Deng since the late 1970s. The content and sequencing of China's economic reforms are determined by the ongoing succession struggles of the Party. In those political power struggles central leaders compete for the support of provincial leaders via reform policies.

On the one hand, devolution gave central politicians the opportunity to win the gratitude and the political support of officials from the provinces (Shirk, 1993). On the other hand, personal control is still one of the most important channels that the Party keeps power over China. This includes selection of the Party's Central Committee (MQX, 2000; Sheng, 2005), which determines Party's policy, and personal appointments at provincial level (Li and Zhou, 2005), which in turn controls lower level regions through similar channels. These have important implications to the nature of Chinese regional decentralization.

There is a growing literature in testing impacts of Chinese fiscal decentralization on regional economic performance. Zhang and Zou (1998) examine the effect of Chinese fiscal decentralization on regional economic growth and find a negative relationship. Lin and Liu (2000) (abbreviated as LL hereafter) and Jin, Qian and Weingast (2005) (abbreviated as JQW hereafter) find contrary and they suggest potential data and methodological problems in Zhang and Zou. By using provincial data from 1970 to 1993, LL find that fiscal decentralization has made a positive contribution to the growth process. They also find that along with fiscal decentralization land reform, the non-state sector, and capital accumulation are the key driving forces of China's growth over the reform years.

Consistently, by using provincial data from 1980 to 1993, JQW find fiscal decentralization is associated with reform measures. Moreover, they find stronger fiscal incentives are associated with faster development of non-state enterprises and with greater reforms in state-owned enterprises. Furthermore, JQW find provincial governments in China faced stronger *ex post* fiscal incentives after the reform. Specifically they find a strong correlation between the current provincial budgetary revenue and its expenditure for the period of 1982-91 when the "fiscal contracting system" was implemented.

Moreover, it is argued that different fiscal federalist approaches between China and FSU explains the performance gap between China and Russia. These are related to well/poorly defined tax rights to regional governments (Berkowitz and Li, 2000), and strong/weak fiscal incentives to regional governments (Shleifer, 1997 and Zhuravaskaya, 2000).

The above arguments are related to well known Tiebout ideas (1956) that under fiscal decentralization and regional competition, households and firms are free to move across locations to find the best match with their preferences. This ensures that regional governments will provide public goods efficiently and should enhance regional social welfare. However, there are doubts on impacts of fiscal decentralization. Moreover, if the Chinese governance structure is not federal in the usual sense some Tiebout conditions may be violated. For example, since most Chinese firms are closely related to regional governments (TBA) their freedom to move may be restricted; More importantly, if the central government's incentive schemes or personnel controls exert great impacts to regional government officials' careers (MQX, 2000; Edin, 2003; Li and Zhou, 2006), their behavior may be different from that induced by Tiebout incentives. There is also a literature which disputes that fiscal decentralization was overturned since 1994 in China

because fiscal decentralization has caused great problems (Tsui and Wang, 2004; Mertha, 2005).

Nevertheless, the LL-JQW evidence may well be consistent with the following alternative argument. Given fiscal decentralization itself is an important part of regional decentralization whereas land reform, non-state sector development, privatization of state and collective firms are all reform measures introduced within the framework of regional decentralization, fiscal decentralization may be a proxy of regional decentralization structure of a hierarchy. Indeed although there is a recentralization in taxation, since the mid 1990s regional governments gain many new powers [literature TBA]. That is, there is an identification problem that the current empirical literature is not able to test alternative hypotheses yet.

Finally, there is another important unsettled debate on interregional competition based on cross country observations. It is argued that there is no guarantee that Tiebout inter-jurisdiction competition always enhances social welfare since competition may end up with a ‘race-to-the-bottom’ [literature TBA, e.g. Rodden; Treisman]. Based on comparison between China and Russia, it is argued that the condition that fiscal federalism will not work unless there is a strong central government (Blanshard and Shleifer, 2000). However, if central enforcement capacity is endogenous, like the debate about the nature of the Chinese central government, regional competition may erode the center’s ability to channel competition in welfare-enhancing directions (Cai and Treisman, 2004). More importantly, what determines the objective of the central government? The famous Riker dilemma (Riker, 1964) is one of the most important dilemmas that the Chinese reforms are facing.

