Economics and Business

经济与商业
Fiscal Decentralization and Regional Economic Development in China

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Abstract

As the main part of intergovernmental relations, fiscal decentralization plays a crucial role in the process of regional economic growth in China. Chinese fiscal decentralization is a close integration of fiscal decentralization and political centralization. Based on such a perspective, this paper analyzes the characteristics of Chinese decentralization and its impact on the behaviour of government officials. Chinese-style fiscal decentralization with the special political promotion tournament model makes regional governments expand intergovernmental competition to chase a variety of economic factor endowments and then develop the local economy. Excessive centralization or excessive decentralization is not conducive to economic growth, so in theory there may be an optimal degree of fiscal decentralization. In accordance with the theory of fiscal decentralization and related literature, this paper selects a suitable method to measure China’s degree of fiscal decentralization at the level of the provinces and calculate to get the national overall degree of fiscal decentralization. The paper finds that China’s overall fiscal decentralization has been close to or has reached the optimal level. The eastern developed region has the highest degree of fiscal decentralization followed by the middle (central) region and the western region and the degrees of these three regions have a trend of convergence. As for the deviation that the speed of regional economic development does not match the degree of fiscal decentralization between the western region and the middle (central) region, this paper uses the cost of political promotion tournament to explain. It shows that China’s fiscal decentralization is not faced with the question of whether there should be further decentralization or centralization but should instead move towards completing or perfecting the systems, including a well-established political promotion tournament...
system. Through the standard, scientific, transparent and fair systems, fiscal decentralization can more easily play its positive function in regional economic growth.

**Keywords**: fiscal decentralization, regional economic growth, political promotion tournament, China

**JEL classification**: H30, H73, H77, R10

1. Introduction

The post-Mao “reform and opening up” process in China has gone through a history of more than thirty years. During the three decades, the position of China in the world economy has been elevated rapidly. Its average annual growth rate of 9.5 per cent always attracts worldwide attention, so does its total economic scale which has increased from 364.52 billion yuan in 1978 to 1.66276 trillion yuan in 2007. In 2006, China’s gross domestic product (GDP) per capita reached 2000 USD, which marks the advent of the Chinese economy entering a new era of development.

Reviewing the history of more than thirty years, we can find that China’s success has largely depended on a series of decentralization reforms based on the market mechanism and the “opening up” initiative. To sum up, these reforms can be broadly divided into two categories: one category involves interest redistribution between the government and micro-economic individuals under the traditional planned economy system, such as the system of contracted responsibilities on the household basis with remuneration linked to output in the village and enterprise reform in the city. The other one is related to the intergovernmental interest redistribution, like fiscal decentralization reform with the main contents of fiscal responsibility, tax sharing system reform and so on. This paper will study the second category of reforms which bring significant change to the governmental governance model. They are the important factors contributed to Chinese “economic miracle”.

Since the 1980s, as an important mechanism to enhance the efficiency of the provision of public goods, fiscal decentralization has been a major trend in many countries’ economic reform process. Since the introduction of tax system reform in 1994, the degree of China’s fiscal decentralization has deepened. Even before that, China has made great efforts to develop the economy, especially the eastern coastal regions. In 1982, Deng Xiaoping, the Chinese supreme leader, stressed that: “Streamlining organizations is a matter of great importance. In fact, it constitutes a revolution.”
For large developing countries such as China, usually a vertical or horizontal integration in a large number of departments and regions with various resources and economic factors is necessary. It requires the existence of an effective division of labour. Therefore, the relationship between central and local governments regarding the division of labour constitutes an important issue that must be faced. In order to achieve the goal of economic growth performance, a well-functioning inter-governmental governance model must be built, not only to make sure that the central government can keep certain constraints and controls on regional governments, but also to form an effective intergovernmental competition and incentive mechanism. Otherwise, the road of Chinese governance will go easily towards two extremes: either excessive decentralization or excessive centralization. Making a general survey of most countries’ development experience, generally both of these two extremes of governance do not do well at the regime level to ensure sustained economic growth. In an excessively decentralized country, the prevalence of local officials’ rent-seeking behaviour will make the central government face a lot of transaction costs in policy implementation and its economic development plans will meet significant difficulties in the regions. Conversely, if the authority of a country is highly centralized at the highest political levels, the regional competition mechanism will be difficult to form and the problem of “who watches the watchman” will also be highlighted. Thus, a suitable central-local governance model has a very important institutional meaning in a country’s economic growth process.

The tax-sharing system can be treated as a typical case of inter-governmental interest distribution reform in China which shows a significant Chinese governance characteristic, that is, the local government has certain economic and administrative autonomy, but its behaviour is still under the central government’s direct supervision and management, while at the same time, the position of local officials is also subject to appointment and revocation by the central government. In other words, Chinese-style fiscal decentralization reform is a close integration of economic decentralization and vertical political centralization system. Compared to other countries’ model, China’s reform presents a significant dual nature, neither in the sense of complete fiscal decentralization, nor a simple centralized management.

On the one hand, the fiscal revenue-expenditure relationship between central and local government has experienced mortifications many times, but as for the fiscal regime, China is one of the most decentralized countries in the world. In the process of booming economic growth, especially in the aspect of public good provision, the local governments are always dominant. However, compared to the local fiscal revenue, the
pressure on local fiscal expenditure is relatively heavy in certain areas. On the other hand, the central government has maintained absolute control of local officials' promotion, especially through the assessment mechanism using regional relative GDP as an indicator, which strongly provides incentives to the behaviour of the local government.

In the decentralization reform, intergovernmental competition is one of the most important parts. As for Chinese economic development, there is nothing with stronger impact than competition and no competition is more important than intergovernmental competition with the purpose of developing the regional economy. There is no other competition which can enable the Chinese economy to quickly get rid of the adverse effects of the traditional planned economy on resources allocation, and via the market mechanism and “opening up” initiative to rapidly accumulate national wealth. It is worth noting that intergovernmental competition does not only stem from the motivation to develop the regional economy, but also constitutes an important channel for local officials to gain political promotion. Therefore, a study of the relationship between China’s fiscal decentralization and regional economic growth can help us to understand the role of intergovernmental relations and the Chinese governance model in the process of economic growth in China.

2. Literature Review

2.1. Chinese Fiscal Decentralization and Economic Growth

Theoretical analyses hold two basic opinions on the function that Chinese fiscal decentralization has on the economic growth. The first opinion admits that fiscal decentralization plays a very important role in explaining China’s rapid economic growth. Qian and Weingast (1996) and Qian and Roland (1998) put forward a Chinese-style federalism” theory in which there are two basic reasons for high-powered incentives from regional governments. One is political decentralization which allows the local governments to have relatively independent economic decision-making authority. Another one is fiscal decentralization which lets the regional governments share financial revenue with the central government. These two reasons have provided incentives to the local governments in China to have such high enthusiasm to preserve the market and develop the regional economy. “Chinese-style federalism” is hence also known as “market-preserving federalism”. Qian and Roland (1998) thought that Chinese fiscal decentralization reform has its pros and cons for the local governments. Decentralization encourages the local governments to develop the local economy and at the same time also punishes the governments whose speed of development is relatively slow.
According to Shleifer and Blanchard (2001), fiscal decentralization plays such a significant role in Chinese economic growth because the central government imposed strict political control on the local governments, which serves to ensure that the central government’s aspirations for economic growth are implemented at the local level.

