Between Separate Stoves and a Single Menu: Fiscal Decentralization in China*

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ABSTRACT A recent body of literature with the paradigm of market preserving federalism at its core contends that China is a *de facto* federalist state. With the autonomy and tax rights of local governments entrenched in the reform era, local governments have allegedly become decentralized engines of growth. Scrutinizing the underlying premises of the above paradigm, this article arrives at a picture of China's local governments as less autonomous and the system of vertical bureaucratic control as more potent than that painted by the above paradigm. Emerging from our findings is an alternative interpretation of China's central–local fiscal relations that may help us understand such recent phenomena as the proliferation of arbitrary charges.

If the Russian great leap to market and democracy has so far turned out to be a litany of unfulfilled aspirations and gross miscalculations, China's somewhat timid excursion into the uncharted waters of reform has been amply rewarded with unprecedented growth. Trying to make sense of such a great divergence is a body of literature that accentuates the role of fiscal decentralization – the devolution of decision-making powers to local governments – as the handmaiden of China's rapid economic growth in the reform era.[1] Throughout this article, such fiscal decentralization is referred to as the "helping-hand paradigm." Forming the backbone to this new literature is the model of market preserving federalism, weaving together a tapestry of Chinese institutional innovations that limit central-state predation and unleash local-state entrepreneurship. Specifically, the fiscal contracting system introduced in the 1980s, the hallmark of China's *fenzao chifan*, or "meals prepared by separate stoves," allegedly commits the centre and the provinces to long-term and stable schemes of sharing the fiscal pie, clarifying their tax rights and thereby restraining central-state predation. Being "residual

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1. See Gabriella Montinola, Yingyi Qian and Barry R. Weingast, "Federalism, Chinese style: the political basis for economic success in China," *World Politics*, Vol. 48, No. 1 (October 1995), pp. 50–81; Yingyi Qian and Barry Weingast, " Federalism as incentives to preserving market incentives," *Journal of Economic Perspectives*, Vol. 11 (Fall 1997), pp. 83–92, Qian Yingyi, "The institutional foundations of China's market transition," in Boris Pleskovic and Joseph E. Stiglitz (eds.), *Annual Bank Conference on Development Economics* 1999 (Washington DC: The World Bank, 2000); Ekaterina V. Zhuravskaya, "Incentive to provide local public goods: fiscal federalism, Russian style," *Journal of Public Economics*, Vol. 76 (2000), pp. 337–368, Daniel Berkowitz and Wei Li, "Tax rights in transition economies: a tragedy of the commons?" *Journal of Public Economics*, Vol. 76 (2000), pp. 369–397. This body of literature also borrows ideas from the works of Jean Oi, e.g. *Rural China Takes Off: Institutional Foundations of Economic Reform* (Berkeley: University of California Press, 1999).

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claimants" or "shareholders" to the fruits of local development, the interests of local cadres are aligned with those of their communities. Furthermore, inter-jurisdictional competition and factor mobility limit local-state predation. With their newfound freedom and autonomy reminiscent of a federalist state, the energy of local cadres is largely channelled into ventures that ultimately account for the spectacular economic performance of China in the reform era. The story has quickly sunk in as a set of stylized facts in the community of economists.[2]

To what extent is the above story a close approximation of China's central–local fiscal relations in the reform era? Is China really so far down the road of decentralization as to fit the description of a "*de facto* federalist state"? If the paradigm predicts that the grabbing hand of the central and local states are tied by the threat of people and investors voting with their feet (the exit option suggested by Hirschman[3]), how can one rationalize the chronic and widespread problem of predatory charges (*luanshoufei*) which is plaguing China in the reform era? This article is an attempt to address these questions and re-examine the premises underlying the helping-hand story. The picture that emerges is a top-down and more centralized central–local governance structure, echoing and complementing the observations of such researchers as Huang Yasheng, Dorothy Solinger and Christine Wong.[4] Of particular interest is the target responsibility system as a concrete manifestation of central control and its effect in shaping the allocation of fiscal resources at the local level.

The organization of the article is as follows. The first section summarizes two features of China's fiscal decentralization pertinent to the subsequent exposition and how the helping-hand paradigm interprets these features. An alternative portrayal of China's central–local relations is the subject of the second section, highlighting the evolution of the cadre management system that provides the levers for upper-level governments to control their subordinates. The remaining sections examine the history in the first two decades of reforms to find out whether the empirical evidences are commensurate with these two contrasting models.

2. For a sample, see e.g. Oliver Williamson, "The institutions and governance of economic development and reform," in Michael Bruno and Boris Pleskovic (eds.), *Proceedings of the World Bank Annual Conference on Development Economics, 1994* (Washington, DC: The World Bank, 1995), pp. 171–197; Aoki, Masahiko, *Toward Comparative Institutional Analysis* (Cambridge, MA: MIT Press, 2000), pp. 165–69; Gerard Roland, *Transition and Economics* (Cambridge, MA: MIT Press, 2001), pp. 279–281.

3. Albert O. Hirschman, *Exit, Voice, and Loyalty: Responses to Decline in Firms, Organizations, and States* (Cambridge, MA: Harvard University Press, 1970).

4. See Huang Yasheng, "Administrative monitoring in China," *The China Quarterly*, No. 143 (1995), pp. 828–842; Huang Yasheng, *Inflation and Investment Controls in China*: *The Political Economy of Central–Local Relations during the Reform Era* (Cambridge: Cambridge University Press, 1996), ch. 4; Huang Yasheng, "Political institutions and fiscal reforms in China," *Problem of Post-Communism*, January/February, 2001, pp. 16–26; Dorothy J. Solinger, "Despite decentralization: disadvantages, dependence and ongoing central power in the inland – the case of Wuhan," *The China Quarterly*, No. 145 (1996), pp. 1–34; Christine Wong, "Central–local relations in an era of fiscal decline: the paradox of fiscal decentralization in post-Mao China," *The China Quarterly*, No. 128 (1991), pp. 691–715.

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In particular, the third section reviews the evolution of China's central–local fiscal relations suggesting a less clear-cut picture of the centre credibly committed to maintaining local autonomy through fiscal contracts and keeping its hands off funds of which local governments are supposed to have ownership rights. The fourth section presents evidence that the proliferation of unfunded mandates is a concrete manifestation and vivid reminder of a vertical control system lurking behind central–local fiscal relations. With local cadres answerable to the upper levels of governments and weak mechanisms holding local cadres accountable, the next section suggests that the different tiers of governments can be quite predatory as witnessed by the proliferation of arbitrary charges in China. The concluding section summarizes the major findings and discusses their implications with respect to the reform of China's central–local fiscal relations.

Fiscal Decentralization and the Helping-hand Paradigm

Before re-examining the premises underlying the helping-hand paradigm, and to clarify some concepts used throughout the article, this section gives a brief introduction to two dimensions of China's fiscal decentralization critical to the helping-hand story. Fiscal decentralization was allegedly a remedy to the highly centralized system of remitting all funds to the centre to be then disbursed among subordinate governments (or what the Chinese often refer to as *tongshou tongzhi*). It was an attempt to assign to local governments more stable sources of revenues and to devolve more decision-making powers to local governments so that they could have greater flexibility in the disposition of their shares of revenues.

