Who Has the Emperor's Clothes? Economic Relationship Between the Central and Local Governments in Mainland China*

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In the case of a centrally planned socialist economy, a distinction should be made between administrative decentralization, which is an in-tra*systemic adjustment of the plan, and economic decentralization, which is an* inter*systemic reform of the institutional structure that transforms the coordination and control mechanisms from a planned to a market economy. The economic changes in mainland China since 1979 have been of the latter, systemic kind. Reform of the fiscal system has increased the taxation and expenditure powers of provincial and lower-level governments as well as initiated a continuing transition from direct administrative command to indirect central and local macroeconomic guidance, within an environment of market or near-market prices and more diversified (but not fully privatized) property forms. However, banking reform has lagged behind other structural changes. As a result of cannibalization by a large, still growing (in absolute terms), and largely unreformed state-owned industrial sector, long-term prospects of overall reform are being threatened.*

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Centralization and Decentralization Theory

To survive and prosper, an economic system must continuously seek an appropriate balance between centralized and decentralized

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allocation and coordination of the limited resources available to it.[1] What is appropriate depends on the specific circumstances of time, place, and technology.

Of this century's dominant economic systems, socialism—both communist and fascist (national socialism)—has sought this golden mean through centralized command and administrative coordination, whereas capitalism (even in corporatist, industrial, and trade policy-enamored Japan and South Korea) has looked for it primarily in diffuse resource ownership and spontaneous ("invisible hand") competitive market coordination. Attempts have also been made (most frequently in bureaucratic socialism) to form personal-political connections (Chinese *guanxi*, Russian *blat*), or "traditional coordination"; these are often accompanied by personal corruption of astonishing dimensions.

Movement along the continuum from theoretically pure centralization (absolute administrative command) toward theoretically perfect decentralization (perfectly competitive market allocation) implies an initial progressive devolution of allocative power from higher (central) to lower (local) levels of the bureaucratic hierarchy. At some rather ill-defined transition point, a qualitative transformation of allocation, control, and coordination mechanisms then takes place: a systemic change at both the institutional and theoretical levels.[2]

Administrative Decentralization

Up to the elusive point at which the process of systemic transition (from plan to market) begins, decisionmaking decentralization takes the form of intrasystemic adjustment, or the degree to which

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[1]By coordination I mean the harmonization of allocative decisions. An important element of the centralization/decentralization process is the nature of public-private property rights within the system, the principal/agent relationship of the prevailing property structures, and the mix of such rights and relationships.

[2]Institutional and notional (theoretical or ideological) transitions are not invariably synchronized. Acceptance of market philosophy may precede the formation of market institutions and vice versa, in which case operational and ideological malaise (China) or crisis (Russia) occurs. The point of systemic transition may be reached incrementally or (as has been the case in Eastern Europe, the former Soviet Union, and less explicitly in China) by a politically or otherwise induced (revolutionary) decision to scrap the former system. Decentralized market economies can and have been known to move in the opposite direction: toward centralized administrative planning. This always happens in times of war, but sometimes (e.g., the Great Depression, post-World War II Britain under Labour Party governments) in peacetime. In such an event, a qualitative change occurs along the decentralization/centralization continuum in which compounded regulation paralyzes allocation, coordination, and market control.

administrative tasks are delegated among bureaucrats. Examples of such adjustment (with backslidings) can be found in the misnamed "reform" experiences of the Soviet Union, Eastern Europe, and mainland China from the mid-1950s through the late 1980s (late 1970s in China). The results were disappointing, to put it mildly, in terms of the sought-after improvement of allocative efficiency and a smooth changeover from extensive to intensive (factor productivity-based) growth.

Administrative decentralization, which remains within the centrally planned, institutional framework of physical indicators (quotas) and vertical communications, consists of allocating selected decision-making powers, including lower-echelon nomenklatura appointments and removals, and occasional attempts to trim the communist party's day-by-day involvement in economic management. Adjustments in the relationship of the socialist enterprise (firm) to the rest of the economic bureaucracy represent this aspect of administrative decentralization. The enterprise, headed by a manager, is the lowest echelon of a multilayered economic bureaucracy, and not, as in a market system, an independent decisionmaker. Attempts to improve socialist enterprise performance have typically included (1) delegating property rights of use/control; (2) transferring rights to retain a designated part of the enterprise's net "profit," which is divided among centrally-specified "enterprise funds," as well as the right to retain some of the foreign exchange earned by the firm's exports through a state trading corporation intermediary; (3) permission to make limited local fixed-capital investments using such funds; (4) allowing latitude in the enterprise's determination of incentive bonuses for workers and employees; and (5) more generally, restricting the party's intervention in the day-to-day conduct of governmental affairs, including the management of state firms. On occasion, enterprises have been granted the right to determine prices of new and local products, but usually only on a temporary basis.[3]

The general effect of administrative decentralization has been to decrease the role of physical/engineering planning instruments and increase the allocation-control-coordination role of financial instruments such as planner-determined prices, wages, profits, interest,

[3]Jan S. Prybyla, "Soviet Economic Reforms in Industry," *Weltwirtschaftiches Archiv* (Review of the World Economy) 107, no. 2 (1971): 272-316.

rent charges, and enterprise funds. However, these instruments are planners' "values," with accounting rules being set by the planners. At best (albeit rarely), they have emphasized a single monetary expression: the relative scarcities created by planners' input and output commands. However, they of course have not indicated opportunity costs in a market sense, that is, the competitive decisions of free buyers and sellers which can be used to determine static efficiency. Nevertheless, the shift of emphasis from tons, liters, and meters to quasi-values, even in a continued setting of constraint, represents a theoretical "revision" of Marx's and Lenin's naive belief that socialist economics could be reduced to simple administrative procedures and abacus-flipping consistent with the communist goal of the eventual abolition of money. It has been a movement away from unidimensional physical measures and technical coefficients (input-output relations that, if properly utilized, could conceivably indicate internal consistency of decisions, but not economic efficiency) toward, at best, two-dimensional monetary expressions of an infinitely complex reality which apportions resources among a multitude of alternative ends. In this sense, it has sowed the seeds for a possible but not ineluctable transition to some variant of the market system. However, it should be noted that intrasystemic adjustment of the socialist, centrally planned system has taken place within an unchanging political framework. The polity has remained in essence totalitarian.

