

Deconstructing Decentralization in China: fiscal incentive versus local autonomy in policy implementation

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This article examines the congruent and conflicting effects of fiscal decentralization and power devolution—two main types of decentralization in post-reform China—in order to tackle the insufficient distinction between them in current academic analyses. Derived from the two types of decentralization respectively are fiscal incentive and local autonomy, which influence local states' policy implementation in turnover taxation. By uncovering the unique logic of either factor, this article argues that contrary to what is widely presupposed, local autonomy is not necessarily congruent with fiscal incentive in affecting local compliance with centrally imposed policy rules during policy implementation. When power devolution and fiscal decentralization follow an internally consistent logic of decentralization as a whole by proceeding at the same pace and favoring the same specific locality, they inevitably generate conflicting effects on local states' implementation strategies. Congruent effects arise only if incoherent evolution occurs between the two types of decentralization. This paradox highlights the contradiction inveterate in the dynamics of decentralization. This argument is first developed through theoretical reasoning, and then substantiated by an empirical comparison between Guangzhou and Shanghai during 1984–1988 and 1992–1995.

I. Introduction

The decentralization of resources and authority within the state hierarchy is a heavily researched and debated subject in China's central-local relations during the reform era. Relevant works, regardless of the variations among competing arguments and research strategies, have all made a conscious distinction between at least two types of decentralization among diverse levels of governments: fiscal decentralization and power devolution in government administration and economic management.¹ As widely conceived, either type of decentralization moves along

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1. For an explicit treatment of both the fiscal and power dimensions as parts of a broad, comprehensive concept of decentralization at the same time, see Jae Ho Chung, 'Studies of central-provincial relations in the People's Republic China: a mid-term appraisal', *China Quarterly* 142, (1995), pp. 497–501; Dorothy J. Solinger, 'Despite decentralization: disadvantages, dependence, and ongoing central power in the inland-the case of Wuhan', *China Quarterly* 145, (1996), p. 1; Shaun Breslin, *China in the 1980s: Centre-Province Relations in a Reforming Socialist State* (London: McMillan Press, 1996); and Zhao Suisheng, 'China's central-local relationship: a

according to its own dynamic quite independently of each other. In addition, power devolution had, well before the post-Mao reform, occurred at intervals since 1957,² while fiscal decentralization did not occur until 1979. Nevertheless, the two types are regarded as homogeneous in terms of both their evolving direction and effect; both types of decentralization move forward to augment localities' capabilities vis-à-vis the Center, and both types are posited to be instrumental for fostering local innovation and spontaneity to spearhead market-oriented economic reform. Such a dual homogeneity, derived from the evolutionary path of China's central-local relations throughout the 1980s,³ has remained largely unchallenged among scholars.

A bifurcation in practice between the two types, however, arose in the 1990s, marking a trajectory quite different from the seemingly unidirectional course in the 1980s and casting into doubt the validity of the dual homogeneity presumption. On the one hand, local states continue to acquire growing decision-making powers during successive rounds of reform initiatives, such as the 1992 package in the wake of the Fourteenth Party Congress and the simultaneous restructuring in 1994 of the foreign trade and banking systems.⁴ On the other hand, *recentralization* has taken place in the fiscal area. The central state has been taking decisive actions to capture a greater share of fiscal revenues—a key economic resource—at the cost of local states' fiscal claims, as demonstrated by the 1994 Tax-Assignment (*fen-shuizhi*, hereafter FSZ) Reform.⁵ That is, decentralization is now reversed in the fiscal realm, yet remains in motion along the power dimension.

To be sure, such a bifurcation defies only half of the dual homogeneity—evolution in the same direction—but suggests little, if anything, about the other half—the similar effects of the two types of decentralization. This article addresses the latter issue as the foremost research goal, by focusing on the following question: to what extent do fiscal decentralization and power devolution generate congruent or conflicting effects upon local states in the process of carrying out centrally formulated policies that manifest reform initiatives? To answer the

Footnote 1 continued

historical perspective', in Jia Hao and Lin Zhimin, eds, *Changing Central-Local Relations in China: Reform and State Capacity* (Boulder: Westview Press, 1994). Likewise, most publications exclusively exploring either the fiscal or the power dimension reveal a conscious recognition of either one as part of a larger picture.

2. For the history of China's decentralization since 1949 of administrative and economic powers as well as the rationales for each round, see Zhao Suisheng, 'China's central-local relationship'; and Jae Ho Chung, *The Politics of Policy Implementation in Post-Mao China: Central Control and Provincial Autonomy under Decentralization* (Ph.D. dissertation, University of Michigan, Ann Arbor: University of Michigan Microfilms International, 1993), pp. 5–18.

3. See, for instance, Breslin, *China in the 1980s*, pp. 50–51; Huang Yasheng, *Inflation and Investment Controls in China: the Political Economy of Central-Local Relations during the Reform Era* (New York: Cambridge University Press, 1996), pp. 1–4; and Jae Ho Chung, 'Studies of central-provincial relations', pp. 488–489. An exception to the steadfast trend of decentralization was the post-Tiananmen recentralization backlash, which proved ephemeral both in time and in actual impact. Though the Center adopted retrenchment measures to tackle economic overheating at different times in the 1980s (e.g. in 1985 and from 1988 to 1989), such deflationary macroeconomic policies are not to be confused with political recentralization in terms of power and authority.

4. Unlike what happened during the post-Tiananmen retrenchment phase, the Center's deflationary economic management since 1993 has not concurrently rolled back the devolution of power to local states, as revealed by the 1994 restructuring initiatives.