However, there are other opinions that Chinese decentralization reform which uses fiscal decentralization as the main body is not necessarily linked to regional economic growth. Cai and Treisman (2006) reviewed China’s economic and related historical information and pointed out that Qian Yingyi’s second-generation market-preserving federalism theory was flawed.¹ The most important reform of China’s economic transformation began in the late 1970s and early 1980s, before the large-scale implementation of fiscal decentralization. Proponents of fiscal federalism insist that fiscal decentralization will bring local government fiscal incentives and harden budget constraint of State-owned enterprises, which is not consistent with reality. But comparatively speaking, government officials’ career concern also brings a strong driving force to improve economic performance. In the interpretation of the relationship between local officials’ incentives and economic growth in China, Zhou Li-An (2007) pointed out that the “Chinese-style federalism” theory did not really explain China’s economic development. Firstly, in accordance with the existing Chinese system of organization, decentralization between the central and local governments represents downward authorization. The delegated authority can be taken back at any time. Secondly, decentralization with Chinese characteristics, neither in politics nor in economy, could make sure the appearance of the market-preserving function. According to Zhou, compared to fiscal decentralization, political promotion tournament among government officials which uses regional economic growth performance as the benchmark is the system basis of regional economic growth.²

Empirical studies on the relationship between fiscal decentralization and economic growth in China also did not reach a unanimous conclusion. Zhang and Zou (2001) used the data of 28 provinces of mainland China to examine the relationship between central-local financial resource allocation and the provincial economic growth from 1978 to 1992. The results show that fiscal decentralization is not conducive to economic growth and a higher fiscal decentralization ratio is always accompanied by lower provincial economic growth rate, especially in the over-decentralization period (1985-1989). They believe that in the early economic development period, for transition countries, effectively concentrating financial resources by the central government to increase infrastructure may be more conducive to economic growth. Using the data
of the 28 provinces of mainland China, Lin and Liu (2000) studied the impact of fiscal decentralization on per capita GDP from 1970 to 1993. In their opinion, fiscal decentralization improves economic efficiency and promotes economic growth in China since the mid-1980s. They deduced that the system reform and the efficiency of resource allocation are important reasons for China’s economic growth rather than more investment. A domestic research by Zhang and Gong (2005) using panel data of 28 provinces of mainland China from 1986 to 2002 found that fiscal decentralization had a positive effect on economic development before the tax system reform. However, after the tax system reform has completed, the effect turned to negative. Shen and Fu (2005) analyzed the effect of decentralization of three periods – 1978 to 1993, 1994 to 2002 and 1978 to 2002, and found a positive effect of decentralization on the regional economic growth. However, there are regional differences in fiscal decentralization. Wen (2006) used provincial panel data from 1980 to 2004 to find that fiscal decentralization promotes economic development more effectively in eastern China.

2.2. The Effect of Chinese Decentralization on Local Government Behaviour

According to Tiebout (1956), the constraint and motivation under the decentralization model comes from the regional governments’ pursuit of maximizing welfare. The level of local residents’ social welfare is decided by district capital endowments as well as the number of public goods, and residents do vote with their feet to evaluate the behaviour of a local government. Capital can move freely between different regions, and the provision of public goods is derived from local governments’ tax collection from capital endowments. In order to seek greater social welfare, the local government must reduce the taxation of private capital as much as possible to attract more capital, thereby increasing the quantity of the community’s public goods and services. Therefore, the decentralization model can further urge local governments to implement tax policy which attracts investment to a certain extent.

As previously stated, the type of fiscal decentralization in China shows a high degree of economic decentralization and political centralization. Existing literature in answering how this system affects the local government behaviour is mainly from the following three aspects. The first category of literature analyzes the impact of the existing decentralization system on the relationship between the government and the market. In the second-generation theory, government under a strong financial motivation has a friendly attitude towards the market.
However, Chen (2002) thought that the tax-sharing system reform in China was adverse to the relationship between the local government and the market. With the weakening of financial authority, the local government will go for predatory public policy which is not conducive to the development of the market economy. Wang (2006) also pointed out that decentralization reform caused regional market segmentation and local government protectionism. Both of them are not conducive to the reasonable flow and allocation of economic resources in the market.

The second category of the literature analyzes the impact of the decentralization system on the structure of local government expenditure. Fu and Zhang (2007) thought that the motivation of the local government expenditure structure, which “aggravated infrastructure, with light investment in human capital and public services”, came from the unique Chinese decentralization model. Intergovernmental competition causes the distortion of such government expenditure structure. Competition incentive does not ameliorate the situation in which the government continuously increases the proportion of infrastructure investment in the western region of China. While in the provinces with higher per capita decentralization, the competition leads local governments to reduce social expenditure and increase investment in infrastructure. Li and Shen (2008) pointed out that local governments were dependent on non-tax revenues under the system of fiscal decentralization. Government expenditure also has the tendency towards heavy expenditure for economic construction and light non-productive expenditure. From a growth perspective, it has negative impact on the regional economy. Though the bias of the local government towards economic construction expenditure does bring about regional economic growth, in the long term it is not conducive to the transformation of the economic growth pattern.

The third category of literature analyzes local government expenditure competition and strategic interaction under the decentralization system. Zhou and Zhang (2008) thought that while decentralization boosted local government competition; at the same time it might also cause malignant competition and inhibit the functioning of the market mechanism. During the process of analyzing the financial competition effect, Wang and Ren (2008) found that there was a significant positive financial response and the financial competition effect was different in different regions, being more apparent in the eastern regions of China.

### 2.3. Fiscal Decentralization and Different Regional Government Behaviours

Besides focusing on the impact of Chinese decentralization on economic growth, related literature also notes the expanding regional differences
caused by competition in such a particular mode of decentralization. Zhou (2003) realized that most parts of the literature on economic growth ignored the government structure. In fact, the structure of government will indirectly affect capital, human capital, technology and other production factors in the process of economic development. Under a “political centralization and economic decentralization” mode, the local government will enter into rivalry of economic resources for political interests. It turns the original brotherly relationship between the local governments in planned economy era into competition between separate economic entities. Because of the vertical administrative structure and resource liquidity constraints, competition between local governments does not necessarily result in benign economic growth. Some regions will take a protective or predatory development strategy, which may damage long-term economic growth. Therefore, appropriate decentralization is very important to economic development.

Cai and Treisman (2005) analyzed how the difference of factor endowments affect the governance mechanism and regional economic performance, assuming that capital could move freely. If a region’s factor endowments are better than other regions’, it will have an advantage in attracting capital investment. When the difference in factor endowments is large, the weaker region may not be able to win the capital competition completely. The policy of the weaker region impedes the access of capital and governance, could not create an environment in favour of investment, and lacks efficiency in public good provision. As a result, the gap between different regions could not be bridged.

Based on the premise of recognizing China’s political centralization and economic decentralization, Zhang (2006) considered the regional imbalance problem in Chinese economic growth process. Taking into consideration the differences in economic structure and transaction cost of tax collection between different regions, the results of decentralization, as well as governance, might be different. In the comparatively more developed region of eastern China, the government has strong motivation to develop the non-State economy through cultivating the market and “opening up” policy to give a hand to local economic growth. On the contrary, in the less developed region in the midwest, the local governments face great pressure in local financial expenditure and have to increase non-budgetary income through grabbing from the non-State economy, hence becoming a kind of predatory government.³

3. Chinese Fiscal Decentralization and Regional Economic Growth: Framework of Theoretical Analysis

In this section, the article specifically discusses the relationship between fiscal decentralization and regional economic growth and focuses on the
analysis of the characteristic of the Chinese decentralization in integrating political centralization with fiscal decentralization. From the perspective of operation efficiency, it analyzes the political incentive factors in the Chinese-style decentralization model and illustrates the important role the political promotion tournament plays in the decentralization process of China. Finally, also discussed is the influence the political promotion tournament has on local governments and the competitive game between the regional governments.

3.1. Brief Overview of the Fiscal Decentralization Reform Process in China

Prior to 1978, the intergovernmental fiscal relations in China showed a highly centralized characteristic. The central government has an absolute control on local governments’ revenue and expenditure. In this period, fiscal decentralization is done within the framework of the socialist public ownership of the planned economy, which means that decentralization does not change the State-owned enterprises’ property nature of public ownership. The central government controls the production and operation of State-owned enterprises directly, as well as their profits and other financial income, and local governments do not have any autonomy.

Under the traditional commune system (*chi da guo fan*), which means egalitarian practice of everyone “taking food from the same big pot”, local governments lack incentives to increase fiscal revenue. In 1978, China implemented a new fiscal system. It is a system that divides revenue and expenditure between the central government and the local governments. On one hand, the central government solved the problem of lacking fiscal revenue. On the other hand, it significantly improved the motivation of the local governments. However, under this system, the local governments had strong fiscal autonomy of income at the corresponding level, and as a result, in later period of reform, revenue of central government dropped significantly.

