

# **China's Economic Growth and Regional Decentralization**

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# China's Economic Growth

- Spectacular Chinese economic growth performance since the reforms started in 1978
  - Growth: prolonged high growth at an unprecedented scale
  - Poverty reduction: largest scale in human history
  - Largest foreign reserve and one of the largest FDI recipients
  - R&D: the 5<sup>th</sup> largest patent applicant country in the world (OECD report, 2007)
  - Huge and fast growing impacts to the global economy
- What are the most important institutional changes which drive Chinese economic growth?
- Chinese regional decentralization as an explanation
- Will Chinese growth sustainable?
  - Is Chinese regional decentralization a proper institution for China's further development and growth?

# Fundamental Chinese institution:

## Regionally decentralized authoritarianism

- China is highly centralized in personal controls and mass media controls
  - Provincial level officials are directly controlled by the central government
  - Nested personnel controls over lower level regional officials
- Highly decentralized in resource allocation & business activities
- Regional governments run the economy
  - Most SOEs are under regional government control
  - Almost all firms in non state sector are under regional government control (regulation and resource allocation)
- Regions (provinces, cities, counties) are relatively self-contained
  - Provide conditions for regional competition and regional experiments
- The degree of decentralization varies over different periods but the fundamental institution has been stable
  - Decentralization-centralization cycles

# Brief Historical Overview of the Fundamental Chinese Institutions

- Mao, On the Ten Major Relationships, 1956
  - Setting up basic principles of regional decentralization
- The first wave of regional decentralization: the People's Commune Movement and the Great Leap Forward Movement, the late 1950s
  - Large scale transfer of power/resources to regional governments
  - Setting up self-contained communes nationwide
  - Coordination disaster and great famine
- The second wave of regional decentralization: “the Cultural Revolution,” 1966-1976
- When reforms started in 1978 the regional decentralization is already in the place
- All variations since then have never changed the basic structure

# Fiscal Decentralization Is Only One Aspect of Regional Decentralization

- Regional governments control major resources within their jurisdictions
  - Most SOEs and COEs are owned by regional governments
  - Land is de facto owned by regional governments
  - Regional governments' influences on allocation of energy and financial resources
- Regional fiscal policy is only part of regional governments' activities
  - It is a good proxy for regional decentralization for certain periods, e.g. 78-93
- Have to be careful when measuring regional decentralization by fiscal policy alone
  - Fiscal revenue/expenditure may not reflect autonomous power delegated to regional governments
  - 1994 fiscal recentralization was associated with an enlargement of regional governments' power in some areas
    - Green lights for various privatization measures in firms and in land

# Chinese Central & Sub-national Fiscal Revenue

Unit: 100 million RMB

Year	Total	Central	Provincial	Provincial/Total	Institutional Changes
1953	213.24	177.02	36.22	17%	1st Five Year Plan
1958	379.62	305.26	74.36	20%	2nd Five Year Plan
1959	487.12	118.78	368.34	76%	Great Leap Forward
1961	356.06	76.65	279.41	78%	
1966	558.71	196.49	362.22	65%	Cultural Revolution
1975	815.61	96.63	718.98	88%	
1978	1132.26	175.77	956.49	84%	Reform Starts
1980	1159.93	284.45	875.48	75%	Fiscal reform starts
1984	1642.86	665.47	977.39	59%	
1988	2357.24	774.76	1582.48	67%	
1993	4348.95	957.51	3391.44	78%	Fiscal decentralization ends
1994	5218.1	2906.5	2311.6	44%	Fiscal rule change
2004	26396.47	14503.1	11893.37	45%	
2005	31649.29	16548.53	15100.76	48%	

# Regional decentralization and Successful earlier reforms

- Most earlier successful reforms involved regional competitions and were based on regional experiments
- A basic reform strategy is to let regions at all levels compete to each other
- Regional experiments initiated by regional governments
  - Household responsibility system initiated by Fengyang and promoted to regions nationwide
- Regional experiments initiated by the central government and promoted nationwide later
  - Special economic zones started from Shenzhen etc. and promoted to regions nationwide

# Evidence: Growth and Regional Decentralization

(Lin and Liu, 2000; with panel data of 1970-93)

- Reforms based on regional decentralization explains most of regional growth
  - Non state sector development had the greatest impact on regional growth
    - The share of non-SOEs' output in the total industrial output (NSOESH)
  - Household responsibility system (HRS) had the second greatest impact on regional growth
- Fiscal decentralization (FD) also affected growth but with substantially smaller magnitude
- $g_{it} = .26NSOESH_{it} + .057HRS_{it} + .026FD_{it} + .054GI_{it}$   
(3.81) (2.30) (1.66) (2.88)

$$R = 0.56$$

# Conditions for decentralization be successful

- Regional decentralization itself is not sufficient for reform/growth to occur
  - Although it provides mechanisms for regional competition and regional experimentation
- Chinese regional decentralization has been in the place for long but reform and fast growth only occur after 1978
- Decentralization in many countries did not work
- Other conditions to make regional decentralization work
  - Central government's objective
    - Incentives given to regional governments
  - Ranges of control delegated to regional governments