5. Jae Ho Chung, 'Beijing confronting the provinces: the 1994 tax-sharing reform and its implications for central-provincial relations in China', *China Information* 9, (1994/1995), pp. 1–23.

question, this article is organized into five sections. Following this introductory section, Section II discusses the implications of policy implementation for China's central-local relations, thereby laying a foundation for probing the particular factors in Section III. Section III introduces two core concepts by deconstructing decentralization in China. They are local states' 'fiscal incentive' defined by 'marginal propensity' of tax collection which stems from fiscal decentralization, and 'local autonomy' which results from power devolution. The emphasis on marginal propensity is intended to remedy the long-standing misconception, as will be shown afterwards, of the analytic consequence of fiscal decentralization. Fiscal incentive and local autonomy are both crucial factors affecting local implementation of the policy of revenue extraction. A dissection of either factor's unique logic regarding how to influence local implementation in such a policy area derives the hypothesized effect of each. Then their hypothesized effects in this policy area are linked with the varying fiscal incentive and local autonomy across Guangzhou and Shanghai, two industrial as well as commercial hubs in coastal China. This linkage unveils that contrary to what is widely presupposed, local autonomy is not necessarily congruent with fiscal incentive in affecting local compliance with centrally imposed policy rules during policy implementation. In fact, when power devolution and fiscal decentralization follow an internally consistent logic of decentralization as a whole by proceeding at the same pace and favoring the same specific locality, they inevitably generate conflicting causal effects on local states' tax policy implementation strategies. Congruent effects arise only if incoherent evolution occurs between the two distinct types of decentralization. Such an argument emanating from theoretical reasoning constitutes the first and foremost theme of this article.

Then, Section IV tests the hypothesized effects and the predicted pattern from the theoretical reasoning above by comparing, again, between Guangzhou and Shanghai, the different local implementation strategies in the policy area of turnover taxation (*liuzhuan shui*) on state-owned enterprises (SOEs) during 1984–1988 and 1992–1995.⁶ The testing through the comparative analysis makes up the second theme, which plays an auxiliary role by corroborating the argument in the first theme. The testing does not seek particularly to offer a better explanation of policy implementation, or to highlight specific local non-compliance in revenue extraction⁷ in China. Rather, policy implementation serves as a vehicle by which to look into whether or not fiscal incentive and local autonomy exert congruent impacts; whether these two factors are the most pertinent variables to account for policy implementation in contemporary China is not a main concern of this article. Finally, Section V concludes the article by summarizing the findings from the conceptual anatomy and comparative scrutiny, and by suggesting a number of

6. The period of 1989–1991 is not covered because it marked an ephemeral rollback of market reform and of decentralization, and thus does not reflect well how the dynamics of decentralization shaped local states' behavior. The period after 1995 is not covered, mainly because for that period although documents on central-local relations along the fiscal and power dimensions abound (but the basic patterns on the two dimensions are the same before and after 1995 with respect to the two localities studies here), no data from field research—the most crucial source of local states' actual behavior in policy implementation—are available.

7. One of the most discussed behaviors characterizing local non-compliance in revenue extraction is *tanpai*, which will be addressed in the next section.

implications for China's contemporary central-local relations in general and within the fiscal realm in particular.

II. Policy implementation of turnover taxation on SOEs

Turnover taxes in China since 1950 correspond to the taxes on goods and services such as sales tax adopted in market economies.⁸ They are, as in market economies, indirect taxes in the sense that these costs are paid for eventually by purchasers or consumers of the goods or services. The turnover tax proceeds remitted by SOEs to the state in China have consistently made the largest contribution to budgetary revenue in China's reform era (see Table 1), making local implementation of this policy a critical issue for understanding central-local interaction.

Implementing the policy of turnover taxation involves the myriad tasks of collecting such tax payments from SOEs. One of the most salient facets of the collection is the well-known practice by local states in China of deflecting the budgetary revenue of tax payments which would be transmitted upward ultimately to the Center. Local states deflect the revenue delivery by allowing enterprises to retain some portion of what should have been remitted as tax revenues, a practice widely recognized inside and outside of China. On the other hand, this phenomenon is documented predominantly with nothing more than anecdotal evidence, lacking formalized and systematic anatomy and thus adequate analytic implication for China's central-local fiscal relations.

When a local government does not collect tax remittance in full from SOEs, one would expect that both the local and the central coffers would shoulder the 'lost' revenue. This is because the locality shares upward its total revenue collections ultimately with the Center (before FSZ), or shares with the Center a preset percentage of collections in that particular category of tax (after FSZ). Yet in reality local states may not suffer any monetary loss in the end, since they are usually capable of tapping SOEs' retained funds—a major component of extrabudgetary revenues (EBRs)⁹—by imposing on the enterprises *ad hoc* or extralegal levies at will. This is a pervasive practice known as apportionment (*tanpai*) by state actors.¹⁰

8. Taxes on goods and services are a category officially labeled in the OECD's classification of taxes in countries worldwide. See Yang Xiuqin, *Guojia Shuishou [State Taxation]* (Beijing: Zhongguo Renmin Daxue Chubanshe, 1995), p. 92.

9. For a detailed discussion of EBR's makeup and vital role in local states' pursuit of economic growth, see Jean Oi, 'Fiscal reform and the economic foundations of local state corporatism in China', *World Politics* 45, (1992), pp. 99–126; and Le-Yin Zhang, 'Chinese central-local fiscal relationships, budgetary decline and the impact of the 1994 fiscal reform: an evaluation', *The China Quarterly* 157, (1999), pp. 122–124.

10. The demands for *tanpai* can be made through widely circulated documents in a locality, or enterprise-specific written notices, or simply via oral communication. Generally speaking, the higher the amount of contribution (in monetary or other forms, such as their products or construction materials) from the enterprises, the more likely it is that documentary notices are issued. A survey performed in 1992, for instance, divulged that in the nation's 22 major industrial cities, 62% of managers of state-owned enterprises acknowledged that their firms had met at least one local state (both party and government) agencies' demand for *tanpai*. See Donald Hay *et al.*, *Economic Reform and State-Owned Enterprises in China: 1979–1987* (Oxford: Clarendon Press, 1994), p. 106. Outside China, a World Bank report estimates that during the 1980s the burden of *tanpai* could eat away as much as 10–15% of enterprises' post-tax profits, the principal source of EBR. See World Bank, *China: Macroeconomic Stability and Industrial Growth under Decentralized Socialism* (Washington, DC: World Bank, 1990), p. 71.