To change this situation, the central government introduced a tax-sharing system reform in 1994. In practice, the tax-sharing system is first and foremost a centralizing reform. Through redistributing taxes or tax sources and tax administration authority between the central and local government, the country substantially increased central government’s fiscal revenue.

Different from decentralized models in other periods, the reform of this period broke the administrative decentralization model and established an economic decentralization model. In the aspect of fiscal expenditure, the country would transfer a greater proportion of government expenditure
responsibilities to the local governments. Therefore, the local governments’ financial pressure is much larger than before.

3.2. Political Incentives under Fiscal Decentralization

According to Zhang (2006), decentralization reform, just as its name implies, means that the central government gives certain economic autonomy to the regional government and the local government to execute the administrative function such as managing the economy and providing public goods and services, which forms a kind of commission between the central and local governments – an agency relationship. In principle, the central government would decide on the benefit distribution relations between the central and local government through specific incentive programmes. Taken in this sense, there is a contractual relationship between the central and local government and the design of this decentralization contract will play a crucial role in the political incentives and constraints.

The traditional view of decentralization theory does not recognize that the problem of constraints in decentralization contracts. In this view, the function of fiscal decentralization promoting regional economic growth is mainly reflected by the information advantages of local governments. In a multi-layered government system, higher-level governments through transferring the economic or administrative autonomy to lower-level governments can achieve the allocation of resources more reasonably, because lower-level governments are able to grasp and understand the local economy and related information better, such as the preferences of the residents, problems met in the process of local economic development, requirements to improve public services and the level of infrastructure, and so on. In a decentralized system, the different regional governments adopt appropriate public policies according to the characteristics of the region’s development, and local economic resources therefore are able to achieve better usage. At the same time, the traditional decentralization theory believes that regional competition can effectively promote the development of the regional economy. From the perspective of income competition, by giving various regions the corresponding autonomy of tax collection, local governments can effectively improve the region’s economic strength by getting more local taxation. Under the dual electoral system in which the residents can both “vote with their feet” and “vote with their hands” (Tiebout, 1956), local government must try to meet the preferences of local residents as much as possible in terms of government expenditures, which then forms a expenditure competition mechanism under the decentralization model. However, this has not been confirmed
in many countries, especially developing countries. The reason is that the traditional decentralization theory has certain theoretical flaws and some assumptions are inconsistent with the facts.

Why is it that decentralization might not necessarily lead to economic growth? It is worth mentioning that no matter what levels of decentralization, there must be a problem of intergovernmental asymmetric information (Cao and Qi, 2006). In the decentralization contract, the local government acts as the agent of the central government. In the process of fulfilling the obligation on the contract to participate in economic construction, the local government may not follow the original intention of the central government to manage the regional economy and promote the development of the local market. What is more important, compared to other institutions concerned, local governments have certain autonomy which can be used to monopolize local political and economic resources through administrative means.

Once the local official finds that the expected return of corruption is larger than the opportunity cost (the political and economic interests the officials gain via the legal channel if the regional economy develops), the government may replace the market mechanism and interfere in the regional resource allocation which may damage the operation efficiency of the economy, with the officials gaining from moonlighting, bribe-taking and abuse of power for personal gain. The more the autonomy given to the local government, the greater is the incentive to seek own political and economic interest (Zhou, 2007). This is the first aspect of moral risk.

In addition, in a transitional economy, the industrial structure will need upgrading and adjustment. If the local economy has formed the fixed department rent with original economic structure and local government also has won the vested interest in the area such as tax, the local government does not have any incentive to act as a regional economic development agent working for central government. Generally, this rent is a result of a monopoly industry.

Even if the local government is willing to develop the economy, it also may come from the incentive to maximize its own interests (Zhou, 2007). The central government could not get the corresponding benefit in the process of developing the regional economy, which forms the second aspect of the moral hazard problem that the central government is facing. This problem is particularly prominent when the scheme of intergovernmental authority distribution is not clear in the decentralization contract. The central government could not fully observe the efforts of the local governments, which means that the central government cannot control the behaviour of local governments, as well as the benefits received
by the local government from the development of the regional economy, because the central government could not grasp complete information.

More importantly, since the decentralization contract itself cannot be observed, local governments are often faced with the problem of soft budget constraint. The officials would not take into consideration the constraints of government expenditure, which leads to a tendency for extravagance and waste. Eventually this would lead to the structure of government expenditure deviating from the original purpose to promote regional economic growth. Therefore, if the central government could not effectively reduce the cost of controlling the behaviour of the local government, in the process of implementing the decentralization contracts between central and local, it will face the problem of information asymmetry and a higher efficiency risk (Cao and Qi, 2006).

In order to reduce the moral hazard of the local government, the central government needs to find a balance between control and incentive in the process of designing the decentralization contracts. On the one hand, local governments must be given adequate incentives, and this requires local governments to have a certain administrative and economic autonomy, as well as sufficient interest in the process of the development of the regional economy. On the other hand, the local government must be subject to appropriate constraints to effectively prevent its interest-capturing behaviour in the decentralization process. For the developing countries that are in the decentralization process but whose legal system is not sound, this aspect of need seems to be more important. The lessons of Russia and Argentina illustrate the failure to form an effective agency relationship between central and local government during their decentralization reforms.

Different from many countries, the success of Chinese fiscal decentralization is because that the central government has designed a reasonable mechanism to ensure effective incentive for and control on the local government – the notion of Chinese-style fiscal federalism according to Qian Yingyi and Berry Weingast. Decentralization reform in China has the characteristics of a combination of political centralization and fiscal decentralization. Although the fiscal decentralization relations of the central and local government was not finalized on the whole until the tax system reform in 1994, the conferring of autonomy by the central government on local government has been continuing throughout the entire process of reform. Therefore, the local government has had the administrative and economic autonomy to develop the regional economy. However, the authority of the local government is not completely independent, but still under the central government’s supervision and management – position changes and promotion of local officials must be subject to approval by
the central government. This means that in the decentralization contract between central and local government, as the agent to promote regional economic growth, the local government is faced with the political constraints from the central government. Hence, the local officials would need to put in efforts to develop the regional economy, thereby increasing the political promotion probability.

3.3. Political Promotion Tournament: Important Carrier of Chinese Fiscal Decentralization

As previously stated, the difference between China’s decentralization model and other countries’ lies in the association of fiscal decentralization with political centralization. In particular, the personnel appointed by the provincial governments are controlled by the central government. It forms a mechanism whereby the promotion of local officials is determined through the assessment of local officials. Therefore, a top-down political centralization system means that if a local government does well in developing the regional economy, the local officials are more likely to attain political promotion. As a result, the incentive of the local government to function as the agent of the central government to improve economic growth is stronger (Yang, 2009). In the central-local decentralization contract, agents go through mutual competition in terms of economic growth to get the opportunity of political promotion. Consequently, a local government will face varying degrees of “yardstick competition” on economic performance with other regions (Besley and Coate, 1995). The “yardstick competition” concept originally comes from industrial organization theory. It means that an enterprise’s competition policy is determined by observing the behaviours of other enterprises. In the area of public administration, “yardstick competition” refers to the local government through mutual competition and imitation seeking support in voting. It is worth noting that Chinese yardstick competition only occurs when higher-level authority uses other regional governments’ performance to evaluate a local government’s administrative capacity, and then the local governments will form mutual competition and imitation. Different from other countries, the intergovernmental yardstick competitions in China are mainly to cater for the assessment requirements of a higher-level authority while the needs of local residents are usually neglected. This has become the most prominent feature of Chinese inter-governmental relations.

Political promotion tournament decreases the central government’s constraints and assessment costs to local officials. At the same time, it also enhances operating efficiency of Chinese decentralization contracts (Zhou,
2007). In fact, for individual local government officials, their performance in developing the economy is not only limited by their own effort level, but also the interference of other factors. If the central government uses absolute growth of the regional economy as the only assessment standard to evaluate administrative performance, local officials can shirk their own responsibility. However, the central government cannot confirm whether the shirking is appropriate. On the contrary, if the central government uses relative growth of the regional economy as the standard, the problem can be solved easily. If a local official’s own effort and economic performance are positively correlated, and the regions are facing similar economic environments, then the effort of this official cannot only be reflected by the particular region’s economic growth but also other regions'. In this process, regional economic development will accelerate because of competition between the officials, and those officials who are doing a good job will be promoted more quickly. According to the study of Li and Zhou (2004), if a leader stays in a management position for five years and the average speed of regional economic growth under the administration is higher than that of other regions by at least a standard deviation unit, the probability of promoting this leader is 33 per cent higher than average. Thus it is not difficult to find that through such a powerful political incentive, the central government can better control the behaviour of the provincial governments. Similarly, the vertical political system also makes sure that governments below the provincial level also have sufficient incentives for effective decentralization.