There are two main features of China's fiscal decentralization pertinent to the subsequent discussion. One of them is the introduction of fiscal contracts between successive levels of governments stipulating formulae to share locally generated revenues as well as subsidies from or remittances to the next level of government. In theory, local governments were supposed to have more discretion over the disposition of local fiscal revenues though they were supposed to face a hard budget constraint and live within their means (or metaphorically local governments had their own separate stoves).[5]

The second important feature is a freer rein given to local governments in tapping off-budget resources. Local governments were encouraged in the reform era to raise funds through multiple channels (*duoqudao jizi*) to make up for their budgetary shortfalls, thereby setting off an explosion in

5. There is already a large literature on the subject. See e.g. Christine P.W. Wong, Christopher Heady and Wing T. Woo, *Fiscal Management and Economic Reform in the People's Republic of China* (Oxford: Oxford University Press, 1995); Susan Shirk, *The Political Logic of Economic Reform in China* (Berkeley: University of California Press, 1993), ch. 9. For a recent and particularly perceptive Chinese account, see Jia Kang and Yan Kun, *Zhongguo caizheng*: *zhuangui yu fazhan* (*Chinese Public Finance: Transition and Development*) (Shanghai: Shanghai yuanyang chubanshe, 2000), ch. 2.

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off-budget resources. Two sources of quasi-public funds fall outside the orbit of local budgets: extra-budgetary (*yusuanwai*) and extra-system (*zhiduwai*) funds.[6] The growth of the former is largely attributable to many charges levied by administrative and institutional units (*xingzheng shiye danwei*). For example, the extra-budgetary funds grew at an astonishing rate of 27 per cent per annum between 1982 and 1995, reaching 223.5 billion *yuan*, as compared with the total budgetary revenue of 298.6 billion *yuan*.[7] The composition of extra-system funds is more complicated.[8] Profits from township and village enterprises are no doubt an important contribution for some regions, a point emphasized by the helping-hand paradigm, but they are by no means the only source. In fact, a broad array of charges often ends up in this account.[9]

The two features are the threads with which the helping-hand paradigm knits together its rendition of China's fiscal decentralization. To understand how they fit into the story, one can do no better than to review the building blocks of the helping-hand paradigm:[10]

- Long-term and stable fiscal contracts gradually nurture a reputation of credible commitment by the centre. Commitment is further enhanced by off-budget funds being hidden from the centre's grabbing hand thanks to informational asymmetry. China is thus a *de facto* federalist state with local governments enjoying a high degree of fiscal autonomy.
- With the property rights of local revenues entrenched and a freer rein in tapping local resources, raising funds through multiple channels leaves room for local cadres' ingenuity to pursue such profitable

6. For details see e.g. Christine Wong (ed.), *Financing Local Government in the People's Republic of China* (New York: Oxford University Press, 1997); Sun Tanzheng, Zhu Gang and Wang Chaocai, *Xiandai Zhongguo nongcun caizheng wenti yanjiu* (*Study on Modern Chinese Rural Public Finance*) (Beijing: Jingji kexue chubanshe, 1995); Guojia jiwei zongheshi ketizu, "20 shiji 90 niandai woguo hongguan shouru fenpei de shizheng yanjiu" ("Empirical study of China's income distribution at the macro level"), *Jingji yanjiu cankou*, 25 April 2000.

7. While part of the revenue under administrative and institutional units accrues to units under the central government, the lion's share is local. For example, in 1990, the amount accruing to units under local governments was 51.602 billion *yuan* as opposed to 6.093 billion *yuan* belonging to units under the central government; see Caizhengbu zongheshi, *Zhongguo caizheng tongji 1950–1991* (*China Finance Statistics 1950–1991*) (Beijing: Kexue chubanshe, 1992), p. 194.

8. The English name "extrasystem funds" has been used by Albert Park, Scott Rozelle, Christine Wong and Changqing Ren, "Distributional consequences of reforming local public finance in China," *The China Quarterly*, No. 147 (1996), pp. 751–778. There does not seem to be any commonly agreed name for this category of quasi-public funds. For example Jia Kang and Bai Jingming, "Xianxiang caizheng jiekun yu caizheng tizhi chuangxin" ("The resolution of township and village fiscal difficulties and innovations of the fiscal system"), *Jingji yanjiu*, No. 2 (2002), coin the term non-budgetary funds (*feiyusuan shouru*).

9. For useful discussions of the sources of funds included, see Guojia jiwei zongheshi ketizu, "Empirical analysis of China macro income distribution in the 1990s"; see also Jia Kang and Bai Jingming, "The resolution of township and village fiscal difficulties."

10. Montinola, Qian and Weingast, "Federalism, Chinese style"; Qian and Weingast, "Federalism as incentives"; Berkowitz and Li, "Tax rights in transition economies"; Zhuravskaya, "Incentive to provide local public goods."

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ventures as township and village enterprises that ultimately lift local communities out of poverty, thereby fostering economic growth.
- Instead of abusing their newfound freedoms, the grabbing hands of local governments are handcuffed by inter-jurisdictional competition and factor mobility. The threat of people and investors voting with their feet helps circumscribe local state predation.

Conspicuously crafted by these premises is an image of either a self-restrained centre refraining from trespassing on the rights of subordinate governments, or an ill-informed centre too weak to meddle with local off-budget resources. There is much to admire in this novel interpretation of China's fiscal decentralization experience and one cannot agree more with the philosophy behind the helping-hand paradigm that institutions matter. Having said that, there still remains the question whether China is really so far down the road of decentralization and local governments so autonomous as to fit the description of a *de facto* federalist state. Insofar as the local autonomy of local governments is at issue, what seems conspicuously missing in the helping-hand story is some discussion of China's system of bureaucratic control or what the Chinese refer to as the cadre management system. The voluminous literature on the subject reveals that an elaborate system of vertical control has evolved in the reform era to monitor and assess local cadres, with significant impact on their careers. Since this is one dimension of China's central–local relations too important to be ignored, we put together a brief discussion of the crucial aspects of China's evolving cadre management system and provide an alternative paradigm of central–local relations that highlights the vertical control system.

Separate Stoves under a Single Menu: Local Autonomy versus Vertical Control

In contrast to the helping-hand paradigm, this section paints a somewhat different picture of local governments as subordinate and less autonomous agents of the centre. At its heart is the evolving cadre management system in the reform era that lays down the incentive structure for local cadres. In particular, under the target responsibility system (*mubiao zerenzhi*, TRS) is a set of performance criteria that induce local cadres to allocate their fiscal resources in ways commensurate with the preferences of the centre.

Compared with the pre-reform days, the management of cadres has become more decentralized (for example, instead of concentrating all the power of appointment at the top, each tier of government is entrusted with the power to appoint keys officials one level below it). However, this did not prevent the centre from moulding a new and evolving cadre management system that is an elaborate apparatus overseeing the appointment, evaluation, promotion and dismissal of local cadres in a more decentralized setting. To manage such a large bureaucracy, the problem of informational asymmetry is likely to be severe and determines how

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effective the TRS is in shaping the behaviour of local cadres. It is, however, far from certain whether the centre or upper-level governments are so ill informed that local cadres have full discretion and autonomy with respect to their local businesses. Some have argued that the centre actually has an information-gathering capability surpassing that of the pre-reform era.[11] The arsenal of weapons that orchestrates local cadres to fall in line with the central agenda has carefully and eloquently been documented by Huang Yasheng and will not be repeated here.[12] Suffice it say that the sticks and carrots are still there, albeit in somewhat different guises.