Table 1. The significance of turnover tax revenues in China's national budgetary revenue, 1979–1999 (in 100 million yuan)

Year	National budgetary revenue (NBR)	Total turnover tax revenue (TTR) ^a	TTR as percentage of NBR	Product Tax ^b	Value-Added Tax	Business Tax	Consumption Tax ^c
1979	1,146.38	N.A.	N.A.	N.A.	N.A.	N.A.	
1980	1,159.93	N.A.	N.A.	N.A.	N.A.	N.A.	
1981	1,175.79	N.A.	N.A.	N.A.	N.A.	N.A.	
1982	1,212.33	N.A.	N.A.	N.A.	N.A.	N.A.	
1983	1,366.95	N.A.	N.A.	N.A.	N.A.	N.A.	
1984	1,642.86	N.A.	N.A.	N.A.	N.A.	N.A.	
1985	2,004.82	953.37	47.55	594.6	147.7	211.07	
1986	2,122.01	1,039.85	49.00	546.59	232.19	261.07	
1987	2,199.35	1,089.46	49.54	533.26	254.2	302	
1988	2,357.24	1,263.22	53.59	480.93	384.37	397.92	
1989	2,664.9	1,448.41	54.35	530.28	430.83	487.3	
1990	2,937.1	1,496.68	50.96	580.93	400	515.75	
1991	3,149.48	1,599.77	50.79	629.41	406.36	564	
1992	3,483.37	2,057.85	59.08	693.25	705.93	658.67	
1993	4,348.95	2,868.99	65.97	821.42	1,081.48	966.09	
1994	5,218.1	3,465.76	66.42		2,308.34	670.02	487.40
1995	6,242.2	4,009.37	64.23		2,602.33	865.56	541.48
1996	7,407.99	4,635.61	62.58		2,962.81	1,052.57	620.23
1997	8,651.14	5,286.99	61.11		3,283.92	1,324.47	678.60
1998	9,875.95	6,018.47	60.94		3,628.46	1,575.08	814.93
1999	11,444.08	6,371.09	55.67		3,881.87	1,668.56	820.66

Source: State Statistical Bureau, *Zhongguo Tongji Nianjian 1999* [*China Statistical Yearbook 1999*] (Beijing: Zhongguo Tongji Chubenshe, 2000).

Notes:

^aBefore the LGS restructuring in 1984, China's turnover taxes from SOEs had been in the form of the Industrial and Commercial Tax.

^bAfter the LGS reform in 1984, the Product Tax was applied from 1985 to 1993, right before the FSZ reform abolished Product Tax.

^cThe Consumption Tax started to apply to SOE in 1994.

Therefore, when local states implement tax policy in ways that leave more funds with SOEs as EBRs which would otherwise be remitted as budgetary revenue, the actual consequence is slashed budgetary revenues for the Center yet an expanded pool of local EBRs to finance local spending.

Against this backdrop, examining local implementation of the turnover tax policy breeds at least the following three implications for China's central-local relations, which constitute a secondary contribution intended by this article. First, apart from the central-local fiscal regimes that distribute fiscal revenues within the state hierarchy,¹¹ attention ought to be paid also to revenue extraction from the economy

11. For the studies where the fiscal regime is a main theme, see Le-Yin Zhang, 'Chinese central-provincial fiscal relationship'; Christine P. W. Wong, *Financing Local Government in the People's Republic of China* (Hong Kong: Oxford University Press, 1997); Donald J. S. Brean, *Taxation in Modern China* (New York: Routledge, 1998);

by state actor in the first place. Second, as local states are able to affect the process of such extraction, it is necessary to attach no less analytic significance to such a stage of 'rule-applying' than to the stage of 'rule-making' marked by the installation of fiscal regimes. The dynamic interaction between players, in terms of how they follow or manipulate the rules, is perhaps more crucial than the static framework established by the rules in determining the actual outcome of central-local policy game. This explains the rapidly growing attention paid, especially in the 1990s, to policy implementation in China.¹² Based on a bottom-up and dynamic view, inquiries along this line open up an alternative avenue to the top-down and static perspective characterizing most works on China's policy formulation and decision making.

Third, the increasingly popular view of China's central-local relations as non-zero-sum needs to be further clarified as well as qualified. A typical effort recently to advance this perspective based on evidence of local conditions is made by Linda Chelan Li. Li's argument rests on the discovery of an interactive central-provincial relationship, where the Center and provinces act as institutional constraints on one another.¹³ Notably, this finding is derived from an empirical analysis of local implementation of investment policy, an area marked by frequent non-zero-sum interplay. To assess the theoretical significance of the non-zero-sum view, one has to consider Jae Ho Chung's well-balanced statement that whereas central imposition and local discretion do not necessarily grow at each other's expense, their interaction displays an issue-variant feature. That is, the condition of central-provincial relative power in any particular issue area is causally independent of those in the others.¹⁴ Therefore, to regard central-local dynamics indiscriminately as non-zero-sum across all issue areas is just as oversimplified as to regard them the

Footnote 11 continued

Christine P. W. Wong, Christopher Heady and Wing T. Woo, *Fiscal Management and Economic Reform in the People's Republic of China* (Hong Kong: Oxford University Press, 1995); Christine P. W. Wong, 'Central-local relations in an era of fiscal decline—the paradox of fiscal decentralization in post-Mao China', *The China Quarterly* 128, (1991), pp. 691–714; Oi, 'Fiscal reform and the economic foundations of local state corporatism in China'; Michel Oksenberg and James Tong, 'The evolution of central-provincial fiscal relations in China, 1971–1984: the formal system', *China Quarterly* 125, (1991), pp. 1–32; Hu Angang and Wang Shaoguang, *Zhongguo Guojia Nengli Baogao [China: A Report of the State Capacity]* (Shenyang: Liaoning Renmin Chubanshe, 1993); Wang Shaoguang, 'Central-local fiscal politics in China', in Jia Hao and Lin Zhimin, eds, *Changing Central-Local Relations*; World Bank, *China: Revenue Mobilization and Tax Policy* (Washington, DC: World Bank, 1990); and Jae Ho Chung, 'Beijing confronting the provinces'.