The substance of political promotion tournament is to strengthen the central government’s authority as an institution. As for regional governments, it refers to two aspects of the incentive. Firstly, regional governments must try to protect the development of the private economy in order to attract foreign investment through market-preserving policy to gain more tax sources. At this point, the probability of local interest-capturing will be reduced (Stigler, 1971). Secondly, the practice of promotion tournament also brings an opposite incentive. If local officials do not work hard, their opportunities to get promoted will be lower. Therefore, the central government can use two aspects of the incentive to minimize the probability of moral hazard of the regional governments. At the same time, under the promotion tournament and in order to pursue higher rate of economic growth, the regional governments must acquire production factors as much as possible, in particular, acquiring accumulation of regional capital elements. Thus, the competitive behaviour between the regional governments for production factors forms and this competition will be exacerbated because of the increasing mobility of production factors. The attitude of regional governments towards the
important production factors will change, and their governance will also be transformed into the “market-preserving” type. Jin and Zou (2005) provide some empirical evidence to support this opinion.

3.4. The Premise of Implementing Political Promotion Tournament

It must be pointed out that the implementation of political promotion tournament in China is closely related to China’s unique political and economic conditions (Qian and Weingast, 1996). At first, the central government has strict constraints and competition mechanism for local officials and there is no motivation for the regional governments to collude to be lazy and irresponsible. As stated before, regional governments have certain economic autonomy but also must face a performance assessment mechanism from the central government, as well as a grim cross-regional competition. In this competition process, officials with relatively better performance will have greater opportunities for promotion. But why the regional governments in the promotion game do not adopt mutual conspiracy to jointly reduce the level of their efforts? The precise reason is that when the officials are under a competitive system in the highly political centralized system, their performance is directly related to their personal political career and any more outstanding performance means lower promotion opportunities for other officials. That is why political competition is a non-cooperative game in essence. Being aware of this point, government officials will treat the cross-regional collusion between governments as a not credible commitment and seek through their own efforts to achieve prominent economic performance in order to obtain the promotion of their political career (Cao and Qi, 2006). Thus, the highly centralized political system ensures that the political promotion tournament system of government officials can be implemented smoothly.

Secondly, the smooth implementation of political promotion tournaments in China is also closely related to its unique economic organizational structure. According to the analysis of Qian et al. (1999), as a whole, China’s economy presents an M-type organizational structure. That is, China’s economy consists of thousands of small, relatively independent regional economic units and each unit has a comprehensive internal structure. As a result, the national allocation of resources is not based on top-down vertical structure because even a small regional economic unit can achieve horizontal allocation internally. Different from the Soviet model under planned economy, for a very long time, Chinese economic resource allocation is horizontal. Therefore, for economies of different regions, resources can be internally allocated and adjusted. The important implication of this issue is that in a decentralization reform,
no matter whether there are political incentives or not, all independent economies do not necessarily need comprehensive cross-regional resource integration. The regional governments can take advantage of their own factor endowment structures. Therefore, the M-type resource allocation structure ensures the relative independence of the regional economic development and the central government can still continue the region’s economic performance assessment.

Last but not the least important, the mechanism design of political promotion tournament is also crucial for the effect of its implementation. First of all, it must make sure that the behaviour of local officials is positively correlated with regional economic performance. In other words, the efforts of local officials can play a significant positive role in regional economic growth. This requires a high degree of autonomy of local governments in the financial and economic management. The second point is to ensure that the performance of local officials on economic growth in different regions is related to their efforts. That is, there is some comparability between the behaviour of local governments and regional economic performance. Taking into account that different regions have different degrees of opening to the outside world, industrial structure and resource endowments, “the central government could not implement the assessment nationwide in a ‘one size fits all’ manner, but must address the specific circumstances of the different regions” (Yang, 2009).

3.5. The Behaviour of Local Governments under Political Promotion Tournament

Political promotion tournament changes the role of the local government in the process of decentralization. As for the central government, its most important function is to promote cross-regional economic competition (Zhou, 2007). The first aspect of the influence of political promotion tournament on the behaviour of local governments is reflected by the intergovernmental competition to attract foreign capital investment. In order to attain more foreign investment, different regional governments introduce a series of public policies to reduce barriers to entry, provide land and preferential tax policies, and promote regional infrastructure investment. In the region with a higher level of “opening up”, the competition for foreign capital is even more significant.

The second aspect of the influence that political promotion tournament has on the behaviour of local governments is the strategic game between the regional governments (Zhou, 2007). Due to the presence of political competition, the ultimate political utility of the local officials is not only affected by their policy, but also the strategies of other competitors.
Generally speaking, in the political game, any policies of other regional governments which promote the economic growth of those other regions will cause certain pressure on this local government and reduce the expected promotion opportunity of the local officials. In order to benefit from political promotion tournament, each local government in the process of making public policy decision must face the game from other regional governments. Therefore, the decision-making process of the government will be seized with the behaviours of competitors; for which Yang (2009) forms two games as follows.

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</tr>
</tbody>
</table>

The second situation


In the above game, it is assumed that the behaviour range of local officials is [strong efforts, weak efforts], so the effort degrees of the government officials are discrete. Their efforts affect their political profits through the region’s relative economic growth performance. Assuming that official 1 lives in a region where the factor endowments and productivity are better, for official 1 the same efforts can gain a higher performance than official 2. Therefore, when two officials make strong efforts at the same time, official 1 can gain one unit of political benefit, always greater than the political benefit of official 2. However, if official 1 does not make strong efforts, s/he will be eliminated in the political promotion with −2
units of political benefit. At last, if official 1 and 2 make weak efforts together, both of them will get –1 unit of political benefit. Therefore, in these two games, we can see that regardless of official 2 taking which kinds of efforts, the dominant strategy of official 2 is always to make a strong effort, and thus gain one unit of political benefit.

Being aware that official 1 will always put in a strong effort, official 2 must make the corresponding choice of strategy. To this end, in the above game matrix, two basic situations are considered. In the first case, the official 2’s political benefit with strong efforts (0) is greater than the one with weak efforts (–2), that is, although official 2 could not achieve political promotion with strong efforts, s/he can still gain a better political benefit. Consequently, the dominant strategy of official 1 is to put in strong efforts and the Nash equilibrium solution is [strong efforts, strong efforts], i.e. both officials adopt strong efforts to achieve local economic development and greater political benefits. Different from the first situation, official 2 in the second situation does not have a strict dominant strategy and s/he will realize that when official 1 makes a strong effort, a decision to follow with another strong effort is not smart. Even if official 2 put in a strong effort because of the political promotion of official 1, official 2 will get –3 units of political benefit. However, if official 2 chooses to make a weak effort, –2 units of political benefit will result. This leads the game to the final result of [strong efforts, weak efforts]. In short, under different circumstances, strategic competitive behaviour between local officials will bring about different consequences.