Of particular interest is the evolving incentive mechanism through which the centre and upper-level governments dispense the various tasks to their subordinates, shaping the provision of public goods and thus the structure of local expenditure. To be more specific and as an illustration, we examine the TRS, a performance evaluation system that has increasingly defined the incentive structure confronting local cadres in the reform era.[13]

The TRS is essentially a management innovation to assess local cadres in accordance with the important tasks and corresponding targets laid down by superior governments. Level by level, these targets filter down and are then decomposed among subordinate governments, departments and individual cadres. Responsibility contracts (*zerenshu*) are signed, detailing quantitatively the targets for the various tasks that have to be attained within a given period of time as well as rewards or penalties depending on the over- or under-fulfilment of those targets.[14] In recent years, this practice has been adopted from the county all the way down to township governments and village organizations.[15]

11. See Huang Yasheng, "Administrative monitoring in China"; Huang Yasheng, *Inflation and Investment Controls*, ch. 4; Huang Yasheng, "Political institutions and fiscal reforms in China."

12. *Ibid.*

13. After completing the preliminary version of this paper, I discovered the interesting works by Susan H. Whiting, *The Political Economy of Institutional Change* (Cambridge: Cambridge University Press, 2001) and Maria Edin, *Market Forces and Communist Power: Local Political Institutions and Economic Development in China* (Uppsala: Uppsala University, Department of Government, 2000), with a useful discussion of the cadre management system and the target responsibility system. This revised version benefits tremendously from their findings.

14. See Han Tian (ed.), *Lingdao ganbu kaocha kaohe shiyong quanshu* (*A Practical Handbook on the Monitoring and Assessment of Leadership Cadres*) (Beijing: Zhongguo renshi chubanshe, 2000).

15. Cao Jinqing, *Huanghe bianshang de Zhongguo* (*China beside the Yellow River*) (Shanghai: Shanghai wenyi chubanshe, 2000), Zhao Shukai, "Zuzhi yu guifan – guanyu yishe difang cunwu guanli weiji de fenxi" ("Organization and institutionalization: analysis on crisis of local management of village affairs"), *Guowuyuan fazhan yanjiu zhongxin diaocha yanjiu baogao* (*Investigative Research Report*), No. 6 (24 January 2000); Zhao Shukai "Nongcun jiceng zuzhi: yunxing jizhi yu neibu chongtu" ("Rural grassroots organizations: operational mechanisms and internal conflicts"), *Guowuyuan fazhan yanjiu zhongxin diaocha yanjiu baogao*, No. 46 (21 March 2001); Zhu Shouyin, "Nongcun shuifei zhidu gaige shiyan yanjiu baogao" ("Research report on the experiments regarding the reform of rural taxes and charges"), *Guanli shijie*, No.2 (1998), pp. 143–153; Zhu Shouyin, "Nongcun jiceng zhidu chuangxin yu shuifei tizhi gaige wenti yanjiu" ("Study on the problems of institutional innovations at the rural grassroots level and the reform of the system

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Since the mid-1980s, the TRS as an important component of cadre evaluation (*ganbu kaohe*) has gradually taken shape amid local experimentation.[16] The provincial political gazettes (*zhengbao*) of the 1990s show a wider and wider spectrum of tasks brought under its rubric, including fertility control, the attainment of nine-year compulsory education and the eradication of illiteracy, environmental protection, suppression of inflation, grain production, and the promotion of agriculture-related projects.[17] By the mid-1990s, a formal set of performance criteria emerged. According to a circular of the Central Organization Department in 1995, local cadres are to be evaluated in accordance with three major sets of tasks. Each of them is in turn broken down into sub-categories, as shown in Table 1.[18]

Grouped under these general headings are often tasks originated in five-year plans, based on which sectoral plans with detailed quantitative targets corresponding to those tasks are formulated. They are also supplemented by annual targets often promulgated by various annual works conferences held at the end of the year. Formal weighting schemes are introduced with points attached to the tasks. The performances of local governments/cadres are then ranked in accordance with the points based on weighting schemes. The larger the weight assigned to a task, the stronger the incentive. In an extreme case, the performance with respect to a target may have veto power (*yipiao foujie*) over all other achievements of local cadres, a case in point being fertility control.[19] More often than not, weighting schemes fixed by the TRS assign heavy importance to economic construction. For example, in a scheme for provincial leading cadres, 60 points out of 100 were assigned to targets related to economic construction.[20] Without actually controlling fiscal resources, upper levels of government may, through these targets, induce local cadres to exert efforts and resources in those directions that are commensurate with their preferences, reducing their autonomy in the disposition of local revenues.

Under the TRS is thus a complex set of incentive contracts between

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footnote continued

of taxes and charges"), *Jingji yanjiu cankao*, 22 September 1999; Nongcun jiceng zhidu chuangxin yu shuifei tizhi gaige wenti yanjiu ketizu, "Nongcun shuifei tizhi gaige de yanjiu" ("Research on the reform of the system of rural taxes and charges"), *Zhongguo nongcun guancha*, No. 6 (1999), pp. 22–34; Whiting, *The Political Economy of Institutional Change*; Edin, *Market Forces and Communist Power*.

16. For a brief history of the TRS and how the system is supposed to work, see Han Tian, *A Practical Handbook*, pp. 100–102.

17. References from the political gazettes are too numerous to be cited. A sample of circulars on the application of TRS to different tasks is available on request.

18. Zhongyang zuzhibu, "Guanyu jiaqiang he wanshan xianshi dangwei zhengfu lingdao banzi gongzuo shiji kaohe de tongzhi" ("Notice on the strengthening and perfection of performance evaluation pertaining to the leadership group of the county (city) party committee and government"), *Zhongzufa*, No. 10 (31 August 1995).

19. See Peng Peiyun (ed.), *Zhongguo jihua shengyu quanshu* (*Encyclopedia of Chinese Fertility Planning*) (Beijing: Zhongguo renkou chubanshe, 1997), for the implementation of the TRS to fertility control in different provinces.

20. See Han Tian, *A Practical Handbook*, pp. 1097–1103.

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Table 1: **Target Responsibility System**

Economic construction	*Social development and spiritual and civil construction*	*Party construction*
1. Economic aggregates, their growth rates and per capita levels 2. State taxation and local fiscal capacity 3. Urban and rural living standards 4. Agricultural production and agricultural development 5. State asset management 6. Enterprise operation and development 7. Infrastructure including transportation, energy, telecommunications, urban construction, water conservancy	8. Population and fertility control 9. Social stability 10. Education, science and technology, culture, sports 11. Environmental protection and ecological conditions	12. Ideological and political construction 13. Building of leadership team 14. Building of democratic centralism 15. Building of Party grassroots organizations

successive levels of governments reminiscent of a hierarchical multi-task principal–agent model, with the principal being successive upper-level governments and the agents being subordinate governments.[21] Insofar as each level of government is empowered to appoint, evaluate and dismiss cadres in subordinate governments, cadres at a given level have the incentives to fulfil the targets from above. Local cadres are thus confronted with the problem of allocating their efforts and fiscal resources with a view to maximizing the benefits of the local bureaucracy without at the same time endangering their career prospects. The strength of target-based vertical control is that local cadres have a strong incentive to exert efforts on those tasks that are easily measurable and to which upper-level governments attach heavy weight, but often at the expense of other important tasks that are less measurable or with less weight attached.