Often missed by analysts but essential to keeping the system alive and easing the transition to a market order has been the presence of an underground market transaction network: a "parallel" economy that has mollified the impact of planners' misallocations and made life livable, if wearisome, for ordinary people. This shadow economy had been almost totally suppressed at the apogees of the Maoist Great Leap Forward and the Cultural Revolution.

Administrative decentralization of a centrally planned system is resorted to, first and foremost, because it is not possible to determine all dimensions of the allocative problem from the center. Central planners are often unable to obtain and convey all information needed for efficient allocation—an objective problem pointed out by F. A. Hayek six decades ago—and have difficulty enforcing bureaucratic compliance with their decisions. To expand control, bureaucratic management must be sought. However, extending administrative control produces its own costs, such as duplication of effort, irrational competition among regions and/or bureaucratic entities, jurisdictional conflicts, "particularism," local protectionism, "separatism," and the distortion of information in its flow through the channels of bureaucracy.[4]

Economic (Market) Decentralization

Economic or market decentralization means that critical decisions regarding resource allocation are made voluntarily by competing, autonomous, rational (utility- or profit-maximizing) buyers and sellers who formulate their choices through opportunity cost signals called "market prices."[5] In this system, public influence over and modification of dispersed, private, market price-coordinated decisions occurs primarily through central bank monetary and government fiscal policies which modify the market-determined parameters of private micro-decisionmaking.

Centralization and Decentralization: Mainland Chinese Practice

Perfect socialist centralization in mainland China, as elsewhere, entails (1) the concentration of decisionmaking power over economic objectives (outputs) in the top communist party-cum-government bureaucracies; (2) the allocation of resource inputs in pursuing those objectives; and (3) the appointment of personnel at all levels to carry out such allocation in conformity with the center's mandatory directives (the nomenklatura principle). Among the more important institutional arrangements used to accomplish this are property rights concentrated in the state's ministries and commissions.

Administrative Decentralization

Of course, perfect centralization is a notional extreme unfeasible in practice for reasons already touched on. Even in the most centralized socialist command economies, some devolution of authority

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[4]The distortion arises because as a rule, it is not in the interest of lower-level authorities to accurately reveal the information available only to them to higher supervisory authorities. It should also be added that some significant dimensions of participants' behavior cannot be captured by the statistics that are the basis of planner calculations, or captured very precisely.

[5]In this context, competition means "the independent effort by different businesses and individuals to make sales and profits in a situation in which a number of other agents are striving to do the same thing," in response, one should add, to independent choices made by many different buyers. William A. Byrd, *The Market Mechanism and Economic Reforms in China* (Armonk, N.Y.: M. E. Sharpe, 1991), 31.

in setting goals, allotting resources, and appointing jobs takes place. Decisions are formally delegated by unelected bureaucrats to other bureaucrats (sometimes the same ones wearing two or more hats) one, two, or three levels down in a particular functional branch or territorial division, depending on the degree of centrally-approved administrative decentralization at the given time.[6] It is a from-above process, which in the case of advanced administrative decentralization reaches down to the production enterprise, i.e., the lowest unit of government, and takes the form of self-accounting (what the Soviets called *khozraschet*).

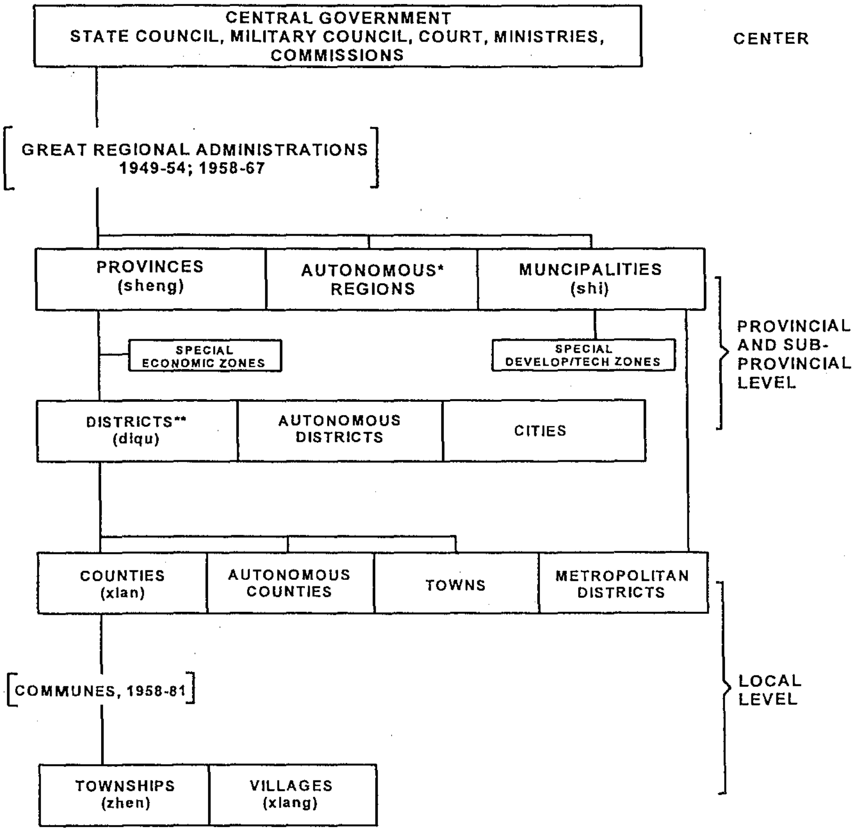
Socialist decentralization, or intrasystemic diffusion of decision-making authority, has often exhibited (especially in mainland China) a circular flow of power involving "reciprocal accountability" (mutual back-scratching) of power-holders chosen by an "elite selectorate"; "dual subordination" of local officials to local and central government bodies; and negotiated consensus, the respective negotiators of central and local authorities being unequal. Some observers view this as an argument against the assumption that conflict between the center and periphery must exist, and instead believe that it represents a "creative tension" between the two.[7] It also provides an opportunity for collusive rent-sharing between the center and its subordinate units, or a tripartite distribution of monopoly power among the center, the provinces, and localities.