[add debates on market-preserving federalism, its concept, conditions and its applicability to China: e.g. Weingast, 1995; Qian and Weingast, 1997; Jin, Qian and Weingast, 2005; Rodden and Rose-Ackerman, 1997; Chang and Wang, 1998; Tsai, 2004; Tsui and Wang, 2004; Yang, 1997, 2006; Mertha, 2005]

[more literature to be included, e.g. Perry and Wong, 1985; Lampton and Lieberthal, 1991; Bernstein and Lu, 2000, 2003]

5.2 Personnel Control over Regional Governments

Differ from a federal system Chinese regional leaders are appointed by upper level government hierarchies not by regional elections. Despite devolution of much power over economic resources to the localities the Party centre still plays a predominant role in membership selection of the Party’s Central Committee (Sheng, 2005), in selection of provincial leaders [TBA]. As an important part of the Party’s control over provincial governments, in the past two decades there is always a reshuffling of provincial leaders before commencement of each Party’s Congress [TBA].

With economic growth as a major objective of the central government since the end of the 1970s [quote Deng and Party documents], appointment and promotion of all level regional officials are tied to growth performance of their own jurisdiction. Whiting (2000)

documents how county governments control township and village officials by linking their performance to promotion.¹⁵ Higher levels of the Chinese party-state have strengthened political control through promoting successful township leaders to hold positions at higher levels and by rotating them between different levels and geographical areas (Edin, 2003). Given the Chinese regional governments' governance structures at different levels all duplicate that of the central-provincial level structure (Qian and Xu, 1993), not surprisingly those institutional descriptions are fully consistent with econometric evidence at central-provincial level (MQX, 2000; JQW, 2005; Li and Zhou, 2005).

However, regional decentralization complemented by multi-level incentives may not always work well to improve social welfare even when the centre has well defined social-welfare enhancing objectives, which represent preferences of constituents. This is because the centre's priorities and policies may conflict to each other, which may lead to failures in some policy implementations. The multi-task nature of the central government's objectives and governance structure of the Chinese economy determine what works and what fails. As a result, there is a strong build-in mechanism for expand investment and to grow faster in the Chinese regional decentralization governance structure. However, the mechanism for macro control or for long run regional social welfare may be very weak.

5.3 Regional Decentralization and Village Election

Given regional leaders are appointed by higher levels of governments, one of the most important unsolved problems of the Chinese regional decentralization is regional governments' accountability and representation to their own constituency. Whereas powers of regional governments have been enlarged in the reforms, whether Chinese regional governments are more accountable to their constituents than before is under debate.

On the one hand, those with scepticism views assert that China becomes a decentralized predatory state. This is because decentralizing property rights and administrative power to local elites during the reforms gave regional government officials great discretion in disposing of state property. Extraordinary new options regional government officials gained from the reform raise the value of their political power, which makes the ruling elites even less willing to yield their power. As a result these lead local elites more keen to trim down popular pressure for change (Pei, 2006).

¹⁵ Performance targets are internally ranked in importance, such as hard targets, which tend to be economic in nature; and priority targets with veto power, e.g. social order (or social stability). While completion of hard targets is important for promotion, completion of priority targets constitutes the basis for personnel decisions (Edin, 2003).

On the other hand, associated with the reforms and regional decentralization, there is a development of local elections at village level. Did these elections improve local governments' accountability?

A village is the lowest operating level in the Chinese government hierarchy, although officially village heads are not in government payroll. A village government is responsible for collecting taxes and levying fees and providing public goods. Onset of the reforms, village heads were appointed by the higher levels of governments (people's communes and county governments). Their performance was evaluated by the upper level governments thus village public services provision was often placed as a lower priority. Associated with land reform and the abolition of people's communes in the early 1980s, the conflict between appointed cadres and villagers over taxation issues has become increasingly worsened (Bernstein and Lu, 2000, 2003). As a consequence, the central government initiated experiments of village election since the mid-1980s. The experiment was promoted nationwide by the central government in the early 1990s. Since then, more than half of villages nationwide have implemented village elections. In villages with elections there is a power sharing between elected village head and appointed village Party secretary (see the previous subsection on Party secretary appointment) (O'Brien and Li, 2000; Oi and Rozelle, 2000; and Paster and Tan, 2000).