In so far as the decisions are top-down, subordinate governments and their appointed officials are in the final analysis answerable to their superiors in the next level up the government hierarchy and ultimately to the centre. Unless local cadres are checked by such disciplining devices as exit and voice, there is no presumption that their interests are always aligned with those of the local communities. For the helping-hand paradigm, and market preserving federalism in particular, the exit option, that is, inter-jurisdictional competition and factor mobility, are supposed to curb local state predation effectively. However, the proliferation of predatory charges (see below) suggests that such a scenario may be too optimistic. The potency of the exit option hinges on unimpeded flows of factors of production within an integrated national market. However there does not seem to be a consensus on how integrated the Chinese economy is.[22] The incentives that drive local cadres to protect local industries and obstruct inter-regional trade and factor mobility were and are still at work. For one thing, taxes and remittances from local enterprises often constitute a large share of local fiscal revenues. Notwithstanding the 1994 tax reform, income taxes from locally owned enterprises have continued

21. See the pioneering article by Bengt Holstrom and Paul Milgrom, "Multitask principal-agent analyses: incentive contracts, asset ownership, and job design," *Journal of Law, Economics and Organization*, Vol. 7 (1991), pp. 24–52. For a recent survey, see Mathias Dewatripont, Ian Jewitt and Jean Tirole, "Multitask agency problems: focus and task clustering," *European Economic Review*, Vol. 44 (2000), pp. 869–877. Also see our companion paper "Decentralization with political trump: vertical control, local accountability and regional polarization," *Chinese University of Hong Kong, Department of Economics Working Paper Series No. 145*, 2002, for a model based on China's vertical control system delineated in this paper.

22. For different viewpoints, see Alwyn Young, "The razor's edge: distortions and incremental reform in the People's Republic of China," *Quarterly Journal of Economics*, Vol. 115, No. 4 (November 2000), and Barry Naughton, "How much can regional integration do to unify China's markets?" mimeo, 1999. A recent report by a research office under the State Development and Planning Commission, citing many pieces of evidence, suggest that the problem of market segmentation is still a rather serious one; see Guojia jiwei hongguan jingji yanjiuyuan ketizu, "Dapo difang shichang fenge duice yanjiu" ("Research on measures to eliminate local market segmentation"), *Jingji yanjiu cankao* (*Economic Research References*), 9 April 2001.

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to be assigned to local governments.[23] There are even signs since 1994 of a resurgence in local protectionism as local governments have become even more reliant on enterprise income tax after 75 per cent of the new value-added tax and 100 per cent of the consumption tax were assigned to the central government under the tax-sharing system.[24] The wave of enterprise re-structuring (*qiye chongzu*) since the mid-1990s further highlights the distortionary impact of such an enterprise tax-sharing scheme when local governments obstruct inter-regional capital mobility in order to protect their tax bases.[25]

Labour mobility, as dramatized by China's floating population, is sometimes taken as a vindication of factor mobility having a disciplining effect on local governments. However, it is one thing to argue that labour mobility increases and thus improves allocative efficiency, it is another to infer that increased labour mobility curbs local state predation, at least in the first two decades of economic reform. Ironically, the household registration or *hukou* system together with other administrative controls on population mobility may even have provided additional rent-seeking opportunities for the local authorities.[26] It is difficult (at least up to now) for an ordinary peasant household to convert its *hukou* status from agricultural to non-agricultural. Even though peasants may find temporary jobs in cities, their *hukou* status is still agricultural. While this confers on them such entitlements as cultivable land, it is also their responsibility to pay local taxes and charges. Ironically, migration generates remittances ensuring that peasant households can pay the taxes and charges that they cannot otherwise afford especially at a time when agricultural prices are in the doldrums.[27] In order to manage the flow of population, regulations have been put in place demanding that migrants secure all kinds of permits from their home towns (such as family planning certificates) as

23. From 2002 onwards, enterprise and personal income tax are to be shared between the central and provincial governments.

24. See Guojia jiwei hongguan jingji yanjiuyuan ketizu, "Research on measures to eliminate local market segmentation," pp. 21–29. Under the tax-sharing scheme, local governments are entitled to rebates of the two taxes from above, though the formula determining the rebates ensures that the central government secure an increasing share of the two taxes in the long run (see below).

25. See Du Ping, "Rouhua xingzhengqu zhengfu guodu ganyu shichang de jichu tiaojian" ("Fundamental conditions for the weakening of excessive interventions by governments of administrative districts"), *Jingji yanjiu cankao* No. 44 (2001); Ke Shuchen and Ma Haitao, "Qiye bingguo guocheng zhong de zhengfu xingwei" ("Government behaviour in the process of enterprise mergers"), *Guoyou zichan guanli*, No. 5 (1998); Liu Weixiong, "Qiye jituan jianshe yunxing zhong de wenti taoshi" ("In-depth look at the problem of the establishment and operation of enterprise conglomerates"), *Guoyou zichan guanli*, No. 6 (1999), pp. 2–55.

26. See e.g. Guojia jiwei hongguan jingji yanjiuyuan ketizu, "Research on measures to eliminate local market segmentation," p. 31, on the hefty fees that rural sojourners have to pay. Municipal governments have been running a very lucrative business selling urban *hukou*; see also "Zhuanfang: naxie wenti yanzhong de zuo'ai liu nongmin liyi de shixian" ("What are the problems preventing the materialization of peasants' interests"), in www.cei.gov.cn, 20 November 2000 and Kam Wing Chan and Li Zhang, "The hukou system and rural–urban migration in China: processes and changes," *The China Quarterly*, No. 160 (1999), pp. 818–855.

27. Fu Guanming, Liu Yuqin and Liu Minggang, "Guanyu Hubei sheng 30 jia nonghu nongcun shuifei de diaocha de sikao" ("Thoughts on a survey on rural taxes and charges of 30 peasant households in Hubei"), *Xiangzheng caizheng*.

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well as from the receiving cities (such as temporary residence permits). These regulations give local authorities a pretext to slap charges on migrants which can sometimes be quite high.[28] It thus seems uncertain and perhaps optimistic that the exit option effectively assumes the role of guardian against local state predation. Not only is migration still hindered by the household registration system, there is yet to develop a land market whereby peasants may freely buy and sell their plots. All the above impediments to the free mobility of factors of production weaken the effectiveness of the exit option as a disciplining device.

All in all, the above portrayal thus suggests a different paradigm of central–local fiscal relations:

- Rather than a centre kept aloof from the businesses of local governments because of its commitment not to breach the fiscal contracts or its inability to intervene due to the lack of information, the above discussion suggests that the centre still exerts a firm grip over local bureaucracy through its control over appointment, evaluation and dismissal of local cadres.
- TRS, a top-down and target-based vertical control, is a system of incentive contracts that align the interests of local cadres with the preferences of upper-level governments and ultimately the centre. TRS thus provides the lever through which upper-level governments can affect the allocation of fiscal resources at the local level.
- Within the current institutional setting, it is perhaps too optimistic to assume that inter-jurisdictional competition and factor mobility are sufficient to hold local governments accountable. With local cadres answerable to upper-level governments under the vertical control system, there is no presumption that what they implement must align with the interests of local residents.