The motivations behind the top-down transfer of selected bureaucratic powers in China have included the central leadership's desire to use local officials as an effective counterweight to the central bureaucracy; secure greater local input into what has remained in

[6]Informal appropriations of decisionmaking power by lower echelons do occur, as well as illegal appropriations by higher-ups of powers formally vested in lower-level authorities.

[7]Susan Shirk, "Playing to the Provinces—Deng Xiaoping's Political Strategy of Economic Reform," in *The Chinese and Their Future: Beijing, Taipei, and Hong Kong*, ed. Zhiling Lin and Thomas W. Robinson (Washington, D.C.: The AEI Press, 1994), 26. "Selectorate" refers to politically self-selected (nomenklaturized) rather than popularly elected officials. See also David S. G. Goodman, "The Politics of Regionalism: Economic Development, Conflict, and Negotiation," in *China Deconstructs: Politics, Trade, and Regionalism*, ed. David S. G. Goodman and Gerald Segal (London and New York: Routledge, 1994), 1-20. "Regionalism—in the sense of a political identification with the region—clearly could [be] and has been utilized as an integrative device rather than as a symbol of parochialism. . . . Moreover, local government is not necessarily an instrument for the expression of local autonomy." David S. G. Goodman, "Political Perspectives," in *China's Regional Development*, ed. David S. G. Goodman (London and New York: Routledge, 1989), 26.

Diagram 1
Mainland China: Regional Administrative Divisions



* "MINORITY NATIONALITIES"
** PREFECTURES

essence a concentrated policymaking process; and compensate for the shortage of technically skilled planners at the center. The formal levels of mainland Chinese organizational hierarchy are shown in diagram 1.

Following China's economic reform on the communist assumption of power (what I have elsewhere called the period of "reconstruction and reform," 1949-52),[8] China's economy underwent a series of intrasystemic adjustments that included one major administrative

[8]Jan S. Prybyla, *The Political Economy of Communist China* (Scranton, Penn.: Intext, 1970).

centralization (the Soviet-type First Five-Year Plan, 1953-57, but see note 10 below); a minor recentralization (1961-64, the period of "Readjustment, Consolidation, Filling-Out, and Raising Standards" in the wake of the Great Leap's disaster); and two major administrative decentralizations (the Great Leap Forward, 1958-60, which was largely decentralization through chaos; and the Cultural Revolution, 1966-76).[9] In other words, from the early 1950s through the late 1970s, despite spectacular and in human terms very costly institutional reconfigurations, mainland China's economic system did not undergo a fundamental overhaul of the institutional structure and a parallel transformation of economic theory and philosophy.[10]

It is the two administrative decentralizations of the Great Leap and the Cultural Revolution—Mao's radical-left interpretation of socialist economics and economic psychology, and his perception of China's needs—that have, I believe, most deeply marked the economic history of Chinese socialism during its four decades of mainland dominance, and which in some respects (but without the leftist radicalism) have persisted to this day. It was a combination of centralized formal authority and de facto decentralization (particularly in fiscal matters) to lower administrative echelons. This created a structure of "subordinate relations" reflected in the financial quasi-ownership rights of different government levels—a legally opaque arrangement with a long tradition in China.[11] Leniniist/Stalinist-type centralization in

[9]There can be some legitimate quibbling about precise dates and the subtle shadings of centralization and decentralization. Administrative decentralization, for example, began cautiously in 1956 during the "liberal interlude" (October 1956-June 1957) before being engulfed by the Great Leap Forward, which at least initially was an attempt at extreme ideological centralization, coupled with a disdain for formal bureaucratic structures. It soon fell apart, resulting in decentralization by default. Some have argued that the Cultural Revolution—marked, like the Great Leap, by attempts at enforcing ideological conformism—really began with the Socialist Education Campaign in the spring of 1963, peaked in 1969, and continued thereafter in a succession of mass campaign aftershocks. The Hua Guofeng episode between Mao's death and Deng Xiaoping's reemergence (1976-79) was a mixture of administrative rebuilding (implying some recentralization) and decentralizing influences inherited from the Cultural Revolution.

[10]Elements of systemic reform were present in the administrative centralizations of the First Five-Year Plan, the clearest of which was agricultural collectivization in 1956, even though it was a transition to higher-level collectives from more elementary forms of enforced cooperation. Elements of administrative decentralization have likewise accompanied the post-1978 systemic reforms.