From the above analysis we can see that the impact of strategic competition between the government officials will be different because of regional factor endowments and various other factors. In fact, this conclusion can also be analyzed from the perspective of decentralization contracts. Under the central incentive mechanism in terms of GDP performance as sufficient statistics, if a regional government official’s performance is relatively poor, the probability of political promotion would be lower. Once the incentive function could not work effectively, the local official may “smash a pot into pieces just because it is cracked” and the behavioural tendencies of the regional government are not conducive to promoting regional economic growth. To a certain extent, it indicates that the central government must note the possible differences between the regions when designing the assessment mechanism for local government officials. If a sweeping approach were to be implemented across the country, even in the regions where the economy is relatively underdeveloped, the behaviour of local government officials may deviate from the central government’s original intention and the role of the local government would not be conducive to regional economic growth.
4. Methodology

4.1. Selecting the Method to Measure the Degree of Fiscal Decentralization

Almost all empirical researches on fiscal decentralization could not avoid the problem of measuring the degree of fiscal decentralization. Reviewing the existing research literature shows that there are three main methods to measure the degree of fiscal decentralization. The first and foremost comes from Oates (1992), which uses the ratio of local government expenditure (or income) and total government expenditure (or income), including intergovernmental transfer payments, to measure the degree of fiscal decentralization. It believes that a higher ratio indicates a higher degree of fiscal decentralization. The relative studies, such as Zhang and Zhou (1998), Jing and Zou (2005) and Zhou and Zhang (2008), all use this ratio to measure the degree of fiscal decentralization. The rationality of this method is that it fits the original intention and definition of fiscal decentralization. In addition, using this method to measure the degree of fiscal decentralization has strong operability on the data acquisition. In fact, this is the main reason why it is widely used. The second method uses the marginal value or incremental value of income to measure. The representative is the study of Lin and Liu (2008). It uses the marginal dividing rate method to measure the degree of fiscal decentralization with the data of provincial government budget revenue. The third method forms a mixture of budget and off-budget revenues as well as the corresponding expenditures to construct the measure criterion. For example, Liu, Yang and Qu (2007) make a price adjustment first and choose the relative higher index of budget revenues and expenditures to mix with the off-budgetary one to construct that “degree of fiscal decentralization = (max {local budget expenditures, local budget revenue} + local budget expenditure and revenue) / (national budget expenditure and revenue)” as the measure criterion.

The above three methods demonstrate that the academia so far is still lacking a deep thinking on the issue of how to measure the degree of fiscal decentralization, and does not form a widely recognized system of measuring. The second measure fully reflects the ideology of marginal analysis, and its essence is a concept of marginal degree of fiscal decentralization. The first defect of this method is the difficulty to obtain the marginal value, thereby leading to unreliable results. The second defect comes from the investigation of the problem impact since people pay more attention to the whole rather than the marginal fiscal decentralization effect. These two points are the important reasons why the second method is always too difficult to be popular after it is established.
The third method has a good starting point, namely that the degree of fiscal decentralization should measure with budget and off-budget revenues as well as the corresponding expenditures, however, since the data collection of off-budget revenue and expenditure is very subjective, therefore, the promotional value of this method in study and practice is still questionable.

Comparatively speaking, the first method mentioned above is used most widely, though it still has many aspects that deserve farther deliberation. First of all, using the ratio of local government budget income and central government budget income is less steady than using budget expenditure. This is because the budget income could not reflect the matching of the government’s fiscal authority and executive power well. A high income of the local government does not necessarily mean an actual high degree of fiscal decentralization because the expansion of fiscal authority does not necessarily lead to the expansion of executive power pro rata. Therefore, the indicators measure the degree of fiscal decentralization should be built based on the expenditure approach, rather than the income approach. However, the expenditure approach is also not perfect or appropriate.

According to this logic, provinces with high financial expenditure (either significantly wealthier than other regions or have an enormous population) usually have a high degree of fiscal decentralization. This conclusion is clearly inappropriate. Although the first method is not perfect in the measure metric design, the idea of the measure is advisable, that is, the degree of fiscal decentralization should reflect a certain proportion of expenditure. Therefore, in order to exclude the impact of differences in regional economic and demographic elements, the degree of fiscal decentralization should be reflected as an indicator with per capita concept. In addition, the construction of the indicators should effectively blend the data of local government and central government expenditure. Based on the above analysis, the following fiscal decentralization measure is adopted here:

\[ FD_i = \frac{AFE_i}{\sum_{t=0} AFE_t} \]

In the above equation, FD represents the degree of fiscal decentralization; i represents the level of the target government, i = 0, 1, 2, 3, where 0 stands for the central government, 1 indicates the province (or the autonomous region or municipality directly under the central government), 2 the prefecture-level city, 3 the county-level city; AFE\textsubscript{i}
## Table 2 Degree of Chinese Fiscal Decentralization at the Provincial Level

<table>
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(continued overleaf)
Table 2 (continued)

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</table>

Note: Before 1997, Chongqing was included as a part of Sichuan.
represents the fiscal expenditure per capita of the government of the corresponding level. This method of measuring the degree of fiscal decentralization is closely linked to the original intention and definition of fiscal decentralization and is operable in data acquisition and calculation. Finally, its values which range from 0 to 1 also accord with the usual understanding of people on “degree”.

4.2. The Degree of Chinese Fiscal Decentralization at the Provincial Level

Using the above measure to calculate the degree of Chinese fiscal decentralization from 1995 to 2006, the results are shown in Table 2.

4.3. The Model Design

The neoclassical growth theory which uses the growth of capital and labour force as the explanatory variables of economic growth is adopted here with the fiscal decentralization indicators added into the model, giving the following equation:

\[ Y_t = c + \alpha \ln v_t + \beta \text{Labour}_t + \gamma \text{FD}_t + \delta \text{FD}_t^2 + \ln f + \text{Tax} + \varepsilon_t \]  

The definition of the variables are summarized in Table 3.

**Table 3 Variables Affecting Economic Development**

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<thead>
<tr>
<th>Variable</th>
<th>Definition</th>
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</thead>
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<tr>
<td>Y</td>
<td>Growth rate of GDP</td>
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<tr>
<td>Lnv</td>
<td>Growth rate of fixed capital investment</td>
</tr>
<tr>
<td>Labour</td>
<td>Growth rate of labour force or employment rate growth</td>
</tr>
<tr>
<td>FD</td>
<td>Degree of fiscal decentralization</td>
</tr>
<tr>
<td>Inf</td>
<td>Inflation rate of the retail price index</td>
</tr>
<tr>
<td>Tax</td>
<td>Average tax rate (the proportion of tax revenue to GDP)</td>
</tr>
</tbody>
</table>

Note: GDP growth rate is the official statistics; labour force growth rate is calculated with the labour and employment data in the *China Statistical Yearbook* of the corresponding year. Inflation rate and average tax rate are calculated with the relevant data. The degree of fiscal decentralization (FD) is for the whole China which is calculated based on the provincial-level data.
Here, it is assumed that the relationship between fiscal decentralization and economic growth is not a simple linear relationship, but non-linear, hence introducing the square of the degree of fiscal decentralization \((FD)^2\) into the equation.

**Table 4** The Value of Variables, 1995-2006

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<th>Year</th>
<th>Y</th>
<th>Lnv</th>
<th>Labour</th>
<th>FD</th>
<th>Inf</th>
<th>Tax</th>
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<td>0.169</td>
<td>0.012</td>
<td>0.441</td>
<td>-0.8</td>
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<td>0.009</td>
<td>0.439</td>
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<td>0.010</td>
<td>0.445</td>
<td>3.9</td>
<td>0.1800</td>
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<td>0.005</td>
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China implemented the tax-sharing system reform in 1994. To avoid selecting a sample period passing from non-existence into existence, sample period of 1995-2006 is hence chosen.

**5. Results and Discussion**

Using the econometrics software Eviews 6.0 to analyze the data in Table 4 based on equation (1), the following estimation equation is obtained (for detailed operation process please refer to Appendices):

\[
Y = 3.422518 - 15.61826FD + 18.14179FD^2 + 0.036637\ln v - 0.042999\text{labour} + 0.001422\ln f + 0.125336\text{Tax} \quad (2)
\]

Take the first derivatives of FD (fiscal decentralization) in equation (2), the following is derived:
\[ Y' = -15.61826 \times FD + 2 \times 18.14179 \times FD \]  \hspace{1cm} (3)

Let \( Y' = 0 \)

then \[ 2 \times 18.14179 \times FD - 15.61826 = 0 \]

and therefore

\[ FD = 0.4304 \text{ or } 43.04\% \]

Based on the estimation of the existing data in the sample period, it can be seen that as for China’s economic growth, the optimal degree of fiscal decentralization is 43.04 per cent. If China’s degree of fiscal decentralization is less than 43.04 per cent, further fiscal decentralization will promote regional economic growth. If the degree of fiscal decentralization in China has exceeded 43.04 per cent, further fiscal decentralization may be harmful for regional economic growth. It should be noted that this optimal level is determined by the historical data and reality of the economic environment, rather than according to any theoretical basis.