Was the unfolding of events in China more or less compatible with the helping-hand paradigm as opposed to our vertical-control paradigm? What seems at issue is how autonomous the local governments are and to what extent the rights of local governments are protected. For the helping-hand paradigm, the key to local autonomy is credible commitment and the evidence is the apparent stability of the fiscal contracts. There follows another look at the evidence. If the story of vertical control is a closer approximation to reality, then credible commitment is difficult to maintain if the power resides in upper-level governments and ultimately the centre. Indeed, we show below that the centre has political clout and did not hesitate to use it to introduce measures undermining local tax rights and their commitment to the fiscal contracts. The vertical control system also manifests itself through the imposition from above of the cascading of mandates, often unfunded or partially funded, with the

28. See Guojia jiwei hongguan jingji yanjiuyuan ketizu, "Dapo difang shichang fenge duice yanjiu" ("Research on countermeasures to dismantle local market segmentation"), *Jingji yanjiu cankou*, No. 27 (9 April 2001), pp. 2–48, cites a research on the fees paid by migrants into Zhongshan city in Guangdong.

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performance of local cadres with respect to these mandates assessed under the TRS. Finally, insofar as the mandates are top-down and it is incentive-compatible for local cadres to fulfil them, we present evidence that local governments at times can become quite predatory.

Credible Commitment and Local Autonomy

An important piece of evidence that is supposed to expand and ensure local autonomy is the debut of long-term fiscal contracts with the centre allegedly bound by clearly defined rules not to trespass on the "tax rights" of local governments. Furthermore, local governments have ownership rights over their off-budget revenues. All these are thought to have protected the autonomy of local governments. However, are the autonomy and rights of local governments all that entrenched? Re-examining the vicissitudes of the central–local fiscal system since the early 1980s, a not so clear-cut picture emerges.[29]

The incentives for the centre and upper-level governments to be fully committed to the fiscal contracts seem *a priori* to be weak. For one thing, there was no independent enforcer of these fiscal contracts. Nor was there anything that rendered them irreversible. And most important of all, the centre had the political trump. Reviewing the history of that period, officials of local governments in the 1980s frequently complained that the centre reneged on its promises and the fiscal contracts were anything but stable, harbouring serious doubts about the centre's commitments.[30] One should not forget that the 1980s was a decade of monumental changes. Amid great uncertainties and fiscal decline set off by reforms, there were strong incentives for both the central and provincial governments to re-negotiate the fiscal contracts in light of new circumstances. The 1980 inter-governmental fiscal contracts hammered out by the central and provincial governments were supposed to last five years. No sooner had the contracts come into force than the central government started "borrowing" huge amounts from the provinces to alleviate its fiscal problems in 1981 and 1982. By 1982, the sharing rules stipulated in the

29. For excellent accounts on the evolution of the central–local fiscal relations in the reform era, see e.g. Wong, Heady and Woo, *Fiscal Management and Economic Reform in the People's Republic of China*; Shirk, *The Political Logic of Economic Reform*, ch. 9; Jia Kang and Yan Kun, *Chinese Public Finance*, ch. 2.

30. For example, in a 1987 article, an official from the Liaoning's Bureau of Finance complained about the frequent changes in the fiscal system and lending to the central government. In his words, "local governments will lose confidence with the current system and affect the incentives of local governments"; see Ning Xueping, "Dui zhongyang caizheng xiang difang caizheng daikuan de kanfa" ("Views on the central government borrowing from the provinces"), *Caizheng yanjiu ziliao*, 1987, pp. 20–22. In another survey report published in 1990, officials in Jiangsu province told two Chinese researchers that local governments, fearing that the central government may change the fiscal contracts, artificially depressed budgetary revenue collection; see Xiang Jinquan and Yang Liangchu, "Guanyu Jiangsu Shanghai caizheng hongguan tiaokong wenti de diaocha" ("An investigation of problems pertaining to macroeconomic stabilization in Jiangsu and Shanghai"), *Caizheng yanjiu ziliao*, No. 1 (1990), pp. 14–20. See also Jia Kang and Yan Ku, *Chinese Public Finance.*

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original fiscal contracts were all but modified. Except for Guangdong and Fujian, all the contracts were revised in such a way that the budgetary revenue was shared between the central government and the province in question based on the ratio of provincial expenditure to provincial revenue. To make matters worse, not only were the loans not paid back, they were transformed into permanent transfers through adjusting the parameters (*jishu*) of the fiscal contracts.[31]

Barely two years after the 1982 revision, the system was replaced by another arrangement in 1985, with the boundaries of local and central revenues redrawn as a result of the tax-for-profit reform (*ligaishui*).[32] As if this was not enough, the centre resumed borrowing from the provinces in 1987. The year 1988 witnessed another overhaul of the fiscal contracts. Even before the ink of the 1988 fiscal contracts had dried, the Ministry of Finance began entertaining a new proposal, envisaging the replacement of the fiscal contracting system by the tax sharing system (*fenshuizhi*).[33] By 1990, advocates of the new system seemed to gain the upper hand. Experiments were carried out in Tianjin, Liaoning, Shenyang, Dalian, Zhejiang, Qingdao, Wuhan, Chongqing and Xinjiang in 1992. Finally, after intense behind-the-scene bargaining, the new tax-sharing arrangement was promulgated at the end of 1993. Ever since its introduction, there have been numerous complaints of a re-centralization of fiscal revenues, putting undue fiscal pressure on governments at the lower rung of the administrative hierarchy. From 2002 onwards, the tax-sharing agreement was again modified with enterprise and personal income tax revenues to be shared between the centre and provincial governments.[34]

There were also other channels chipping away the credible foundation of the fiscal contracts. National policies and reforms pushed through by the central government often had spill-over effects on the local budget. Provincial governments frequently complained about reductions in fiscal revenues induced by changes in ownership of enterprises. For example, the transference of Shanxi's electricity-generating enterprises, non-fer-

31. *Ibid.* pp. 66–67. For instance, the central government secured loans from Guizhou in three consecutive years (1981–83) through reducing Guizhou's subsidy stipulated in the fiscal contract. Since 1983, the loan to the central government was transformed into a permanent transfer through reducing the baseline parameters (*jishu*) used to derived Guizhou's subsidy; see Guizhou sheng difangzhi bianzhan weiyuanhui, *Guizhou sheng zhi*: *caizheng zhi* (*Annal of Guizhou: Public Finance*) (Guiyang: Guizhou renmin chubanshe, 1993). The same is true with respect to other provinces.

32. See Du Lingfeng, *Zhongguo shehuizhuyi caizheng guanli* (*China's Socialist Fiscal Management*) (Beijing: Zhongguo renmin daxue chubanshe), 1983, p. 75, or Xu Yi and Xiang Huaicheng, *Di liu ge wunian jihua shiqi de guojia caizheng* (*State Public Finance during the Sixth Five-year Plan*) (Beijing: Zhongguo caizheng jingji chubanshe, 1987).