[11]"Quasi-proprietary financial rights" refers to an arrangement whereby different levels of government are authorized by the center to retain for their own use all or a portion of net revenues generated by locally-run ("owned") enterprises. If a local

China was shorter, weaker, and less inclusive than it had been in the Soviet Union; in fact, the Soviet model of top-heavy centralization was for all intents and purposes discarded by China's communist leaders only four years after its adoption.

Economic (Market) Decentralization (1979-96)

In a centrally planned economy, no matter how bureaucratically decentralized it may be, economic decentralization means reform, that is, systemic change at both the theoretical and institutional planes, albeit not necessarily synchronously. Reform of theory implies changes in economic analysis (positive theory) and economic ethics (normative theory, or ideological conceptualization of the economy). These two changes have not been perfectly aligned in post-1978 China. Whereas market analysis has, by and large, replaced the theory of central administrative command planning, at the ideological level there continues to be an official insistence on Marxism-Leninism-Mao Zedong Thought (the "Four Cardinal Principles") and a rejection of "bourgeois liberalism" and the "unhealthy tendencies" allegedly associated with it, including the "red eye disease" (monetized greed).[12] Such

government's revenues are insufficient to meet its centrally mandated expenditures, the locality receives a subsidy from the center financed by proceeds from the national industrial-commercial tax and local taxes. If revenues from locally-run enterprises exceed centrally determined local expenditures, the locality remits the surplus to the center. In the past, under this arrangement, "most provinces gave the center more than they received from it." See Shirk, "Playing to the Provinces," 29. According to Jean Oi, the Maoist legacy in the post-1978 decentralizing reforms consists of (1) a formerly, at least, highly disciplined bureaucracy (in an international perspective) extending to all levels of society ("an impressive organizational apparatus"), and (2) the Maoist insistence on distributing administrative power over economics to the localities. This line of reasoning assumes the importance of an effective interventionist bureaucracy to successful early economic development, as in Louis Putterman and Dietrich Rueschemeyer, eds., *State and Market in Development* (Boulder, Colo.: Lynne Rienner, 1992). Jean C. Oi, "The Role of the Local State in China's Transitional Economy, *The China Quarterly*, no. 144 (December 1995): 1133-34. I would add rule by grand imperial gesture to this inheritance list, the opposite of the rule of law. The genealogy of such charismatic authority reaches far into China's history and finds its counterpart in an uncommon submissiveness of the emperor's subjects. The latest example of it has been Deng's early 1992 southern tour which, with the help of a few aphorisms attributed to a barely sentient leader, instantly revived then-flagging nationwide reforms.

[12]At the pop-cultural level and in the whisperings of intellectuals, these "unhealthy tendencies" appear to have made significant inroads since the slogan "it is glorious to get rich" was popularized back in the early 1980s. For pop-cultural infiltration, see Nicholas D. Kristof and Sheryl WuDunn, *China Wakes: The Struggle for the Soul of an Asian Power* (New York: Times Books/Random House, 1994), chap. 8; for the influence on intellectuals, see Merle Goldman, *Sowing the Seeds of Democracy in China: Political Reform in the Deng Xiaoping Era* (Cambridge, Mass.: Harvard University Press, 1994).

lagging ideology and occasional outbursts of populist yearning for the good old orderly days of communism represent, I think, a common human phenomenon (also present in post-Soviet Russia and central-eastern Europe) sometimes referred to as *nostalgie de la boue*, or "longing for muck."

Institutional reform means marketization and, at the very least, de facto privatization of the domestic economy and its external linkages—the lateralization of formerly vertical, command exchange relations among competing buyers and sellers and a change in which demand and supply choices are determined by multidimensional (opportunity cost) market prices.

Specifically, marketization involves (1) free information flows about relative demand preferences and supply costs for domestic and foreign products, such information being quantified in market prices; (2) coordination of this information through the market/price mechanism; and (3) replacement of a motivational apparatus dominated by coercion and fear of punishment with an incentive system of monetary rewards ("satisfizing" buyers' utilities and sellers' profits), which requires a hardening of enterprise budget constraints, i.e., the notion of individual or corporate responsibility for losses incurred in the course of business.

In mainland China's post-1978 reforms, privatization has meant the pluralization of property forms rather than outright private ownership of productive assets or free associations (joint stock companies, partnerships). Such de facto privatization has meant that, with the exception of some 100,000 large enterprises employing (as of 1996) more than 100 million workers and owned by the central or provincial governments, the share of gross industrial output value of these statistically dominant "state-owned" enterprises has fallen from more than 90 percent before 1979 to below 50 percent in 1995, and most industrial enterprises are now "non-state"/collective. They are "quasi"-owned by various local governments, especially at the county, township, and village levels, or run jointly with foreign or domestic private parties, or by various cooperatives ("one factory, two or three systems"). "Collectively-owned" (using official statistical terminology), "non-state" firms have been the fastest growing industrial property.[13]

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[13]David S. G. Goodman of the Institute for International Studies, University of Technology, Sydney, Australia, classifies the Chinese post-reform collectives into six groups, each of which "must operate within the market economy but is also inextricably part

Truly private firms represent a small share (about 8 percent in 1992) of total industrial output value, but account for almost 80 percent of all industrial firms. Nevertheless, firms statistically classified as "state enterprises" employ about 50 percent more people than they did before the reforms (70 percent of urban industrial employment), their stock of fixed capital is greater than it was in 1978, and their claim on scarce resources—by and large inefficiently used (44 percent of state-owned firms suffered financial losses of 41 billion *yuan* in 1995)—has not diminished. In this respect, unlike what has occurred in much of post-1989 east-central Europe, an important facet of Chinese industrial economic decentralization has been deferred, very likely at substantial long-term cost. Meanwhile, state enterprises have indulged their hunger for investment, thereby reinforcing a distorted pre-reform industrial structure and undermining, as we shall see, the banking system.