According to the model, 0.4304 or 43.04 per cent is the optimal degree of fiscal decentralization for China’s regional economic growth. Using the mean value of 31 provinces’ annual data in Table 4 as the national degree of fiscal decentralization of China, the latter is derived in Table 5.

<table>
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<td>0.441</td>
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</table>

<table>
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<th>2005</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>National</td>
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<td>0.441</td>
<td>0.439</td>
<td>0.444</td>
<td>0.453</td>
<td>0.458</td>
</tr>
</tbody>
</table>

Further analysis of the change in China’s degree of fiscal decentralization gives its trend in Figure 1. The horizontal axis represents the time span of 1995-2006. The vertical axis represents the degree of fiscal decentralization. It can be seen in Figure 1 that, other than the year 2000, China’s fiscal decentralization always exceeds the optimal level of 43.04 per cent and that the degree of fiscal decentralization continuous rise after 2000.

Based on the above finding, the degree of fiscal decentralization after the year 2000 should have a negative influence on economic growth. However, based on existing researches, such as Akai and Sakata (2002) etc., as well as the observation of the reality after the tax system reform in
1994, fiscal decentralization seems to have a significant positive influence on economic growth. This is mainly because the tax system reform overcomes the drawbacks of the mechanism whereby regional authorities take full responsibility for their finances and make China’s fiscal decentralization more standardized. Thus, although the degree of fiscal decentralization after the tax system reform in 1994 is greater than 43.04 per cent most of the time (1995-2006), through the tax system reform, the positive role of standardized and impartial fiscal decentralization can be maximized. Prior to 1994, the fiscal decentralization of China is very irregular, unstable, resulting in repeated investment, regional blockade and other drawbacks. As a result, many mechanisms supporting fiscal decentralization are in a state of absence, which had served to hinder the positive role of fiscal decentralization.

From this contradiction, we can find that fiscal decentralization in China is not facing an issue of whether there should be further decentralization or centralization, but rather there is a need to further improve the transparency and normalization of financial resource distribution to perfect and complete the system. Based on the data in Table 4, the average degree of fiscal decentralization of the 31 provinces (including “autonomous regions” and municipalities directly under the
central government) from 1995 to 2006 can be derived respectively. To further the analysis, this paper now looks into the division of these 31 provincial-level administrative units into three regions, namely eastern, western and middle (central) China.

According to Li (2009), the eastern region includes Beijing, Tianjin, Liaoning, Shanghai, Jiangsu, Zhejiang, Fujian, Shandong, Guangdong and Hainan; the middle (central) region covers Jilin, Heilongjiang, Hebei, Inner Mongolia, Shanxi, Guangxi, Henan, Hunan, Hubei, Anhui and Jiangxi; and the western region comprises Sichuan, Chongqing, Yunnan, Guizhou, Shaanxi, Gansu, Qinghai, Tibet, Ningxia and Xinjiang. This paper adopts this classification method and derives the degree of fiscal decentralization by region as shown in Figure 2.

This result is consistent with widespread expectations. Firstly, China’s economically developed provinces and municipalities directly under the central government are basically concentrated in the eastern part of the country.

**Figure 2** Degree of Fiscal Decentralization by Region, 1995-2006

Note: Before 1997, Chongqing was included as a part of Sichuan from which it has been separated since 1997. The analysis here is based on 31 provincial units including also the “autonomous regions” and those municipalities, such as Chongqing since 1997, which is directly under the central government.
country, and having higher value of GDP per capita. Even in the case where the eastern region and western region retain the same proportion of fiscal revenue, the eastern region also has a relatively higher degree of fiscal decentralization (or financial freedom). On the other hand, China’s special economic zones are basically located in the eastern region and the “opening up” also began there. These arrangements include a series of decentralization policies, not only in financial terms. Therefore, its degree of fiscal decentralization is naturally higher than the western and middle region. The fact that the degree of fiscal decentralization in the western region ranks second among the three regions and is in fact higher than that of the middle region is against general expectations. However, in fact, this situation exactly reflects the government’s macroscopic readjustment and control in China’s policy orientation. These ten western provincial administrative units, according to Li (2009)’s classification, are not only areas where the economy is relatively backward, but mostly are also minority nationality areas, and in many of them is implemented the country’s particular system of regional ethnic autonomy.

In order to stabilize the border areas and reduce regional disparities, the central government through transfer payments and other policies such as providing assistance to a focused area has allowed the western region to acquire a greater degree of fiscal decentralization and financial freedom. The “Great Development of the West” strategy which began in 1999 is the epitome of the country’s policies favouring its western region. In fact, this policy has also been reflected to a certain degree in Figure 2: from 1995 to 1999, the overall degree of fiscal decentralization of the western region shows a slow downward trend, however, during the period under the “Great Development of the West” strategy after 1999, the western region’s fiscal decentralization shows a general upward trend.

By comparison, how the fiscal decentralization of the central/middle region ranks in the last position is not accidental. The macro-development strategy of the central government is to let the eastern region be rich first and help and support the western backward areas. As for the middle region, some reflections of the “grabbing hand” hypothesis (Frye and Shleifer, 1997) might help to explain in some way the overall lower degree of fiscal decentralization.

From Figure 2, certain useful observations can be made. First of all, no matter of which regions of China, on the whole, the degree of fiscal decentralization is relatively stable, without any dramatic changes. This indicates that after the tax system reform was implemented in 1994, the degree of fiscal decentralization in China has been in an ideal state where a relatively stable financial relationship between the central government and the local governments has been formed. This assertion is consistent
with the conclusion of the model – the degree of fiscal decentralization in China should have been close to or even have arrived at the optimal level. Secondly, the degree of fiscal decentralization of these three major regions has a convergent trend which is more obvious after the year 2003. This paper argues that this is an intrinsic requirement and inevitable choice: once China’s economy has developed up to a certain level, the degree of fiscal decentralization of different regions would move into a general convergent trend to realize equalization of development in various regions.

As a general consensus, China’s eastern coastal area is the region whose economy is developing fastest in China. The speed of development in middle China is lower than the eastern region but still higher than the western. However, based on the provincial-level data of fiscal decentralization, the degree of fiscal decentralization is ranked in the order of eastern ~ western ~ middle. The speed of regional economic development does not match with the degree of fiscal decentralization between the western region and middle China. This paper tries to explain this deviation using the cost of political promotion tournament.

6. The Cost of Political Promotion Tournament

Professor Zhou Li-An, the authority on Chinese-style political promotion theory holds the opinion that the political promotion tournament also has a certain cost. However, the cost is comparatively subjective and consists of the factors which are not quantitative. They are difficult to be reflected by the change of specific numerical value and this is why this paper does not add the political promotion tournament into the earlier model as a variable affecting regional economic development. This paper believes that the function of political promotion tournament does not work, hence causing the deviation between the degree of fiscal decentralization and regional economic development in certain regions, due to the following factors and reasons.

6.1. Distorted Incentives of Government Officials

The first is about preference alternative. According to Zhou (2004), the biggest problem of political promotion governance lies in ignoring residents’ preferences and using the GDP index instead. In the early stage of economic development and market transformation, this kind of GDP preference has its rationales. When the vast majority of the people still need to meet the problem of getting adequate food and clothing, economic development and income improvement are what they actually require. But with the substantial improvement in their incomes and living conditions,
their preferences and needs become more diversified. Then GDP growth and even green GDP growth have not accurately represented the preference structure of the highly diverse residents. Moreover, according to Zhou (2007), the local residents and businesses directly under the regional government’s governance could not directly affect the careers of local officials. The authority of appointment and removal is in the hand of the higher-level government or superiors and hence the local officials do not have sufficient incentives to make adequate and effective response to the diversified preferences of the residents and businesses. Therefore, the direction of future reform should be how to incorporate public satisfaction into the assessment system for local officials in a proper manner and becomes an important factor of their political career. This is a kind of perfection of the appointment system.