33. Caizhengbu caishui gaige bangongshi, "1988–1995 nian zhongqi caishui gaige zongti shexiang gaiyao" ("Abstract of the 1988–1995 medium term plan for the reform of the fiscal reform"), reprinted in *Caizheng yanjiu ziliao*, No. 61 (1988), pp. 3–17. Conferences were organized, with specialists and officials from the various ministries and local governments attending. For a summary of the views expressed, see the same issue of *Caizheng yanjiu ziliao.* Apparently, no consensus emerged on the merits of the fiscal contracting system and the tax sharing system.

34. Guowuyuan, "Guanyu yinfa shoudeshui shouru fenxiang gaige fang'an de tongzhi" ("Circular on the publication of the reform plan for the sharing of income tax revenue"), *Guofa*, No. 37 (2001).

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rous metal enterprises and coalmines upwards in the 1980s was a major sticking point between the province and the centre. Similarly, changes in the ownership of the oil and mineral-processing industries in 1983 transformed Gansu into a province receiving central subsidies. The same was true with respect to the electricity and non-ferrous metal industries in Yunnan in the early 1980s.[35]

Local governments' property rights over off-budget revenues were not all that secure either. Ever since the late 1970s and early 1980s, the Ministry of Finance has been toying with the idea of putting public funds dispersed among local authorities (extra-budgetary revenues being one of them) under the rubric of an integrated plan. Local governments perceived such integrated fiscal planning as a potential threat to their ownership of extra-budgetary funds.[36] Indeed, the central government, under fiscal pressure, did take from the extra-budgetary account. The initiation of the major energy and transportation projects fund (*nengyuan jiaotong zhongdian jianshe zijin*) and the state budget adjustment fund (*guojia yusuan tiaojie zijin*) is examples of the central government tapping into the local extra-budgetary funds. By 1990, the amount remitted to the centre was 34.65 billion, or 12.8 per cent of the total extra-budgetary revenue, though these funds were rescinded in the mid-1990s.[37]

Throughout the 1990s, the reform of the extra-budgetary account was gathering pace. The centre was trying to strengthen its control over and surveillance of these funds, with perhaps their integration into the formal budget as the ultimate goal. The starting point was a large-scale investigation of extra-budgetary funds that began in the mid-1990s.[38] This uncovered astounding irregularities and paved the way for a resolution of the State Council, setting the tone for major extra-budgetary reforms.[39]

35. On the effect of changing enterprise ownership on the budget of Shaanxi, Gansu and Yunnan, see Han Manshou and Shen Ronghua, "Dabaogan shi xiang fenshui fenji caizheng guanli tizhi de guodu" ("Fiscal contracting is moving in the direction of tax sharing fiscal management system"), 1988, pp. 20–25; Gansu sheng zhi bianzhan weiyuanhui, *Gansu sheng zhi: caizheng zhi* (*Annals of Gansu: Public Finance*) (Lanzhou: Gansu renmin chubanshe) 1990, p. 327; Hebei sheng caizhengting ketizu, " Zhongyang yu difang caizheng tizhi gaige de zhongqi guoxiang" ("Thoughts on the medium term reform of the central–local fiscal relations"), *Caizheng yanjiu ziliao*; Yunnan sheng zhi bianzhan weiyuanhui, *Yunnan sheng zhi*: *caizheng zhi* (*Annals of Yunnan: Public Finance*) (Kunming: Yunnan renmin chubanshe), p. 50.

36. For example, an important reason behind the failure of integrated fiscal planning in Jiangsu in the early 1980s was stiff resistance from the sub-provincial authorities which interpreted integrated fiscal planning as an excuse to reverse fiscal decentralization. See Jia Kang, "Jiangsu zonghe caizheng jinkuang de diaocha yanjiu" ("Investigative research of the recent situation of Jiangsu's integrated fiscal planning"), *Caizheng yanjiu ziliao*, No. 69 (1984).

37. See Caizhengbu zhonghe jihuasi yusuanwai yichu, "Qiwu shiqi yusuanwai zijin shouru qingkuang jianxi" ("A simple analysis of revenue and expenditure of the extra-budgetary account in the Seventh Five-year Plan"), *Caizheng yanjiu ziliao*, No. 22 (1992), pp. 20–23.

38. Caizhengbu, Guojiajiwei, Shenjiju, Zhongguo renmin yinhang and Jianchabu, "Guanyu baosong 1996 nian qingli jiancha yusuanwai zijin gongzuo zongjie de baogao" ("On the submission of the report summarizing the sweeping investigation of the extra-budgetary funds in 1996"), *Caijianzi*, No. 51 (6 December 1996).

39. Guowuyuan, "Decision to strengthen the management of extra-budgetary funds"; Caizhengbu, "Guanyu yinfa yusuanwai zijin guanli shishi banfa" ("Notice on the

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Departments and units have since lost their ownership rights. More far reaching has been the gradual implementation of the reform entitled "income and expenditure separated into two different channels" (*shouzhi liang tiao xian*) that subjects extra-budgetary funds to more stringent monitoring.

Rather than highly autonomous local governments with tax rights entrenched and a weak centre, the unfolding of events suggests that the centre had the political clout to introduce *ad hoc* measures (such as borrowing from local governments) that encroached on the local coffers, pushed through changes in the central–local fiscal system and tightened control over local off-budget revenues that were supposed to be the preserves of local governments.

Cascading Mandates

Other than the frequent adjustments of the budgetary and off-budget systems, the power of vertical control palpably makes itself felt through the proliferation of unfunded or partially funded mandates.[40] A study of the Chinese literature since the early 1980s reveals growing numbers of complaints of arbitrary shifting of responsibilities (*luan kai kouzi*) to subordinate governments, suggesting a less than clear-cut assignment of expenditure responsibilities.[41] Often attached to these mandates are the

footnote continued

promulgation of the method for implementing the management of extra-budgetary funds"), *Caizongfa*, No. 104 (18 November 1996). For a background leading to the above documents, see Wang Hui, "Yusuanwai zijin guanli tizhi gaige" ("Reform of the extra-budgetary funds management system"), *Difang caizheng*, No. 12 (1998).

40. The problem of unfunded mandates has been plaguing local governments throughout the 1980s and 1990s. Complaints of unfunded mandates appeared almost immediately after the implementation of the fiscal contracting system; see e.g. Duan Bingren and Zhao Zhiyou, "Guanyu wanshan fenji caizheng tizhi de tantao" ("Exploration on perfecting the hierachical fiscal system"), *Caizheng yanjiu ziliao*, 9 August 1982, pp. 4–9 and Zhou Xiangyuan, "Xianji caizheng shixing huafen shouzhi fenji baogan de tizhi xuyao yanjiu jiejue de ji ge wenti" ("A number of problems that have to be resolved after the implementation of the fiscal contracting system"), *Caizheng yanjiu ziliao*, 9 August 1982, pp. 11–14. For more recent discussion, see e.g. Wang Bin, "Fading zhichu: yi ge kujie de huati" ("Mandatory expenditure: a bitter topic"), *Difang caizheng* (*Local Public Finance*), No. 10 (1997), pp. 8–10; Zhao Guangfeng, "Xianji caizheng gaoshouru weihe caili hai jinzhang" ("Why are there shortfalls in fiscal capacity despite high increases in fiscal revenue?") *Zhonggou caizheng*, No. 8 (2000), pp. 32–33.