According to some Western economists, the de facto quasi-privatization of non-state industrial and service enterprises has stemmed from the market-driven motivation of those in charge of these firms. These economists argue that as these enterprises have to buy and sell in more or less competitive markets, bureaucrats now reap the potential benefits and, for the first time, bear the risks of business transactions, in contrast to administratively commanded transfers before the reforms. In addition, bureaucrats have concentrated on real profit-making, and risk-averse bureaucrats have become quasi-entrepreneurs—"quasi" because of persisting personal-political connections and other bureaucratic imperfections, such as privileged access to scarce market-priced goods. Jean C. Oi notes, "What has changed is not necessarily the personnel, but the incentives that are embedded in the institutions that shape the actions of officials. . . . For China the issue is not whether bureaucracy was capable of generating growth, but whether it had incentives to do so."[14] A weakness of this argument

of the party-state." The six groups are: large-scale collectives (e.g., the West Lake District Company of Hangzhou); state sector subsidiaries; social collectives; local (rural, town or village) collectives; share-based collectives; and private enterprise collectives. David S. G. Goodman, "Collectives and Connectives and Corporatism: Structural Change in China" (Unpublished paper, 1994).

[14]Oi, "The Role of the Local State," 1136. "In China it is the Communist Party first secretaries who are leading much of the rural industrialization. Institutional context and incentives matter. . . . Altering fiscal flows and property rights [local governments retaining property rights over a key portion of township and village industry] overcame the inertia that many associate with Communist officialdom" (p. 1148).

is that it dismisses the prebendal element in "as-if" privatization, i.e., personalized government ownership with changed forms of rent-seeking.[15] By acting like real owners within an androgynous economic and monopolistic political system, party and government officials in charge of industrial and commercial assets have lined their own pockets on a mind-boggling scale. This exercise in red robber baron capitalism is plain to see, but has been largely overlooked by outside observers who focus on the importance of the "developmental state" that provides the "right" (market) incentives to its civil and uncivil servants.

The reforms of 1979-96 have laid the foundations of capitalism in China, just as—albeit with more pain and violence—the reforms of 1949-52 prepared the ground for a centrally planned socialist system. One might add that contrary to widespread belief in the irreversibility of current reforms, history suggests that this need not be the case. Thus far the architecture of reforms has borne greater resemblance to East Asian models of state capitalism in the 1950s and 1960s than to the more individualistic American blueprint.

In market systems the state, in its several central and local manifestations, intervenes in the economy primarily by means of macroeconomic, fiscal and monetary policies. Government fiscal policies affect the size and patterns of individual buyers and sellers' choices through taxes, government spending on public goods, and income redistribution. The relatively autonomous central bank's monetary policies (discount rates, reserve requirements, open market operations) and treasury bond issues affect lenders and borrowers' behavior, as well as consumers' and producers' decisions. The main objectives are monetary stability, reigning in and smoothing out

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From this it is an easy step to assert that "a minimalist state is not necessarily the answer [to efficient allocation]. The goal should be more effective government," and "privatization is not the only way to stimulate economic growth" (pp. 1146 and 1148). Both assertions constitute a fundamental, if implied, assault on the thesis that private property and the market system are inseparable and, by extension, that private property is essential not only to economic freedom and the formation of market prices, but to liberty (Hayek, von Mises, Kornai). The argument for the subsidiary importance of private property finds support in Oskar Lange's treatment of the principal/agent problem under socialism, and in some World Bank economists, notably, as I read him, William A. Byrd, *The Market Mechanism and Economic Reforms in China*. Cf., the political scientist David S. G. Goodman (note 13 above): "Control is more important than ownership as an explanation of economic behaviour" ("Collectives and Connectives and Corporatism," 2).

[15]Oi, "The Role of the Local State," 1140-42.

business cycles, and encouraging growth. The state (particularly the activist developmental state) intervenes directly in the market through administrative rules and regulations as well as moral arm twisting, but such interventions are subsidiary to the state's influence on the economy through price mechanisms.[16]

Fiscal System

The government influences market outcomes through expenditures from the state budget, tax revenues, and income redistributions (transfer payments). This includes purchases, taxes, and transfers at both the central and local levels. Optimal distribution of these powers between the central and local governments is of considerable importance not only to efficient resource allocation, but to national economic unity and social stability—both objectives high on the priority list of mainland China's leadership.

Pre-reform fiscal system. In line with the formula of "unified leadership, level-by-level management" promulgated in 1951, China's center (1) laid down provincial budgetary expenditures, including investments, independently of provincial revenues; (2) appointed the heads of provincial finance departments; (3) appropriated for itself the lion's share of enterprise revenues on the basis of quasi-ownership (profits of centrally-run enterprises went to the center and those of locally-run enterprises to local governments); and (4) decided what share of tax revenues was subsidized to the localities in the event of local deficits, or remitted to the center when local budgets showed a surplus. Revenue-sharing contracts were renegotiated annually, with the center having final say in the matter. Taxes (e.g., the national industrial and commercial tax) and enterprise profits of local enterprises were collected by local authorities and remitted by them to the center. Numerous decentralizing adjustments were made to this fiscal mechanism prior to the reforms, particularly during the two Maoist interludes. "Two enthusiasms" [central and local], Mao argued, were better than one [central].[17]

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[16]*The East Asian Miracle: Economic Growth and Public Policy*, A World Bank Policy Research Report (New York: Oxford University Press for the World Bank, 1993); Putterman and Rueschemeyer, *State and Market in Development*.