12. See, for example, David M. Lampton, *Policy Implementation in Post-Mao China* (Berkeley: University of California Press, 1987); Yang Xiaohui, *Shengji Zhengfu de Zizhu Xingwei: Kaifang Gaige Shiqi de Guangdong Zhengfu [Autonomous Behaviors of the Provincial Government: the Guangdong Government during the Period of Reform and Opening]* (M.A. thesis, Department of Politics and Public Administration, Chinese University of Hong Kong, 1990); Huang Yasheng, *Inflation and Investment Controls in China*; Ma Jun, *Intergovernmental Relations and Economic Management in China* (New York: St. Martin's Press, 1997); Linda Chelan Li, *Centre and Provinces: China 1978–1993: Power as Non-Zero Sum* (Oxford: Clarendon Press, 1998), chs 3–6; Peter Tsan-yin Cheung, 'Introduction: provincial leadership and economic reform in post-Mao China', and Jae Ho Chung, 'Appendix: study of provincial politics and development in the post-Mao reform era: issues, approaches, and sources', in Peter Tsan-yin Cheung, Jae Ho Chung and Lin Zhimin, eds, *Provincial Strategies of Economic Reform in Post-Mao China: Leadership, Politics, and Implementation* (Armonk, NY: M. E. Sharpe, 1998); and Jae Ho Chung, *Central Control and Local Discretion in China: Leadership and Implementation during Post-Mao Decollectivization* (New York: Oxford University Press, 2000).

13. Li, *Centre and Provinces*.

14. Jae Ho Chung, 'Studies of central-provincial relations', pp. 504–507.

other way around. In this connection, the policy implementation examined here, due to the local EBR claim on what should otherwise have been the Center's revenue, is a typical zero-sum issue.

III. Fiscal incentive and local autonomy in tax policy implementation

Fiscal incentive of local states

The elaboration above leads us to a dissection of the distinct effects of fiscal incentive and local autonomy on local states' behavior. Fiscal decentralization (and recentralization) is designed to induce localities to cope with fiscal and economic affairs in ways propitious to market-oriented reform. As a result, fiscal decentralization structures their incentives, and shapes the central-local distribution of fiscal resources among various regions as well as levels of government into diverse patterns. In probing such effects, the existing literature depends uniformly on a comparison among the local retention (or remission) rates of the *overall* local collections of budgetary revenues (*yusuannei shouru zonghe*) or the baseline figure (*shouru jishu*) under different revenue-sharing formulas.

Nevertheless, this article argues that to understand the formulas' impact on local behavior of collection, it is *not* the sharing rate of overall revenue or baseline figure, but that of localities' *marginal* revenues that determines local governments' incentive to collect tax payments from enterprises. Analysts often start with the realization that fiscal decentralization was in the first place meant to induce local economic development and tax collection efforts. What follows is an intuitive inference that the more revenue a locality preserves for itself *on the whole*, the more induced it will be.¹⁵ Yet this intuition overlooks the fact that such efficacy of fiscal decentralization as a policy tool distinct from the others ought to be measured against the relevant *changes* it brought about. Simply, it was the *growth* in local output and revenues, among other things, which was expected of fiscal decentralization. Any effect was by definition unveiled by a comparison with the status quo.

From any given year to the next, accordingly, fiscal decentralization influenced local budgetary revenue in terms of its *aggrandizement* rather than its *total amount*. The former was determined largely by two crucial factors—the drive for growth innate to the economy and local tax efforts. Taking fiscal contracting during the

15. This view is explicitly or implicitly held by, with only one exception, *all* of the presently existing literature in English and Chinese on China's central-local fiscal relations, whenever trying to explain local economic development or tax efforts. The exception is Gabriella Montinola, Yingyi Qian and Barry R. Weingast, 'Federalism, Chinese style', *World Politics* 48, (1995), p. 64. Yet that work offers no more than a sketchy delineation of the role of marginal remittance rate in inducing local effort for economic development only, without touching on revenue mobilization at all or providing any theoretical reasoning and empirical evidence. In addition, just like all the other analyses available to this author, that work falls short of *comparing* how varying sharing rates are correlated with local efforts. More importantly, in all those works that examine in some way the role of overall revenue sharing rate, the focus is predominantly local economic development. Local revenue effort is seen just *as a side point along the same logic*. Whereas the overall sharing rate may affect local development through availability of financial resources, it is far less relevant than the sharing rate of marginal revenues to revenue efforts. It is likely, therefore, that these works suffer the problem of confusing the two different phenomena to be explained—the local economic development on the one hand, which is an objective condition in reality, and local governments' tax behavior on the other, which reflects to a much greater degree the subjective willingness and incentives held by local cadres.

1980s as an example, fiscal decentralization took into account the first factor by setting a growth parameter in terms of a percentage or absolute amount for benchmark or remitted revenue.¹⁶ The first factor then affected the second by shaping local governments' expectations that they would reap a greater share in the increased revenue collections than in those of the benchmark or total revenue. As this example shows, only when fiscal decentralization yielded a higher rate of return to the local treasury from such marginal revenues than from benchmark or total revenue, would local governments be motivated to step up their collection efforts toward the marginal revenues. By doing so, local governments were then able to achieve overall revenue growth in addition to what stemmed from economic drive.