41. For complaints at the provincial level, see Wu Wei, He Jinsheng and Shen Xiaoping, "Guanyu Hunan sheng caizheng tizhi de diaocha yu jianyi" ("Proposals and survey with respect to Hunan's fiscal system"), *Caizheng yanjiu ziliao* (1987), pp. 4–7; "Caishui gaige zongti shexiang zuotanhui guandian zongshu" ("A summary of the viewpoints on the overall blueprint for fiscal reforms"), *Caizheng yanjiu ziliao*, No. 61 (1988), pp. 7–17; Xiao Jianjun, "Caizheng tizhi de zhuyao maodun shi caizheng zijin de gongxu biancha" ("The major contradiction of the fiscal system is the misalignment of supply of and demand for fiscal funds"), *Caizheng yanjiu ziliao*, No. 61 (1988), pp. 31–32; Han Manshou and Shen Ronghua, "Dabaogan shi xiang fenshui fenji caizheng guanli tizhi de guodu" ("Fiscal contracting is a transition to a fiscal management system of tax sharing"), *Caizheng yanjiu ziliao*, No. 94 (1988), pp. 20–25; Hu Qibiao, "Dui Zhejiang caizheng tizhi gaige de huigu yu fenxi" ("Review and analysis of Zhejiang's reform of the fiscal system"), *Caizheng yanjiu ziliao*, No. 2 (1990). At the county level, see Zhou Xiangyuan, "A number of problems that have

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so-called legislated expenditures (*fading zhichu*), that is, expenditure standards stipulated by laws and regulations to be put aside for the mandates. For example, expenditure per capita for fertility control was stipulated to be one *yuan* in the Seventh Five-year Plan, increased to two *yuan* for the Eighth Five-year Plan, and then doubled to four *yuan* during the Ninth Five-year Plan.[42] Similarly, to ensure the fulfilment of such targets as compulsory nine-year education and the eradication of illiteracy, the target for public expenditure on education as a share of GDP was fixed at 4 per cent towards the end of the Ninth Five-year Plan to be funded through multiple channels.[43] As targets pass down through each tier of government, more mandates may be added, sometimes leading to a cascading effect so that the final burden on the lowest rung of government may be onerous.

Many of the mandates and their corresponding targets are often incorporated into the responsibility contracts signed with upper-level governments so that careers of local cadres are tied to their fulfilment. Thus, local cadres in each tier of government have an incentive to make sure the targets are fulfilled or even over-fulfilled by themselves and their subordinate governments. Some of the targets are very hard, an example being fertility control.

The autonomy-reducing effects of unfunded mandates and legislated expenditures cannot be more obvious. Even without laying their hands on local revenues, upper-level governments, through the lever of the target responsibility system, can actually shape the structure of local expenditure to match their preferences.

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footnote continued

to be resolved," pp. 11–14; Zhai Liansheng, "Xian caizheng chizi bixu zonghe zhili: Wuwei xian caizheng chizi qingkuang diaocha" ("County fiscal deficit has to be tackled through an integrated approach: survey of Wuwei county's fiscal deficit"), *Caizheng yanjiu ziliao*, No. 76 (1988), pp. 4–9; Mo Fangling, "Junnan xian caizheng kunnan de chengyin ji duice" ("Reasons behind and countermeasure against the fiscal difficulties of Junnan county"), *Shandong caihui*, No. 8 (1999), pp. 19–23; Chen Minren, "Dangqian xian (shi) yu jingji fazhan de wenti ji duice" ("Problems of and countermeasures against the current problems of economic development at the county (municipal) level"), pp. 32–38. Christine Wong has long pointed out this problem in "Central–local relations in an era of fiscal decline."

42. Speeches by the Commissioner of the State Family Planning Commission at the National Conference on Financial Works of Family Planning, 8 November 1991, excerpt reprinted in Peng Peiyun, *Encyclopedia of Chinese Fertility Planning*, pp. 1020–24; Minutes of the National Conference on the Financial Works of Family Planning (excerpt), in *ibid.* pp. 1025–27.

43. Zhonggong zhongyang and Guowuyuan, "Zhongguo jiaoyu gaige he fazhan gangyao" ("Principles for the reform and development of China's eduation"), 13 February 1993; Guojia jiaowei, "Guanyu yinfa jiaoyu shiye jiuwu jihua he 2010 nian fazhan jihua de tongzhi" ("Circular on the release of the national development plan for education during the Ninth Five Year Plan and up to 2010"), 10 April 1996.

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Arbitrary Charges

The discussion in the last section presents evidences of a top-down decision-making process in the provision of local public goods. Insofar as such disciplining devices as exit or voice are only weakly effective, there is nothing to rule out the equally likely scenario that self-interested cadres, central or local, may put their careers and the interests of local bureaucracies before the public interest. As mentioned before, the TRS may be thought of as a multi-task principal agent problem. It is well known to be difficult to design an incentive system in a multi-task setting. Agents have an incentive to substitute efforts away from those tasks that have lower weights and are less measurable.[44] In the Chinese context, this weakness of target-based central control is partly to blame for the proliferation of arbitrary charges. The problem of predatory charges presents a paradox to the prediction of the helping-hand hypothesis that local autonomy with inter-jurisdictional competition and factor mobility handcuffs the grabbing hands of both the central and local governments.

Continuing with the story of unfunded mandates in the last section, local governments are permitted to levy an array of charges to finance the various tasks handed down from above. Lamenting over the plight of township governments, the authors of a recent article detail a long list of responsibilities ranging from education to fertility control often imposed from above.[45] To fulfil those duties, township governments have to levy multifarious charges. Prominent among them with their recommended rates on net peasant income are the following, though this list is by no means exhaustive:

Educational surcharge	2 per cent
Health services	0.5–1 per cent
Dissemination of agricultural technology	0.5–1 per cent
Defence education, training of militia and conscription	1.5 per cent
Family planning	1.5 per cent
Retained revenues (*tiliu*) for village cadres	1–1.5 per cent

In a way, the mandates effectively enable higher levels of governments to take from the off-budget coffers of subordinate governments even without actually controlling these resources, thereby not only shaping the structure of within-budget local expenditures but also mobilizing off-budget resources to fulfil the targets handed down from above. In scrambling to fulfil the mandates, fiscal pressures are often translated into charges, inciting tensions at the grassroots level between village cadres anxious to

44. See Holstrom and Milgrom, "Multitask principal-agent analyses." For the perverse effects of incentive systems in a multi-task setting, see Dilip Mookherjee, "Combating the crisis in government accountability: a review of recent international experience,"*mimeo*, December 2001.

45. Meng Fanjing and Meng Jigang, "Zonghe zhili nongcun sanluan jianqing nongmin fudan" ("An integrated treatment of the three arbitrary charges in order to reduce peasant burdens"), *Shangdong caihui*, No.6 (1999), pp. 10–14.