# Conditions that make Chinese regional decentralization successful

- National government is sufficiently strong
  - To keep political stability
    - Political stability can be an equilibrium when there are strong collective incentives among the elites for political stability at the end of the Cultural Revolution
  - To keep national unity
    - Long history of being a unified country with ethnic homogeneity
  - To keep macro control
- Regional governments have controls over sufficient amount of resources in wide ranges
  - As a condition to make regional autonomy possible
  - This is particularly important for developing countries where markets are not well developed

# Determinants of the objectives of the national government

- Improving economic performance provided legitimacy for the first generation of national leadership after the “Cultural Revolution”
  - Politics at the end of the Cultural Revolution: Deng vs. “Gang of Four”
  - An agenda shared by most officials and constituency: The popularity of “the Four Modernization” vs. declined revolutionary ideology
  - Against the Cultural Revolution legacy change is necessary
  - An agenda with political implications: replacing the agents of the “Gang of Four”
- Reform has been regarded as necessary to improve economic performance
  - Lessons from FSU and CEE stagnation and reforms – no reform no growth
- Reform and performance provide legitimacy for later generations of national leaders
  - They are consistent with and necessary for nationalism
  - Most reform agendas have to be implemented through regional governments
- Economic reforms and regional decentralization are in the interests of most national officials

# Tradeoffs Posed by Chinese regional decentralization

- Two sides of the same coin
  - Spectacular performance and severe problems are both created by regional decentralization
- Regional decentralization leads to regional competition
- Consequences of regional competition
  - Drives regional growth
    - Attracting regional FDI
    - Regional urbanization
  - Drives regional protection
  - Drives land/environmental abuse
  - Distorts law enforcement; resists judiciary independence
  - Resists macro control
  - Ignores factors creating externalities (e.g. social security)
- Tradeoffs of regional decentralization determines what China does and where China goes

# Tradeoffs: regional competition

- Devolution of self-contained regions creates conditions for yardstick competitions at higher levels of regional governments (Maskin, Qian and Xu, REStu 2000)
  - Compete for setting up regional business, e.g. attracting FDI
- Race to the top?
  - Compete for growth
  - Promotion/demotion is linked to regional growth (MQX, 00; Li and Zhou, 06)
- Race to the bottom?
  - May compete for resisting macro control
  - May compete at abusing land/environment
- There is multiple equilibrium and some equilibriums are not optimal

# Regional decentralization and experiments

- Self-contained autonomous regions create conditions for regional experimentations for testing reform policies (Qian, Roland and Xu, JPE 2006)
  - HRS, SEZ, fiscal decentralization (Jiangsu, 1997), privatization (gai-zhi), social safety net, etc.
- The tradeoffs associated with regional competition determines directions of experiments
- What are chosen to be experimented and what are chosen to be promoted are determined by incentives of regional governments – race to the top/bottom?
  - May experiment some suboptimal policies
  - May refuse to promote better policies which have been successfully experimented in other regions
- There is multiple equilibrium and some equilibriums are not optimal

# Multi task nature of regional governments

- Control mechanism of a regional decentralized authoritarian regime
  - Regional competition within a region based multi level hierarchy  
Personnel control (appointment, promotion/demotion) is the key of the control
- Multi task nature of the regional governments
  - Regional governments are responsible for multiple objectives
  - Officials have ‘private business’ or rent seeking activities
  - There are conflicts among these multiple objectives
- Incentives of regional governments
  - With a properly designed incentive scheme regional competition can lead to a race to the top, if
    - All tasks are well measured (MQX (2000) and QRX(2006) are examples)
  - If one objective is well measured but others are not regional competition may lead to a race to the bottom for poorly measured objectives
  - Sustainable growth may depend on many objectives

# Regional decentralization: past and future

- At early stages of Chinese reforms (before the early 2000s)
  - Economic growth was the most important objective
    - Commonly agreed by the central government, regional governments and the constituency
    - Sacrificing other objectives are tolerable
  - Regional competition helps for fast growth MQX (2000) and QRX(2006)
- At later stages of Chinese reforms (after the early 2000s)
  - Value of other objectives, e.g. inequality & environment, is raised
  - Sustainability of growth requires better solutions of these issues
  - Multi task nature becomes more pronounced
- Can the problem be solved within the regional decentralized authoritarian framework?
  - To deal with multi tasks within a hierarchy agents have to be given low powered incentives
  - It will reduce agents' efforts greatly
    - Vigorous regional competition may not be desirable any more
  - An ultimate solution is beyond such hierarchical structure

# Conclusion

- Mechanisms associated with regionally decentralized authoritarian drove the changes of the Chinese economy
  - Region based hierarchy: multi task nature
  - Regional competition under the control of the central government
- There are build-in mechanisms for growth, for expanding land use and urbanization
- But there is no sufficient build-in mechanism for macro control and for important aspects affecting sustainable growth
  - Admin approach for credit control in the mid 1990s
  - Central government's failing in macro control since 2004
  - Alleged widening regional disparity (poverty trap for poor regions)
  - Environmental problems associated with abuse of land
  - Social instability caused by low compensation in land requisition (lack of legal protection of property rights)
- There is no ready theoretical solution for the multi task problem within the decentralized authoritarian hierarchy
- Regional governments have to be accountable to their constituencies rather than incentives within a hierarchy