From their field work Brandt and Turner (2006) find that Chinese village elections provide leaders with strong incentives to act in the interests of their constituents and rent seeking has been reduced by elections. That is true even when elections are corrupted. Similarly, Zhang et al. (2004) finds significant effect of village election on the structure of revenues and allocation of public expenditures. They find that elected local leaders tend to shift direct tax burdens from households to enterprises; Moreover, elections reduced the opportunities of wasteful spending.

Although positive reports from the field studies are promising, introducing elections to further up levels, such as township and county or even province will be much more difficult. There is a great deal of uncertainties whether village election will become the first step to transform the Chinese governance structure into federalism.

5.4 Legal Reform and Regulatory Decentralization

The regional governments were endowed with lawmaking power when the PRC was established in 1949. Although during the centralization era of the 1950s most of their de jure lawmaking power was taken away, they kept some de facto lawmaking powers. Associated with decentralization policy regional governments were granted lawmaking power since 1979 [literature TBA, (http://www.china.com.cn/zhuanti2005/txt/2003-02/27/content_5283965.htm)]. This lawmaking power is further institutionalized by the 1982 constitution amendment. In addition, the central government some times gave further lawmaking powers to regional governments such as authorized lawmaking power (*shouquan lifa*) or beforehand lawmaking power (*xianxing lifa*) in experimenting new laws. As a result, more than six

thousands laws have enacted by regional governments nationwide since 1978 [TBA (commercial law web)]. Overlapping and conflicting between regional laws and national laws are issues complained often.

Regional governments' role in law enforcement is a lot more important than their roles in lawmaking. Regional governments are responsible for most law enforcements in China [elaborate details and literature TBA]. One of the most serious problems associated with the role of regional governments in law enforcement is the dependency of the court on the regional government (Clarke, Murrell and Whiting, 2006). It is non-controversial that the lack of judiciary independence has created grave problems. However, in many regions private businesses were developed ahead of relevant laws that protect them. When law development is lagged behind business practice, regional governments usually step in as a substitute a governance vacuum is avoided (Pistor and Xu, 2005).¹⁶ The constitutional protection to private property rights was enacted in 2004 when the private sector was already one of the largest sectors in China after more than one decade's double digit growth. Indeed, the development of private sector, including privatization, pretty much relied on initiatives and protections by regional governments (Cao, Qian and Weingast, 1999; Garnaut, et al., 2005; Cull and Xu, 2006; Guo and Xu, 2006). However, many of the initiatives and protections provided by regional governments to private firms are not fully consistent with the constitution. Thus, strong incentives given to regional governments for the risks involved are necessary. It is worth to notice that similar developments happened in European and American history as well that business practice went first and relevant laws developed later. For example, important securities laws (US 1933/34 Acts) were developed decades behind the development of securities markets in the US. However in Europe/US, there were functioning legal systems that effectively enforce general laws, such as contract law, tort law etc., to new business practices (Xu and Pistor, 2006). But in Chinese reforms, a functioning legal system is under construction. Thus, it is essential to have some functioning mechanisms to fill in the governance gap (Pistor and Xu, 2005).¹⁷ [Regional governments' law enforcement: e.g. Clarke, Murrell and Whiting, 2006; Region based regulatory regime: Pistor and Xu, 2005; Du and Xu, 2006; Regional government's lawmaking: lack of judiciary independence: close link between regional governments and regional courts.]

6. Regional protections

¹⁶ Pistor and Xu (2005) focus on financial regulation whereas Gordon and Li (2003) discuss distortions of Chinese financial markets from a different angle.

¹⁷ Without a functioning legal system corruption must be a major syndrome for the powerful and deeply involved regional governments. Anecdotes and mass media coverage have been consistent with this expectation. However, it is not clear that regional governments' who support private sector more are necessarily more corrupted or less corrupted. Based on a recent nationwide survey Guo and Xu (2006) find that regional government corruption is uncorrelated with regional governments' support to private firms.