This analysis of local state's marginal propensity of tax collection is in fact based on the same logic of those applying the 'marginal' notion in economics to the consumption and investment behaviors of individuals and organizations. There seems no reason to expect China's local state to be an exception to this economic rule in the reform era, though the literature on contemporary China's central-local fiscal relations has not come to grips with this rule whenever local tax efforts are under scrutiny. According to this analysis, how much a locality could claim in benchmark or total revenue did not influence its tax efforts. This was because even if the locality did not intensify collection efforts and had a zero revenue growth in a given year,¹⁷ it lost nothing in terms of retained revenue compared to the previous year, whether measured as a percentage or absolute amount. It can be thus inferred that a locality had a stronger incentive to collect revenues than another locality simply because the former was entitled to a higher retention rate of marginal revenues—regardless of a higher or lower retention rate of benchmark or total revenue—than the latter.

Thus we can now conceptualize fiscal incentive as the extent to which local governments are induced to collect budgetary revenues, measured by the retention rate of marginal revenues under fiscal decentralization. Fiscal incentive defined as such is equivalent to the marginal propensity of tax collection. The higher the retention rate of marginal revenues a locality is entitled to, the greater share it expects to retain from each additional unit of budgetary revenue collected locally, and thus the stronger the fiscal incentive as well as the greater marginal propensity the local state will have in tax collection.¹⁸ This by definition means a smaller likelihood that the local state will divert the revenue delivery by withholding its tax effort. The reasoning above generates the following hypothesis regarding fiscal incentive, a hypothesis this article will test through a comparison between Guangzhou and Shanghai:

16. This factor of 'natural' economic growth was the chief rationale for progressive remittance quotas applied in fiscal contracting to the richer provinces until 1993. Normally, the more prosperous a province, the higher its progressive parameter.

17. This was based on the strong assumption that the total revenue did not increase even by virtue of a thriving local economy.

18. Note that a locality's retention rate of marginal revenues dictates the localities' 'incentive' of tax-collecting behavior, as a *result*, instead of a direct *measure*, of fiscal decentralization. That is, the concept of such a retention rate is not to be understood in this article as a yardstick to compare among localities the varying degrees of fiscal decentralization *per se*.

Hypothesis one (H1): The stronger the fiscal incentive that a local state has to collect marginal revenues from the economy because of fiscal decentralization, the less likely that the local state will implement turnover tax policy in ways that deflect revenue delivery to the Center.

But how is the strength of a particular locality's fiscal incentive determined in relation to the multitude of parameters composing fiscal regimes? An illustration of the conditions in Guangzhou and Shanghai is helpful. During various periods the fiscal incentive of Guangzhou was determined by the retention rates for marginal revenues specified in the regime governing Guangzhou's fiscal remission upward. That regime, in turn, has always been shaped on the basis of the fiscal scheme between Guangdong and the Center. From 1982 to 1984, Guangzhou was entitled to 32% and had to remit 68% of the baseline figure (*jishu*) of revenue under the corresponding revenue-sharing arrangement. And Guangzhou retained 50% of the actual revenue collections in excess of the benchmark figure.¹⁹

This case serves to clarify the aforementioned impact of the sharing rates of marginal revenues. Whether this retention rate of 32% was more favorable than other comparable localities did not affect the level of Guangzhou's tax efforts. This was because once the remission rate, amount for the benchmark revenue, and annual progressive rate were set, there was a predictable amount of remittance target predetermined by these parameters. This target had to be fulfilled by Guangzhou anyway, *no matter how much input the city government was willing to deploy in collecting revenues.*²⁰ If the remission rate for benchmark revenue had been higher or lower than 68%, the differential would have only meant an increased or decreased remittance target for Guangzhou to meet. For the local tax collectors to capture the marginal revenues that could not be grabbed if the collectors stopped at the point where the remittance target was met, additional impetus must be created *uniquely* with respect to the marginal revenues. The greater the portion that Guangzhou could retain out of the marginal revenues, the more the local officials were willing to collect. This was true even though the remission rate of the benchmark revenue had been as high as 90% or as low as 10%, and, accordingly, the remission rate of total budgetary revenue had been much higher or lower than it actually was. Therefore, the binding rate of revenue retention dictating Guangzhou's incentive of tax collection during this period was 50%, the retention rate on its marginal revenue.

During the several rounds of adjustment in central-provincial fiscal regimes after 1984 that changed Guangdong's sharing rates with the Center, Guangzhou's retention rates for marginal revenues were revised accordingly. From 1985 to 1987, the city's revenue-sharing formula with Guangdong was 'delimiting the baseline figure of budgetary revenue, fixed remittance target, and sharing the increased revenue' (*heding jishu, dinge shangjiao, zengshou fencheng*). The marginal revenue

19. Guangzhou Jingji Nianjian Bianji Weiyuanhui [Editorial Committee of Guangzhou Economic Yearbook], *Guangzhou Jingji Nianjian* [Guangzhou Economic Yearbook] (Guangzhou: Guangzhou nianjian chubanshe, 1983), p. 333.

20. As a rule, the remittance targets for all localities under fiscal contracting were predetermined by considering, among other things, that they would not overstrain local collecting capacity. For instance, the targets were set according to reasonably estimated growth rates of local economies.

was thus the increased revenue in the formula, which referred to the amount in excess of the baseline figure. Guangzhou still retained 50% of the marginal revenue.²¹ This marginal retention rate was then raised to 100% from 1988 to 1993. Each year Guangzhou remitted to the province a baseline amount of 1.834 billion *yuan*, plus an annual progressive amount of 60 million *yuan*.²² Yet since the progressive amount remained unchanged no matter how much the annual increased revenue was, this amount had nothing to do with marginal revenue. As Guangzhou was entitled to all of the revenue in excess of the baseline plus the progressive amount of remittance upward, the retention rate for marginal revenue was 100%.