The second incentive distortion always occurs under the atmosphere of multi-tasking. Usually, local officials are only concerned with the assessment indicators rather than those not in the scope of examination or difficult to measure. GDP competition will lead some region government to be keen to engage in vanity projects and even fabricate the economic growth figures (Yang, 2009). The situation is particularly evident in the western and backward regions which are lack of economic resources and opportunities to develop. On the other hand, the rapid economic growth has also brought about serious environmental pollution and high energy consumption problems (Besley and Case, 1995), which also constitute one of the consequences of the impulse of quantitative expansion caused by political promotion tournament. It makes local government officials care only about the regional short-term economic growth and overlook the long-term effects of economic growth, especially where the indicator is not included in the scope of examination. The above-mentioned distortions notwithstanding, the Chinese-style political promotion tournament does cause intergovernmental competition in both political and economic aspects. Nevertheless, economic competition could also has a problem of resource allocation distortion due to the domination of political competition characterized with zero-sum game, such as the intergovernmental non-cooperative tendency, including the existence of long-term local protectionism and redundant infrastructural constructions (Zhou, 2004).

6.2. Political Promotion Tournament and Transformation of Government Functions

Chinese-style governance model of political promotion tournament carries inherent contradictions in the nurturing and development of the market
economy, resulting in the government’s role conflict in market-oriented reform and the difficulties in transforming government functions.

The role conflict comes from the political promotion tournament requiring the local officials to be responsible for local economic development and use all means to achieve economic development. Also included here are certain dubious means to maintain the market order, such as indulging local enterprises with false and inferior production, applying market entry formalities or credit guarantee for enterprises illegally. “The government always plays the roles of referee and athlete at the same time, which causes the market order to be difficult to set,” commented Yang (2009). In fact, the more accurate description is: in the political promotion tournament, on the one hand, local officials are the athletes of regional economic growth competition; on the other hand, they are the referees of market competition in their regions. This is the most serious problem in China’s process of economic marketization. Once the practices of some sectors such as strict quality supervision come into conflict with regional interests, local officials can still spend a lot of regional resources to exert effective pressure on them. Political promotion tournament further strengthens the alliance of local officials and regional interests, and then renders the effort of the central government to maintain the normal order of market ineffective.

“In order to achieve the improvement of GDP and taxation, some local officials will treat the safety supervision as the interference of regional economic growth and directly intervene in the safety supervision or slacken enforcement, which means having an inactive attitude towards or even protecting enterprises’ illegal production, etc.,” commented Zhou (2007). Under such circumstances, the implementation process of the production safety supervision is bound to deviate from its regulatory objectives.

In short, the political promotion tournament lets the assessment be focused on a region’s economic development, hence making the local officials more concerned about economic indicators during their administration rather than social welfare issues like education, healthcare and housing, because while such investments have an impact on regional economic growth in the long term, they could not contribute to economic growth in the short term. Although the public’s concern for the education, healthcare and housing issues is paramount, they could not directly determine the appointment and removal of local officials, hence it is difficult for these issues to be prioritized by the local officials vis-à-vis economic growth.

6.3. Political Promotion Tournament with China’s Economic Growth Pattern

China has made remarkable economic achievements over the past three decades and as the “world’s factory” its total economic scale has ranked in
the forefront of the world. However, under such halo, the traditional mode of economic growth in China and its increasing high cost have been the focus of criticisms and doubts from the public.

Chinese enterprises generally lack a well-known brand in the world and do not grasp the important core technology. Linked to this, the R&D investment of the vast majority of Chinese enterprises is very low and their main advantage has always been cost advantage in processing and manufacturing. More seriously, though high-speed economic growth does directly lead to serious environmental pollution and worrying high energy consumption, the situation also constitutes the main competitive advantage of Chinese enterprises, that is cost advantage, which is unfortunately established on the long-term man-made distortions of the production factor prices (Zhou, 2004), e.g., the “zero premium” land price in the country’s western region and the fact that capital cost is artificially low due to low interest rates and policy loans or guarantees. At the same time, the labour cost is also lower in western China than in the middle region and eastern region due to inadequate labour protection and social welfare. It can be seen that the distortion on the prices of all these production factors is closely linked to the impulse of political promotion or even primarily caused by the latter. Due to the fact that positions of political promotion are always limited, political promotion tournament always carries a “winner-take-all” and “zero-sum game” characteristic (Montinola and Qian, 1995). It means that that promotion of a certain official is bound to reduce the opportunities of promotion for other competitors. Therefore, this intense political competition will be transformed into a vicious economic competition for political gain without the consideration of economic costs and benefits. Taken in this sense, political promotion tournament is one of the causes of the Chinese-style extensive, distorted economic growth pattern.

6.4. “Voting with ‘Hand’ and ‘Feet’” under Political Promotion Tournament

G. Brennan and J.M. Buchanan (1980), in their study of the impact of fiscal decentralization on the scale of local government, described the government as an entity in pursuit of maximizing tax revenue. Fiscal decentralization will lead to competition among local governments to attract tax sources such as local residents and commercial enterprises, and tax rate competition is able to curb the excessive expansion of the scale of government, according to the “leviathan hypothesis”.

The leviathan hypothesis assumes that improving the degree of fiscal decentralization will act as a constraint on the regional government. It mainly relies on two mechanisms to achieve this. Firstly, fiscal
decentralization will increase the political participation of local residents with voting rights who will, through the political votes ("voting with their hand"), restrict the behaviour of the local officials. Secondly, fiscal decentralization makes regional governments fight for the tax sources, as local residents through the interregional migration ("voting with their feet") will respond their regional governments’ increasing the tax burden or changing the scale of government expenditure. Due to the existence of these two mechanisms ("voting with hand" and "voting with feet"), the regional governments will compete for highly liquid tax sources through cutting tax rates and developing the regional economy. However, the applicability of above-mentioned mechanisms is different in the different areas of China.

First of all, since Chinese local officials in the provinces, municipalities, prefectures and counties are appointed by their superiors rather than through local elections, the mechanism of "voting with hand" does not function well in China. Chinese-style political centralization makes the local government officials only accountable to their superiors rather than to local residents (Zhang, 2007). China’s current system arrangements make the political participation of local residents low and constrain their ability to “vote with their hand”.

Secondly, the area where the mechanism of “voting with feet” could function well is also limited. For a long time, China has implemented a household registration system that limited the population flow and an urban-rural different treatment policy to limit population migration, which makes the local residents unable to constrain local government behaviour through the “voting with their feet”. In fact, the main direction of China’s population migration is from western or middle China to the eastern developed provinces or municipalities. The purpose of migration is to gain higher personal income rather than in response to the regional tax policies. In China, the foreign investment enterprises had played the role in influencing such “voting with feet” mechanism at the early stage, and then gradually the domestic enterprises also started to play a certain role.

Chinese political promotion tournament uses the GDP as the main indicators of regional officials’ assessment, and hence investment attraction becomes very important to the regional governments. However, in the environment that liquidity of domestic capital factors as well as the foreigner investment is limited, the mechanism of “voting with feet” may not function well. As a result of the large gap between the eastern developed region and western or middle China in terms of such factors like infrastructure, policy environment, labour quality and so on, the eastern region has an absolute advantage in the competition of attracting
foreign investment capital inflows vis-à-vis the other regions. That is why the main competition of attracting foreign investment occurs in China’s eastern coastal developed regions. Distorted incentives of government officials affect all levels of government in China and influence the regional governments’ functional transformation. This kind of transformation and China’s economic growth pattern represent the results of the Chinese-style political promotion tournament and could go against regional economic development in the long term. Due to the difference in political environment and level of political transparency, the “voting with hand” and “voting with feet” mechanisms could not function well in all regions of China, hence leading to the imbalance in development.

7. Conclusion

Based on a review of research literature on fiscal decentralization, this paper has selected an appropriate approach to compute an index of China’s overall degree of fiscal decentralization as well as those at the regional level of provinces, “autonomous regions” and municipalities directly under the central government, and construct a model to analyze the optimal level of China’s fiscal decentralization. The paper’s findings can be summarized as follows:

(1) China’s eastern region has the highest degree of fiscal decentralization which is followed by the western region, while the middle region always has the lowest degree. At the same time, the problem of China’s interregional imbalances in terms of fiscal decentralization becomes more serious.