The Chinese regional decentralization does not always paint a rosy picture. One of its major negative impacts is that it may motivate regional governments to take regional protection measures. Similar to trade barriers erected in international trade, regional governments may want to put up barrier to shield local firms and industries. Interregional trade barriers regional protectionism can become a serious problem unless there are effective central-government policies. It was reported that in the mid-1980s regional governments tried to retain low priced raw materials, such as wool or silk, within their jurisdictions in order to favor local manufacturers (Watson, Findlay et al. 1989; regional protection (Wong, 199x; Bernstein and Lu, 2000, 2003). This is confirmed by numerous domestic and international mass media coverage.¹⁸ However, there are also abundant literature, statistics and mass media reports on the fast growing inter-regional trade [reference TBA]. Indeed, one of the most important early reforms is legalization of cross region trades carried by all types of merchants including private traders [reference TBA]. Lau, Qian and Roland (2000) contend that the “dual-track system” introduced in the reforms promotes interregional trades. That is because under the “dual-track system”, local officials can “sell” the rights to purchase a certain percentage of raw materials and final products at lowered planned prices. Since opening up the market to other regions may significantly increase the market price, it is beneficial for local officials.

It is also plausible that regional protection is a reaction caused partly by ever increasing interregional trade and partly by regional interests facing the interregional competition. If so it is not surprise that whether regional protection gets worse over time is controversial (Bai, Lu and Tao, 2004).

By investigating evolution of provincial economic structures (structure of GDP or national income), Young (2000) finds that they are similar and becoming more similar through the early 1990s. Based on these discoveries he concludes that regional protection is getting worse and has actually led to the fragmentation of the domestic markets. By studying capital mobility cross provinces, Boyreau-Debray and Wei (2005) find Chinese financial system is regionally fragmented, which indicates regional protection.

However, by using a more disaggregate and more recent data than those of Young (2000), Bai, Du, Tao and Tong (2004) find that regional specialization has been strengthened and has become dominant over the forces of regional protection in recent years. Moreover, Fan and Wei (2006) provides evidence of price convergence in Chinese markets, which implies market integration. Furthermore, they discover that the patterns of price convergence in China was highly comparable with those in the United States and

¹⁸ A recent New York Times report demonstrated trade barriers among Chinese regions. To protect their local made car manufacturers, “Tianjin local officials barred taxi companies in the city from buying Geelys,” which is produced by a Zhejiang based car manufacturer (NYT, 11/17/2006). A casual observation confirm this as a general phenomenon that most taxi cabs in many major cities, e.g. Beijing, Tianjin, Shanghai, Changchun, Guangzhou, etc., are made locally:

Canada; and the estimated speed of price convergence for China is even faster than those estimated for these countries.

It is worth to point out that there are some important unresolved theoretical issues involved in the debate. As Naughton (2003) points out that without an underlining theory and without a cross country comparison, looking at one country's regional specialization alone might be misleading. Indeed state manufacturing sectors in the U.S., an integrated national economy, became less specialized recently that in 1987 they became more similar than they were in the past (Kim, 1995). Moreover, by using the same approach as Young (2000), Holz (2006) finds that indeed Chinese provinces are similar to American states in degree of regional specialization.

Following a similar approach as Kim-Young-Holz, it would not be surprised to find out that regional specialization in Russia (and former Soviet Union) is much higher than that in China. According to MQX, which takes composition of regional economies as exogenous and does not consider scale economy, extremely high regional specialization would hamper effectiveness of yardstick competition in that economy. However a more complete theory is yet to be developed to analyse more dynamic and more subtle regional competitions when both composition of regional economies and scale economy are endogenously chosen by players.

[Add literature on losing Macro Control, inflation, land problems etc. caused by regional decentralization: e.g. Wang, 1991; Brandt and Zhu, 2000]

[Add literature on regional protection and the break-up of the nation: Hu and Wang (199x) take Yugoslavia as an example in claiming regionalism may lead to break-up of the nation; relationship with the general literature on the break-up of nations: Bolton and Roland, 1997; Alesina, Spolaore and Wacziarg, 2000; Alesina and Spolaore, 2003].

7. Regional disparity

Beside the record breaking prolonged fast growth rapid widening disparity of wealth in China has been a major concern. On the one hand, arguably, in the last quarter of century China has experienced the largest scale of poverty reduction in human history. The Chinese population in absolute poverty (defined as \$1/day income) has dropped from 50% to 7% in twenty years with a reduction in the number of individuals in absolute poverty by almost 400 million. This number is nearly three quarters of poverty reduction in the whole developing world (World Bank, 1995). On the other hand, the Gini coefficient has been increasing in the last quarter of century that disparity in China is getting close to those of some of the most unequal countries in the world [World Bank, 200x; others TBA].