Turning to Shanghai, at the outset of reform in 1979 the municipality together with Beijing and Tianjin was left out of fiscal decentralization. The exclusion was by virtue of Shanghai's leading role among all provincial entities in providing the Center with fiscal revenues ever since the establishment of the People's Republic of China.²³ After all, the Center could not afford to let this cash cow go. From 1980 to 1984, Shanghai's fiscal regime with the Center was 'delimiting baseline amounts of both budgetary revenues and expenditures, linking budgetary expenditures with revenues, basic sharing of total revenues, and adjusting baseline amounts every year' (*dingshou dingzhi, shouzhi guagou, zonghe fencheng, yinian yiding*), the formula applied since 1976. Under this formula, a baseline figure of total budgetary revenue was first determined by referring to the previous year's actual total revenue and a forecast of the current year's growth. Then a fixed retention rate of 13% was used to multiply this figure to derive the baseline figure of local retained revenue. For the current year's total collections of budgetary revenue above the baseline figure, 70% went to the Center and 30% was left with Shanghai. The baseline figure of total budgetary revenue was reset (always upward) every year, leading Shanghai's remitted and retained revenues to change accordingly.²⁴

Ostensibly the marginal retention rate was the 30% just mentioned. In fact, however, because every year the Center set the baseline figure of budgetary revenue so high, it was literally impossible for Shanghai to accomplish any increase. Therefore, the corresponding retention rate of 30% became simply irrelevant to Shanghai's tax effort. What actually determined Shanghai's fiscal incentive in tax collection was the 13% for baseline budgetary revenues.

From 1985 to 1987 Shanghai was subject to a new fiscal regime known as *heding jishu, zonghe fencheng* (delimiting baseline amounts of total budgetary expenditures and revenue, and basic sharing of total budgetary revenue). Under this formula a retention rate of 23.54% each year applied to the actual collections of

21. Wang Zhuo and Wen Wuhan, *Guangdong Gaige Kaifang Pingshuo* [Evaluation and Delineation of Guangdong's Reform and Opening] (Guangzhou: Guangdong Renmin Chubanshe, 1992), p. 63.

22. *Guangzhou Jingji Nianjian* [Guangzhou Economic Yearbook] (Guangzhou: Guangzhou Nianjian Chubanshe, 1989), p. 354.

23. Lin Zhimin, 'Reform and Shanghai: changing central-local fiscal relations', in Jia Hao and Lin Zhimin, eds, *Changing Central-Local Relations in China*, pp. 239, 244; Lin Zhimin, 'Shanghai's big turnaround since 1985: leadership, reform strategy, and resource mobilization', in Tsan-yin Cheung et al., eds, *Provincial Strategies of Economic Reform in Post-Mao China*, pp. 51–53.

24. Shanghai Academy of Social Sciences, *Shanghai Jingji Nianjian 1982* [Shanghai Economic Yearbook 1982] (Shanghai: Shanghai Jingji Nianjian Chubanshe, 1983), pp. 738–739; *Shanghai Jingji 1949–1982 Neibubao* [Shanghai's Economy 1949–1982, internally circulated edition] (Shanghai: Shanghai Shehui Kexueyuan Chubanshe, 1984), pp. 891–892.

total budgetary revenue, including both the baseline amount and the increased portion.²⁵ Thus this rate of 23.54% was the retention rate for both the overall and the marginal revenues.²⁶ The State Council's Central Document No. 27, issued in February 1988, bestowed Shanghai a new fiscal regime intended for five years (which was afterwards extended for an additional year). The new formula was 'delimiting the baseline figure of budgetary revenues, fixed remittance target, and sharing the increased revenues' (*heding jishu, dingde shangjiao, zengshou fencheng*), exactly the same as that for Guangzhou from 1985 to 1987. From 1988 to 1990, Shanghai only had to remit a fixed amount of 10.5 billion *yuan* each year, while keeping all the marginal revenues above the baseline figure of 16.5 billion *yuan*. This led the municipality's marginal retention rate to be 100%. From 1991 to 1992 (actually extended to 1993), Shanghai would still turn in the same fixed remittance, but retain only 50% of the marginal revenues above the baseline figure.²⁷

What about the fiscal incentives of the two localities after 1994? The FSZ Reform of 1994 unified across all provinces the fiscal incentive to collect taxes, by abolishing disparate revenue-sharing arrangements and replacing them with nationally universal rules on the sharing ratio of each category of revenue. For instance, for the three major categories of turnover taxes—Valued-Added Tax, Business Tax, and Consumption Tax—the first is shared between the Center and any province in a 0.75:0.25 ratio, the second is claimed entirely by provinces, and the last accrues totally to the Center.²⁸ All provinces are subject to the same formula above regarding the marginal revenue from any of the tax categories. The only interregional difference in fiscal relations with the Center is the amount of the Center's fiscal refunds of tax (*shuishou fanhuan*) to localities, based on their budgetary revenues from Value-Added Tax and Consumption Tax in 1993 and 1994 adjusted with a given weight.²⁹ Such refunds are by definition determined at fixed levels at the beginning of 1994 and 1995, however, and thus do not cause marginal propensity to collect revenues to vary across local governments. Needless to say, this is true of Guangzhou and Shanghai.

The foregoing elaboration on Guangzhou's and Shanghai's retention rates for marginal revenue during various periods entails the following hypothesized effects of fiscal incentive on their implementation of tax policy, as summarized in Table 2. This expected result of H1 will be tested afterwards by comparing the two localities.

25. Shanghai Academy of Social Sciences, *Shanghai Jingji Nianjian 1988* [*Shanghai Economic Yearbook 1988*] (Shanghai: Shanghai Jingji Nianjian Chubanshe, 1989), p. 477; *Shanghai Jingji 1983–1985 Neibuban* [*Shanghai's Economy 1983–1985*, internally circulated edition] (Shanghai: Shanghai Shehui Kexueyuan Chubanshe, 1986), p. 31.