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meet those targets and peasants unwilling to pay arbitrary taxes and charges, thus casting a long shadow on rural stability.[46]

The many tiers of government in China's administrative hierarchy aggravate the problem of arbitrary charges. While relaying the mandates from above to subordinates, governments in each tier also add their own. While many unfunded mandates and their corresponding charges are from the central ministries, there are perhaps even more from local governments that also have their own agendas. For example, of the 90 thousand charges uncovered in a 1993 investigation, many of them were stipulated by sub-provincial governments. Of the 150 billion *yuan* of contributions to the various capital funds, 55 per cent accrued to local governments.[47] With the mandates from different ministries and local governments cascading down the five-tier hierarchy, the ultimate fiscal burdens finally fall on the ordinary citizens and enterprises, with every department and tier of government getting a share.

The fact that the vertical bureaucratic control system is embedded in a context of prodigious regional disparities aggravates the problem. In decomposing targets among subordinate governments, there is a tendency to prescribe uniform standards such as nine-year compulsory education that may be within easy reach of richer regions but too ambitious for poor regions. Even if the targets sometimes take into account the level of economic development of a locality, there may be a tendency to overshoot because of inter-jurisdictional competition (that is, local cadres trying to compete with their counterparts in neighbouring jurisdictions with their neighbours' achievements serving as yardsticks).[48] Local governments in coastal regions, through running profitable ventures such as township and village enterprises, not only benefit themselves and their jurisdictions but also generate sufficient revenues to cover expenditures on public goods, without letting the fiscal burden fall directly on the residents. However, the less developed a region, the larger the fiscal pressure, and the stronger the incentives for local cadres to boost revenue rather than maintain low taxes and charges. More often than not, with

46. There is a rapidly growing literature on rural fiscal governance and rural stability. See e.g. Thomas P. Bernstein and Xiaobo Lü, "Taxation without representation: peasants, the central and the local states in reform," *The China Quarterly*, No. 164 (2000), pp. 743–763. Susan Whiting, *The Political Economy of Institutional Change*; Edin, *Market Forces and Communist Power*; Cao Jinqing, *China beside the Yellow River*; Zhao Shukai, "Organization and institutionalization"; Zhao Shukai "Rural grassroots organizations"; Zhu Shouyin, "Research report on the experiments"; Zhu Shouyin, "Study on the problems of institutional innovations"; Nongcun jiceng zhidu chuangxin yu shuifei tizhi gaige wenti yanjiu ketizu, "Nongcun shuifei tizhi gaige de yanjiu" ("Research on the reform of the system of rural taxes and charges"), *Zhongguo nongcun guancha*, No. 6 (1999), pp. 22–34; Li Zhihe and Liu Xing, "Dangqian nongcun yishe difang ganqun guanxi jinzhang de yuanyin he duice" ("Reasons for and countermeasures against the current tension between cadres and the masses in rural China"), *Dangjian neican*, No. 4 (2001), pp. 1–5.

47. Quanguo zhili sanluan lingdao xiaozu, "Guanyu zhili sanluan gongzuo zongjie baogao" ("The final report on tackling the three arbitrary exactions"), 17 December 1992; Caizhengbu, *Zhongguo caizheng nianjian* (*Chinese Public Finance Yearbook*) (Beijing: Caizheng jingji chubanshe, 1995).

48. See e.g. Cao Jinqing, *China beside the Yellow River*, pp. 300–307 for interesting cases; see also the references cited in n. 46.

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their non-agricultural sectors much less developed than those of their coastal neighbours, the fiscal burden induced by unfunded mandates inexorably falls on the peasants and the burden is particularly onerous at times such as the 1990s when peasant income grew only slowly.

Conclusion

In contrast to the helping-hand paradigm portraying China as a *de facto* federalist state, the above discussion puts together evidence in support of a more nuanced interpretation of China's *fenzao chifan*. The reform era has witnessed the emergence a target-based vertical control system, providing upper-level governments with levers to manipulate the structure of local spending through, *inter alia*, unfunded or partially funded mandates. The mandates are backed up by a cadre management system that controls the appointment, evaluation and dismissal of local cadres. Thus, the degree of centralization cannot be solely measured in terms of the share of the fiscal revenue accruing to the central government but also predicates on the less measurable vertical control mechanism shaping the allocation of fiscal resources at the local level. Though not easily quantifiable, we show that vertical control is no less palpable by scrutinizing and re-interpreting the experience of *fenzao chifan* in the first two decades of reform, suggesting a less credible commitment by the centre and a lesser degree of local autonomy enjoyed by local governments. Vertical control and the TRS in particular are also manifested through the proliferation of unfunded mandates and arbitrary charges.

Rather than the rosy picture painted by the helping-hand paradigm, there is a whole host of problems plaguing the central–local fiscal governance that, if ignored, may ultimately have deleterious effects on the economy. This is especially the case if economic growth slows down in the new millennium after two decades of expansion at a hectic pace. Those problems have already received much attention. The tax-for-fee reform (*feigaishui*) of abolishing all charges and replacing them by a reformed agricultural tax system is the centre's response to the problem of predatory charges; a recent World Bank report calls for the re-assignment of taxes and expenditure responsibilities between the central and local governments to address vertical imbalances (the uneven distribution of resources between the different tiers of governments) leading to arbitrary charges.[49] Some Chinese scholars suggest compressing the five-tier government structure that is thought to have aggravated the problem of tax assignments.[50] These remedies only help alleviate the symptoms without tackling the root cause of the dysfunctional governance structure. Insofar as the incentives induced by the target-based vertical control system remain intact, with cadres putting their career concerns before the interest of the public, it is hard to see how these

49. World Bank, *China:National Development and Sub-National Finance*, Report No. 22951 – CHA, 9 April 2002.

50. Jia and Bai, "The resolution of township and village fiscal difficulties."

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suggestions alone can fundamentally resolve the problem of arbitrary charges without modifying the incentive structure embedded in the vertical control system. Our apprehension is not unfounded and seems to have been vindicated by the centre pulling back the ambitious plan of implementing the tax-for-fee reform in all provinces in 2001.

It is beyond the scope of this article to explore in detail how to reform China's central–local relations. Though not sharing its interpretation of China's fiscal decentralization, market-preserving federalism has aptly put into focus the importance of institutions and their attendant incentives in ensuring accountability. For a vast country like China with prodigious regional differences, devolution of decision-making powers is desirable for efficient governance. The problem in the case of China is that local governments are given more responsibilities and a freer rein to tap local resources and yet they are, owing to career concerns, more accountable to upper-level governments than to the citizens in their jurisdictions. The question is how such distorted incentives may be changed so that the interests of local cadres are better aligned with those of the general public. A bottom-up decision-making process for the provision of public goods to be bolstered by voice and exit as disciplining devices may be the long-term solution. This means replacing appointed local officials by elected ones to re-align their incentives with the citizens in their jurisdictions. Rural elections have already been experimented with in China, but much remains to be done. Other measures to encourage local participation will help. Voice may also be bolstered by the exit option, especially with respect to the peasants who in recent years bore the brunt of arbitrary charges. Not only should the household registration system be relaxed with the ultimate goal of its abolition, a market for rural land should be allowed to develop so that land can change hands easily if the threat of the exit option is to have teeth. Only by strengthening the voice and exit option can there be an environment conducive to credible decentralization. Only then will such remedies as the tax-for-fee reform or the re-design of the central–local fiscal system mentioned above become more effective.

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