The relationship between growth and inequality is a major debating subject (for a recent survey sees Aghion and xxx, 1999). On the one hand, inequality is regarded as necessary and transitional in the process of industrialization or growth (Kuznets, 1955). Moreover, increase of inequality may not be so bad even for the poor when an economy grow fast since the poor benefit more from increasing aggregate growth than from

reducing inequality through redistribution (Quah, 2003; Deininger and Squire, 1998; Dollar and Kraay, 2001). China's fast increasing per capita income came together with rises in inequality is used as a major example to illustrate the above point (Quah, 2003). The reform policy in the first two decades of Chinese reforms, 'let some people become rich first' [Deng, xxxx], is in line of this thought. On the other hand, it is also argued that inequality has impacts on politics, investment etc. which in turn can harm stability and growth [TBA, e.g., Alesina and Rodrik, 1994].

How to understand the fast growing inequality in China, is the Chinese duo (high growth and increasing disparity) a 'normal' development path prescribed by the well known Kuznets curve? To what extent is it related to regional decentralization?

The impact of regional decentralization on inequality is a major debating subject. It has been argued that without a strong central government or federal government, fiscal federalism may lead to regional disparity (e.g. Rodden, 2002 and Rodden and Rose-Ackerman, 1997). Based on Chinese provincial fiscal data Jin, Qian and Weingast (2005) claim that decentralization is good for regional equity. However, based on county level data, Tsui (2005) and Zhang (2006) find that the regional fiscal disparity has worsened since the 1994 fiscal reform. There are some scholars who even argue that rapid widening of regional disparity caused by regional decentralization can lead disintegration of China (Hu, Wang and Kang, 1995). In parallel to these arguments, the Chinese central government has made huge fiscal transfers to regional governments in the last decade [TBA, including World Bank reports]. However, the impacts of these policies are under debate [TBA].

As a closely related subject, regional income inequality is also a major subject under hot debates. By studying Chinese rural household data from 1987 to 1999, Benjamin, Brandt and Giles (2005; 2006) find regional inequality was declined and the increased inequality was mainly due to widened differences between households within the same village. However, Kanbur and Zhang (1999, 2005) suggest that regional decentralization was positively correlated to regional disparity, which in turn has contributed for about one third of the Chinese inequality. Based on provincial level aggregate data, Lin and Liu (2005) and Fleisher and Chen (1997) also find widened regional disparities. Fleisher and Chen attribute the widened disparity to central government's policies of favoring coastal regions' development. But Lin and Liu emphasize on different regional governments' strategies and their effectiveness in economic development. Park, Rozelle, Wong and Ren (1996) also report negative distributional effects of regional decentralization [Elaborate; Add more literature, e.g. West and Wong, 1995;; Knight and Li, 1999; and also literature on poverty relief in poor regions by Park, Wang and Wang, 2002)].

8. Conclusion: Tradeoffs of Regional Decentralization

How to explain the spectacularly successful Chinese reform is a major challenge in economics. The best known successful Chinese reform policies are fairly standard, such as land reform (the HRS), globalization (or 'open door' policy in Chinese terms).

However, on the other hand corporate ownership and governance structures of majority Chinese firms were highly unorthodox, government involves deeply in business and legal institutions are terribly weak. An incredible combination between poor institutions and the most spectacular performance makes China a puzzle. This paper intends to solve this puzzle. We argue that one of the keys to understand the ‘un-explainable’ is the regional decentralization. We appreciate that the successful Chinese reform ought to be explained by multiple factors and reform policies, and many of them are complementary to each other that they should not be treated separately. By focusing on regional decentralization our focus is on basic institutional conditions for experimenting and implementing reform policies, be they successful or failure. That is, we regard regional decentralization as a critical complementary factor to the success or failure of other important reform policies.

It should be pointed out that solutions brought up by regional decentralization are the second best at substantial costs. In the literature there are papers focusing on benefits of regional decentralization and there are papers on problems caused by regional decentralization. This paper will analyze tradeoffs between the costs and benefits of regional decentralization by organizing the debates in the literature into a coherent conceptual framework. In addition to a comprehensive understanding the Chinese reform, this analysis will help us to find out optimal regional decentralization, what should be decentralized, to what degree, etc. Moreover, the tradeoffs of regional decentralization are closely related to some of mostly debated predominant tradeoffs that China is facing.

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