26. Note that the overall revenue as a parameter of fiscal regime is relevant only under the formula of *zongde fencheng*, and that in such a formula the retention rates for overall revenue and for marginal revenue are by definition identical.

27. *Shanghai Jingji Nianjian 1988*, p. 477.

28. Dubravko Mihaljek, 'The new revenue-sharing arrangement in China: an illustrative example', in Ehtisham Ahmad, ed., *Financing Decentralized Expenditure: An International Comparison of Grants* (Cheltenham, UK: Edward Elgar, 1997), p. 337.

29. For the detailed equation and explanation of how the tax refund is determined, see *Zhongguo Caizheng Nianjian 1995* [*Fiscal Yearbook of China 1995*] (Beijing: Zhongguo Caizheng Zazhi Chubanshe, 1996), p. 563.

Table 2. Hypothesized effects of fiscal incentive (HI) on policy implementation in Guangzhou and Shanghai

	Locality	1984	1985	1986	1987	1988	1992	1993	1994	1995
Retention rate of marginal revenue	Gz.	50%	50%	50%	50%	100%	100%	100%	depends*	depends*
	Sh.	13%	23.54%	23.54%	23.54%	100%	50%	50%	depends*	depends*
Fiscal incentive to collect taxes	Gz.	stronger	stronger	stronger	stronger	same	stronger	stronger	same	same
	Sh.	weaker	weaker	weaker	weaker	same	weaker	weaker	same	same
Likelihood to deflect revenue	Gz.	less	less	less	less	same	less	less	same	same
	Sh.	more	more	more	more	same	more	more	same	same
delivery										

Note: *The retention rate of marginal revenue in 1994 and 1995 depends on the category of turnover tax, but is always uniform across localities. For instance, the retention rate is 25% for Value-Added Tax, 100% for Business Tax, and 0% for Consumption Tax, for both Guangzhou and Shanghai after 1994.

Local autonomy

Power devolution as a specific type of decentralization in China's state hierarchy has revolved around the formal aspect of decision-making powers, either in the executive or legislative spheres, during various rounds since 1957. Yet the devolution engenders broader consequence for the autonomy of local states beyond the formal aspect in the reform era. Local autonomy due to power devolution since 1979 has been widely conceived in terms of the leeway for local states' discretion in choosing whether and how to conform to centrally imposed policy preferences, where such discretion may or may not correspond to their formal authority as permitted by the Center.³⁰ Following this conception, local autonomy in this article refers to the capacity of local states to identify and choose from a particular range of feasible actions in implementation, as a result of power devolution in the state hierarchy. Accordingly, the magnitude of such capacity is positively correlated with the breadth of this range of actions, vis-à-vis the constraints on the range imposed by centrally crafted policy rules. The breadth of range, moreover, is determined by both the local states' formal decision-making powers delegated ultimately by the Center in specific policy areas, and their overall latitude allowed for by the Center in a non-formal fashion to exercise discretion on the degree of complying with policy rules in general.³¹

In the implementation of tax policy characterized by central-local zero-sum competition over budgetary revenues, one can infer that the greater local autonomy shown by formal powers or non-formal latitude to exercise discretion, the more likely that local states divert revenue delivery by running against tax policy rules. Thus the hypothesis on local autonomy is derived as follows:

Hypothesis two (H2): The greater local autonomy a local state is granted due to power devolution, the more likely local implementation will depart from centrally installed

30. This line of conceptualization underlies most, if not all, of the studies probing issues of local compliance with centrally framed policies. See, for instance, Yang Xiaohui, *Shengji Zhengfu de Zizhu Xingwei*; Huang Yasheng, *Inflation and Investment Controls in China*; Jae Ho Chung, *Central Control and Local Discretion in China*.

31. This characterization of local autonomy is premised on a quite significant correlation between localities' formal decision-making powers, or the so-called 'rule-based' autonomy, and their overall latitude through the Center's non-formal permission, or the so-called 'discretion-based' autonomy. Whereas the distinction between the rule-based and discretion-based autonomy might be a conceptually useful one, we have to consider at least two aspects of their interrelations demonstrated in the actual evolution of China's central-local relations. First, local autonomy often stems from the Center's installment of all the varying rules to devolve power to different localities, as the Center's power devolution is spelled out in official documents, a key form of centrally imposed rules. But the actual effect of local autonomy from such a source is mostly for localities to exercise their discretion, especially in policy implementation. Second, to determine the extent of local states' compliance with a particular national policy, both their rule-based power and their overall latitude allowed for discretion to exercise direct and tangible impacts. This is exhibited in, for example, the subsequent elaboration on how Guangdong's various privileges authorized through official documents can be related to Guangzhou's adaptation of tax policy regulations, and on how Guangdong's general latitude to deviate from national policies is key to understanding Guangzhou's expansion of the contracting approach to turnover taxation. Second, it is often overlooked that rule-based and discretion-based autonomy tend to be positively correlated with each other. Given the nature of power devolution in reform China, the more formal power in specific issue areas in a locality is granted through decentralization, the more likely that it will also enjoy greater leeway in general in exercising discretion. That the contrasts between Guangzhou and Shanghai in these two dimensions are positively correlated, shown in the following section, is a perfect example of this reality.

policy rules on turnover taxation, so as to deflect revenue flows from the local economy to the central state.

Thanks to Guangdong's pioneering status in receiving preferential measures from the Center during the reform era, Guangzhou had enjoyed immense local autonomy compared to the nation's other industrial hubs. The following survey of Guangdong's specific formal authority and general latitude granted by the Center will reflect in large part Guangzhou's local autonomy in policy implementation. This is mainly because the exercise of powers that were devolved to the province, especially those bearing on tax policy and SOEs, was translated directly into the discretion by the city government of Guangzhou, given the high concentration of SOEs in the city.