(2) China has formed relatively stable intergovernmental fiscal relations, the overall degree of fiscal decentralization has been close to or has reached the optimal state, and the future fiscal decentralization reform should focus on structural adjustment and optimization rather than continuous expansion.

(3) The degrees of fiscal decentralization of various regions of China reflect a slow convergent trend, which is the inevitable result of improved financial strength of the country and the requirement for various regions to attain equalization in development.

(4) The political promotion tournament in China has its own cost which causes the mismatch of the degree of fiscal decentralization and the speed of regional economic development between western and middle China. Chinese-style fiscal decentralization makes the “voting with hand” and “voting with feet” mechanisms unable to function well in all regions of China, hence leading to the imbalance in development.
The first policy implication of this study is regarding China’s financial reform. Though fiscal decentralization is a global trend, it is neither endless nor unlimited. China’s fiscal decentralization reform has been close to or even has reached the optimal level (0.4304 or 43.04 per cent according to the finding of this study), hence further fiscal reform should focus on the optimized adjustment of internal structure, such as how to mitigate the pressure of significant imbalances in development among various regions. This paper also analyzes the political promotion tournament under Chinese-style decentralization and indicates that the political promotion tournament system provide a strong incentive for the local officials’ behaviour and efforts. However, the paper does not analyze its impact using a specific quantitative model because it is difficult to be reflected by the change of specific numerical values. Moreover, considering the difficulty of indicator selection, the most important explanatory variable of the model – the degree of fiscal decentralization – is described mainly by the government expenditure. Whether from the perspective of theoretical or empirical analysis, how to better depict the characteristics of Chinese fiscal decentralization should constitute an important direction of future research.

APPENDIX

Operation Process of the Model

Dependent Variable: Y
Method: Least Squares
Date: 04/13/12 Time: 11:00
Sample: 1 12
Included observations: 12

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R-squared 0.888093
Adjusted R-squared 0.753805
S.E. of regression 0.006174
Sum squared resid 0.00191
Log likelihood 49.27518
F-statistic 6.613330
Prob(F-statistic) 0.027946
Notes

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1. Decentralization is usually divided into three levels. At the first level of decentralization, the local government gains autonomy of financial expenditure to manage the local economy and provide economic services. At the second level, the local government can self-determine tax rates and how to dominate the local tax revenue. At the third level, local governance is via elections by local residents democratically. The decentralization model of a country usually shifts between these three levels or they might overlap without a fixed pattern. For example, the decentralization model of China is mainly in the area of economic rather than political affairs, in contrast to India’s decentralization model (Mookherjee and Bardhan, 2005). The content of decentralization is not solely fiscal decentralization but the latter certainly weights most. The idea of the central government’s decentralization of competences to the local governments is symbiotic with the idea of federalism. As early as the era of Enlightenment, the thought of power separation had already existed. However, federalism in the modern
sense emerged only in the 1940s and 1950s, and contained two generations of fiscal decentralization theory. The first generation is also known as classical financial federalism theory which emphasized the benefit of decentralization as the information priority of local government. Effective supply of local public goods can be achieved through decentralization and this idea is supported by two main sources. The first one comes from the article “A Pure Theory of Local Expenditure” (Tiebout, 1956), which stressed the importance of local residents “voting with their feet” to trigger a competition akin to market competition mechanism among the different regions. It gives a solution to match the taxation, public goods supply and resident preferences. Another source is Hayek (1945)’s theory of decision-making power and information symmetry. It assumed that the centre government had no idea about existing geographical heterogeneity and local residents’ preferences of public goods in different regions. Without considering regional competition, the way that gives the financial authority of distributing and managing the public good provision to local government will lead to an improvement in social welfare, unless there is a certain obvious interregional spillover (Musgrave, 1959; Oates, 1972, 1999). Based on the first generation of fiscal decentralization theory, a group of economists represented by Qian Yingyi created the second generation of fiscal decentralization theory according to their understanding of the Chinese development model. Compared to the first generation of fiscal decentralization theory, the second-generation theory of fiscal decentralization stands at the point of system efficiency to analyze the importance of fiscal decentralization to economic growth. In its view, the traditional decentralization theory does not completely explain the mechanism of decentralization, especially about the constraints of government officials. For the marketization issues, the government should use some kind of commitments to provide “positive” and “negative” incentives. A “positive” incentive is used to prevent predatory behaviour of the government and a “negative” one is used to punish the soft budget constraint. Under the incentive, the local government will implement a series of market-preserving public policies such as promoting the privatization of the regional economy, and binding the budget constraints of State-owned enterprises. Therefore, in the second generation of fiscal decentralization theory, the most important role of decentralization is to encourage local governments to adopt a policy which is friendlier to the market-oriented economy. A general survey of the two generations of fiscal decentralization theory shows that decentralization seems to bring the regions certain economic growth through relevant mechanisms. However, the crucial problem is whether there is any necessary causal connection between fiscal decentralization and economic growth and whether decentralization will lead to more effective governance, more supply of public goods and a better economic performance. In fact, even for countries which are similarly relying on decentralized governance, their economic growth performance can be very different, and absolute causal relationship between decentralization and economic performance does not seem to exist, for about
whether decentralization can promote economic growth, empirical researches have still not been able to arrive at a consistent conclusion. Akai and Sakata (2002) used state-level panel data in the early 1990s to find a positive effect of decentralization on economic growth. However, Xie et al. (1999) did not find that decentralization could have affected economic performance in the past fifty years. Woller and Phillips (1998) found that there is no significant positive or negative relationship in developing countries. On the contrary, Davoodi and Zou (1998) recognized that there was a significant negative relationship in the developing countries, while it was not significant in the developed countries.

2. Part of the literature on fiscal decentralization questions the two generations of the fiscal decentralization theory (see Note 1 above) and explains regional decentralization more comprehensively, in particular extending the theory of fiscal decentralization to the dimension of politico-economic interaction. In economic decentralization, there is a political clientage between central and local governments, as well as local voters and the regional governments, which is a kind of agency problem. Central government entrusts local government to develop the regional economy and local voters must rely on the support of public goods and social welfare from the local government. However, as the principal, both the central government and local voters grasp the behaviour information of local officials incompletely. This causes transaction costs in the political market. In developing countries, the transaction costs or agency costs are usually more prominent. Prud’homme (1995) and Tanzi (1996) believed that if the local government was flawed in public good provision, the benefits of fiscal decentralization would not definitely be attained. For example, when local officials’ administrative efficiency is low, the supply of local public goods and services is likely to be inefficient. Furthermore, Besley and Coate (2003) pointed out that besides residents’ preference heterogeneity, it is difficult to find other reasons to support the existence of the decentralization model in theory. They advocated that a reasonable explanation of the decentralization model must include both the political and economic dimension.

3. Based on a game theory analytical framework, Qian et al. (2008) found that in the aspects of economic growth and regional financial equality, the central government has to make a choice. Since the reform and opening up, the process of seeking economic growth has really caused the different developments in terms of the regions’ financial ability and economic level.

4. To avoid conceptual confusion with the use of the term “central” as in “central government”, this paper uses “middle region” and “middle China” instead of “central region” and “central China” when referring to the regional divisions of China.

5. Please see Note 4 above.

6. Such regional demarcation, though geographically accurate, somewhat differs from the official version in which the eastern region includes Beijing, Tianjin, Liaoning, Shanghai, Jiangsu, Zhejiang, Fujian, Shandong, Guangdong, Hainan
and Hebei; the central region covers Jilin, Heilongjiang, Shanxi, Henan, Hunan, Hubei, Anhui and Jiangxi; and the western region comprises: Sichuan, Chongqing, Yunnan, Guizhou, Shaanxi, Gansu, Qinghai, Tibet, Ningxia, Xinjiang, Guangxi and Inner Mongolia.

7. China reformed some sectors’ governance model one after another since the mid-1990s. For example, in the banking industry the cross-region administration has been realized. While these reforms were also supposed to limit and correct the intervening behaviour of the regional governments, they do not fundamentally change the influence of the local governments on these functional sectors. It is because in the political promotion tournament the local officials still need these functional sectors to contribute to regional economic development.

References


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