[17]Shirk, "Playing to the Provinces," 28-32. Most notable was the "Third Line" strategy of the late 1960s-early 1970s, which involved not only the physical relocation of heavy industry complexes to the more inaccessible inland provinces, but the wholesale transfer of central enterprises to provincial quasi-ownership. Mao Zedong, "On

By the end of the 1970s, fiscal decentralization had gone as far as it could under the centrally planned system. It included a "fixed rate responsibility system" whereby provinces were empowered to determine their own budgets and, after transferring a contracted-for lump sum to the center, entitled to keep and spend any surplus at their discretion. Under a regime of inflexible planner-fixed wages and prices[18]—low prices for centrally-run heavy industry products, relatively high prices for products of locally-run light industries—local governments' profits rose and, combined with their expanded powers in using their shares of those profits, tilted the balance of decision-making power in their favor, encouraging them to promote relatively lucrative consumer-oriented industrial enterprises. All in all, however, the pre-reform administrative adjustments were limited in scope and depth. For instance, they did not reach down to the enterprise level, but stopped at local government bureaus.

Fiscal system reform. Reforms since the 1980s have brought about qualitative changes in basic economic institutions, particularly price determination and the role of emergent market-oriented prices in resource allocation, coordination of choices, and behavior motivation. Provincial, subprovincial, and local governments and their quasi-owned enterprises, as well as joint ventures, cooperatives, and private firms have begun to use their expanded revenue and expenditure rights (e.g., direct contracting with buyers and sellers) within an imperfect but sometimes highly competitive market environment. Domestic prices have been less controlled, and export-oriented local firms have paid more attention to prices prevailing on the world market as conveyed by increasingly flexible foreign exchange rates. The formula has been "state-owned, privately-run": state owners at various bureaucratic levels—communist party capitalist entrepreneurs, their relatives, political friends, and protégés—have behaved as if they were real owners in a growing, formally/informally regulated, market/capitalist, neomercantilistic, cryptocorporatist order—a messy and capricious concept, but one that has done well by the ordinary worker thus far. "Don't debate, just try," Deng Xiaoping was al-

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the Ten Major Relationships" (1956), in *Selected Works of Mao Tse-tung*, vol. 5 (Peking: Foreign Languages Press, 1977), 292-95.

[18]After the mid-1960s, the prices of the same goods were differentiated according to different costs of production in large and small, technically advanced or technically backward factories. This was an accounting adjustment related to Marxist value theory. Similar changes were made in the Soviet Union at about the same time.

leged to have aphoristically said during his January 1992 tour through the south. Still, despite the excitement of newfound pragmatism, "kite-flying," and the rising tide of market rationality, the discreet but pervasive presence of the old planning mentality and dogmatic aversion to private property has continued and should not be overlooked.[19]

The history of central-local fiscal relations after 1978 can be classified into (1) the 1980-82 sharing of revenue by specific sources; (2) the "tax-for-profit" (*ligaishui*) reform of 1983-84; (3) the fiscal contracting of 1988-89; and (4) the tax assignment system of 1993-94.[20] These were essentially fiscal decentralizations punctuated by attempts at recentralization. The latter have reflected the center's concern about its ability to extract enough revenue for its needs from the provinces under the new fiscal regime, as localities have resorted to tax avoidance and evasion under the pretext of undiminished expenditure obligations. Provinces have resorted to such strategies, including diversion of resources into less stringently controlled extrabudgetary, non-tax channels, because they, too, have found themselves financially squeezed. They are responsible for many expenditures—including capital outlays, urban food subsidies, and increased payments for education—which formerly had been assumed by the center. By 1988, local expenditures were nearly 50 percent of total state budgetary expenditures, compared to 25 percent in 1978, while local revenues were 60 percent of total state budgetary revenues, compared to 85 percent in 1979.[21]

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[19]"Provinces send plans to the prefectures [districts], which send them to the counties, which send them to the townships. For example, the county still sets the annual procurement quotas for agricultural goods such as grain and cotton, and allocates the agricultural tax to townships. . . . In addition, localities from the province on down also set annual industrial production and fiscal targets which are not necessarily dictated by upper level directives." See Oi, "The Role of the Local State," 1145 n. 34.

[20]E.g., Christine Wong, "Public Finance and Economic Decentralization," in *China's Economic Reform*, ed. Walter Galenson (San Francisco: The 1990 Institute, 1993), 187; Dali L. Yang, "Reform and the Restructuring of Central-Local Relations," in Goodman and Segal, *China Deconstructs*, 80ff.

[21]Wong, "Public Finance and Economic Decentralization," 186 (table 6.4), 190 (table 6.5). For details on the various changes in the fiscal regime, see Christine Wong, "Fiscal Reform and Local Industrialization: The Problematic Sequencing of Reform in Post-Mao China," *Modern China* 18, no. 2 (April 1992): 197-227, and her "Central-Local Relations in an Era of Fiscal Decline: The Paradox of Fiscal Decentralization in Post-Mao China," *The China Quarterly*, no. 128 (December 1991): 691-715; Zhong Zhu Ding, "Mainland China's New Dilemma: Decentralization and Central-Local Conflicts in Economic Management," *Issues & Studies* 31, no. 9 (September 1995): 19-36.

Rather than delve into a detailed examination of the many changes made since 1980 in central-local fiscal relations, I note several highlights that have systemic reform implications.

1. The post-1978 fiscal changes represent on balance a continuing, incomplete transition from direct central administrative control of the system to indirect central and local macroeconomic guidance deployed within a significantly changed institutional environment of market or near-market prices and more diversified property forms.

2. In the process, local governments have gained broader revenue rights and acquired greater expenditure responsibilities, particularly the latter. This diffusion of fiscal power does not appear to have significantly diminished the extractive power of the state, nor has it led to zero-sum conflict between the center and the localities, although it has given rise to tensions between the two. This is so because within the emerging market system, coordination and control are more efficiently accomplished through economic decentralization. A relative decline in the central share of revenues and expenditures (particularly investment outlays) is a necessary condition of the transition from central administrative command planning to a reasonably competitive market system, i.e., one of fiscal rationalization. However, the distribution of budgetary resources between the center and the localities is only one measure of the latent power of central and provincial governments. "Submission of the parts to the whole" through the exercise of coercive powers; official appointments, reassignments, and dismissals; and reciprocal dependence of officials matters greatly. It is in this way that one should view the more recent (1993-94) expansions of local authority over local development, which was once limited to special economic zones, economic-technical development zones, open cities, and other territorial delineations. The incompleteness and frequent incoherence of China's institutional transition, including the fiscal regime, have contributed more heavily than central-local conflicts to macroeconomic instability. Incidentally, localities in China are not homogeneous and do not have identical interests vi-à-vis the center; there is competition among them as there is among the ministries, commissions, and other administrative divisions of the central government.

3. The emergent reformed system of industrial organization resembles market corporatism in some respects. At the provincial and subprovincial level, for example, associations of producers and buyers for particular products (e.g., clothing, steel) have been set up. Their function is to provide members with market information, organize

marketing conferences, and so on. This suggests that local economic growth in China since the reforms has taken on a corporate form. As Oi writes, "Somewhat akin to a large multi-level corporation, the county can be seen as being at the top of a corporate hierarchy as the corporate headquarters, the township as the regional headquarters, and the villages as companies within a larger corporation. Each level is an approximate equivalent to what is termed a 'profit centre' in decentralized management schemes used in business firms. Each successive level of government is fiscally independent and is thus expected to maximize its economic performance." The levels are "intimately connected" with explicit hierarchies and obligations, with the lower levels being subject to the directives of higher levels, turning a portion of their revenues over to the latter. "[E]ach level has the opportunity to draw on the resources of the larger corporate body," Oi notes.[22] In addition to formalized connections laid down by law and decree, there exist among the levels what David S. G. Goodman (note 13) calls "connectives," or "highly personalized networks of influence" on which officials rely for obtaining scarce inputs, finding markets for their outputs, and, most importantly, gaining bank credit. Given the cultural context, these connectives enable market transactions to go forward, but they also raise prices by at least the amount of the "facilitation payments" involved (not counting premiums for the risk of being caught), distort allocation, and inject an element of capriciousness into the market process which, if it becomes widespread, can destroy the market mechanism and undo the reform.

4. Despite many changes, the fiscal system remains particularistic, although less than before. What is lacking is a transparent, predictable, broad-based system of nonnegotiable taxes at uniform rates. In this sense the fiscal reform borders on administrative adjustment. It remains partial and incomplete.

Money and Banking

Among the more troubling aspects of China's reform effort is the condition of its banking system. Despite a good deal of rhetoric

[22]Oi, "The Role of the Local State," 1138. Unlike the typical multinational corporation of an East Asian newly industrializing country (NIC), in mainland China the local Communist Party secretary is a key economic decisionmaker. Oi argues that "this is not Communist politics as usual." That may be so, but reports suggest that considerable abuse of authority, graft, and bullying are frequently involved. There is hardly any mention of this in Oi's otherwise valuable study.

about systemic transformation of this vital sector and some ongoing reformist policies put into effect since November 1993, not much has been done to bring the banking system into harmony with the nascent market system. In short, reform of banking seems to have been deferred, a postponement that could prove dangerous to the overall reform and stall China's economic modernization.

Specifically, the central bank (People's Bank of China) remains an arm of the government, the four state-owned specialized banks are the economy's main source of credit, and the three policy banks established in 1994 which were supposed to lead the way in commercializing the specialized banks have not done so thus far.[23] The central bank continues to manage the money supply more through administrative controls than interest rate policies. Nevertheless, Xi Yang, a Hong Kong journalist, was given a twelve-year jail sentence in 1994 for allegedly writing about this subsidiary interest rate policy. There has been a spectacular expansion (from 5 billion *yuan* in 1991-92 to 1 trillion *yuan* in 1995) in lending by nonbank financial intermediaries.

The banking problem has two related dimensions. The first is the continued influence of politics over monetary policy, which translates into government pressure on the banking system to extend loans for a variety of fixed and circulating capital purposes at interest rates that correlate very poorly, if at all, with market credit conditions. Bank loans as a share of gross domestic product have risen from 20 percent at the outset of the reforms to 70 percent as of the end of 1995 (90 percent if loans made by nonbank financial institutions are included). The second dimension of the problem, indeed its crux, is to be found in the failure to reform state-owned enterprises by hardening their budget constraints through exposure to market competition and changing their property structure. Roughly 80 percent of all bank loans bail out these highly indebted, inefficient survivors of the *danwei* system, many of which are nonviable in the long run.

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[23]Chen Bo-chih, "Mainland China's Monetary and Financial Policies: Operational Changes," *Issues & Studies* 31, no. 5 (May 1995): 25-48. The four state-owned specialized banks are the Industrial and Commercial Bank of China, the Bank of China (which deals with foreign transactions), the People's Construction Bank of China, and the Agricultural Bank of China. The three policy banks are the National Development Bank, the Import-Export Bank, and the Agricultural Cooperative Bank. The intent was to introduce an integrated foreign exchange market and a market-based, managed floating exchange rate.

Their debt/asset ratio of 80 percent in 1994 was, on average, seven times what it had been in the late 1970s, without taking into account the fact that many state-owned firms do not pay interest on their bank loans, or fail to include unpaid interest as a business cost. Ninety percent of their debts are state bank loans, two-fifths of them non-performing (1 trillion *yuan* in 1994), and in many cases the return on enterprise assets is insufficient to pay interest on the loans (7 percent average return on assets, 12 percent average nominal rate on loans).[24] All in all, the state-owned industrial (and commercial) sector is much larger in absolute terms than it had been before the reforms. It is inefficient, highly leveraged, and survives by "cannibalizing" (Nicholas R. Lardy's term) the banking system. In this respect, the economy (unlike that of formerly planned central Europe) has not grown out of the plan.[25] Were the banking system to recover only, say, half the debts owed by the (central/provincial) state-owned industrial enterprises through liquidation of borrowers' assets, the banks' losses would destroy China's banking system and adversely affect overall reforms and the economy's growth. The major reason for the state authorities' reluctance to restructure or systemically reform the state-owned industrial sector and a good deal of nonretail commerce is fear of massive unemployment and urban social unrest resulting from the liquidation of perhaps as many as half of state-owned enterprises. Another reason is the residual reluctance to abandon the principle of state ownership.

Conclusion

Administrative decentralization was practiced in mainland China during most of the period 1957-78. This type of decentralization involved the government-party center delegating many executorial economic functions to lower-level government-party authorities within a command system lacking a spontaneous, multidimensional price mechanism and notions of private property. At the same time, the

[24]Nicholas R. Lardy, "China's Economic Transformation" (Paper presented at The Army War College's 7th Annual Strategy Conference, "China Into the Twenty-first Century: Strategic Partner and/or Peer Competitor," Carlisle Barracks, Pennsylvania, April 23-25, 1996).

[25]Barry Naughton, *Growing Out of the Plan: Chinese Economic Reform, 1978-1993* (New York: Cambridge University Press, 1995).

center retained strategic levers of control, including the power of appointment, transfer, and dismissal of personnel in charge of the economy.

Since 1978, the institutional framework of the economy has been substantively, albeit not uniformly, reformed. Mandatory, planner-determined, physical/engineering input and output quotas—the chief coordinating and motivational devices ("success indicators") of the system—have been progressively replaced by market prices with various degrees of competitive imperfection. World market prices are allowed to exercise their influence through a half-open door policy: wide open for exports, not so open for imports (the East Asian NIC model pioneered by Japan). Property rights reform inaugurated by large-scale agricultural decollectivization has been more limited, consisting primarily of de facto privatization of use rights, partial privatization of rights to residual income, and restrictions on transfer rights. A large and expanding (in an absolute employment and fixed-assets sense) state-owned industrial sector, which will accumulate worrisome structural problems in the future, has been retained. The relative decline of that sector's output has been due to the more rapid expansion of output value (and productivity) in so-called "non-state" ("collective") industrial and commercial enterprises. China's economic reforms have thus been institutionally lopsided, resulting in a hybrid economic system with a very high corruption content.

The transition from administrative decentralization to market decentralization and intrasystemic adjustment to intersystemic reform since 1978 has been accompanied by a parallel but not synchronous transition from direct administrative to indirect fiscal and monetary methods. Such instruments of state intervention have involved, particularly on the fiscal side, delicate but not necessarily antagonistic division-of-power issues between the central and local governments. This division has been based on enterprise ownership: what level of government owns which enterprises.[26] It is precisely this question on which the legal situation lacks transparency and is characterized by arbitrariness, due to the absence of the rule of law—as when, for

[26]"The difference [with earlier periods] is that with reforms linking local expenditures more directly to revenue collections, enterprise 'ownership' has now acquired new significance. In fact, this change [has] fundamentally altered the relationship between local governments and their enterprises and significantly decentralized the fiscal system." See Wong, "Public Finance and Economic Decentralization," 189.

example, the center "borrows" surplus funds which by right "belong" to local governments by virtue of the latters' "ownership" of enterprises that generate these funds. More ominous has been the decision to retain some 100,000 large, nonviable enterprises in state ownership, partly out of remnant ideological belief, but mostly from fear of urban social unrest resulting from the application of market criteria to these enterprises. It is thus possible that what admirers of China's "market socialism"—particularly its deemphasis of "troublesome" and "disruptive" de jure privatization, as per central Europe—regard as one of the keys to its recent reform success may, in fact, turn out to be reform's Achilles' heel.

The two most important institutions of an economic system—those that coordinate resource means-to-ends decisions and property ownership—are not purely economic constructs. They have political components, some compatible with the thrust of economic changes, some less so, others not at all. Thus, as China's reformers have discovered, a two-tier price system consisting of competitive market-determined and planner-commanded prices is not, over the long run, the way to restructure the coordination mechanism if economically efficient resource allocation and productivity-based growth are the objectives. In the same fashion, state and quasi-state property in the context of a one-party, dictatorial polity is not subject to external constraints such as the rule of law and civil society. Granting quasi-ownership rights to provinces, counties, townships, and village government authorities without iron-clad constitutional guarantees and applying these rights arbitrarily (or as some prefer to call it, "pragmatically," i.e., according to the autocratic government's perception of what is expedient) will distort the rationalization process. Decentralization in this situation takes on the attributes of an administrative adjustment and threatens long-term prospects of market reform.

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