In terms of formal authority, one of Guangzhou's earliest specific prerogatives devolved by the Center was in the output and prices of certain products under economic plans. Central Document No. 50 in 1979 (hereafter CD [79] No. 50) and State Council Correspondence (*guowuyuan tongbao*) No. 25 in 1988 (hereafter SCC [88] No. 25) permitted Guangdong to set prices locally for an increasing number of within-plan products and to decide when and how to launch price reforms. With regard to the determination of the size of wage bill and bonuses in SOEs, CD [79] No. 50 and SCC [88] No. 25 allowed SOEs in Guangdong to bypass the restrictions regarding the size ceiling and the annual increase relative to productivity growth. Finally, in administering SOEs' remission of profits and taxes, Central Document No. 41 in 1980 (hereafter CD [80] No. 41) authorized Guangdong to keep at the local level SOEs' depreciation funds which were part of production costs, instead of having to remit them upward. In addition, Central Document No. 27 in 1981 (hereafter CD [81] No. 27) permitted local governments in Guangdong to waive taxes and reduce profit remittances for those enterprises suffering inadequate funds for capital construction.³²

What facilitated Guangzhou's autonomous implementation more than the devolution of specific powers was Guangdong's general discretion to defy national policy rules across policy areas. The province had been repeatedly encouraged by the Center through both personal and organizational channels to implement policies in unique and flexible ways, as long as such actions were aimed at unshackling planned control and conducive to the reform program. Such support came from major leaders (such as Hu Yaobang, Wan Li, Yao Yilin, and Gu Mu) during the 1980s, and was exemplified in a Central Secretariat's work conference in 1980 and in Document No. 5 issued by the CCP's Central General Office (*zhongyang bangong ting*) in 1981. The leaders publicly endorsed Guangdong's flexible implementation by suggesting the need to confront central ministries 'head-on' (*ding*).³³ To the degree that Guangdong had remained the foremost pacesetter of reform among all provinces until 1992, this legitimacy virtually constituted a

32. Wang Zhuo and Wen Wuhan, *Guangdong GaigeKkaifang Pingshuo*, pp. 393–448; Liao Bowei *et al.*, *Zhongguo Gaige Kaifang yu Zhujiang Sanjiaozhou de Jingji Fazhan* [China's Reform and Opening and the Economic Development of the Pearl River Delta] (Hong Kong: Nanyang Commercial Bank, 1992), pp. 19–81, 100–114; Peter Tsan-yin Cheung, 'The case of Guangdong in central-local relations', in Jia Hao and Lin Zhimin, eds, *Changing Central-Local Relations in China*, pp. 213–229.

33. Wang Zhuo and Wen Wuhan, *Guangdong GaigeKkaifang Pingshuo*, p. 397.

generalized form of power devolution and was a constant underlying factor accounting for Guangzhou's exceptionally strong local autonomy.

Shanghai began to benefit from power devolution from the Center much later than did Guangzhou. The metropolis was granted special economic treatment for the first time in October 1984 as one of the 14 open coastal cities (OCCs) and was then selected as a key area covered by the Center's package of coastal development strategy in 1988. Yet the economic prerogatives until 1988 solely concerned the opening to foreign trade and investment; local autonomy in administering enterprise finance or taxation was not included.³⁴ In comparison with their counterparts in Guangzhou, the SOEs in Shanghai were bound by a larger number of stringent rules on tax and profit remission, among other things. While Guangzhou made headway over years in deciding on such issues itself, Shanghai did not.

It was not until 1992 that Shanghai emerged *in an institutionalized way* as the core of the new wave in regional development and reform initiatives, thanks to the Center's *official policy* regarding Pudong, an area in Shanghai's eastern section. In the First Plenary Session of the Fourteenth Central Committee, the Pudong New Area was targeted to become the nation's foremost international trade and finance center, and was to enjoy more special privileges than any SEZ has ever had. Equally important is that all the preferential treatments for the Pudong New Area, except those for the Waigaoqiao Free Trade Zone, have been applicable to the rest of Shanghai as well.³⁵ The extension of Pudong's special policies to Shanghai as a whole adds to the local autonomy the metropolis enjoys concerning both SOEs' internal finance and their revenue delivery to the state.³⁶

The discrepancy in local autonomy between the two localities is evident from the survey above. Before 1992 Guangzhou led Shanghai in this respect, mainly on account of the Center's policy to devolve power in favor of Guangdong. Since 1992, however, Shanghai has caught up and reversed the balance by literally supplanting Guangdong as the regional center of market reform, thus necessitating greater privileges to permit local initiatives and discretion. Such a pattern, as expected by H2, is exhibited in Table 3.

Congruence and conflict between the two factors in tax policy implementation

By merging the causal logics in Tables 2 and 3, Table 4 displays the congruence and conflict between the effects of fiscal incentive and local autonomy in various years under national policy frameworks of turnover taxation. The following three patterns of the relations between the two factors in affecting local implementation emerge from Table 4, of which all are useful to test H1 and H2 in the next section.

34. Commission for Reforming the Economic System of Shanghai, *Shanghai Jingji Tizhi Gaige Shinian [Ten Years of Reforming the Economic System in Shanghai]* (Shanghai: Shanghai Renmin Chubanshe, 1989), pp. 35–47.

35. World Bank, *China: Internal Market Development and Regulation* (Washington, DC: World Bank, 1994), p. 248; Tian Gang, *Shanghai's Role in the Economic Development of China: Reform of Foreign Trade and Investment* (Westport, CT: Praeger, 1996), p. 52.

36. For a discussion of Shanghai's institutional privileges after 1992 that strengthen its local autonomy in this issue area, see J. Bruce Jacobs and Hong Lijian, 'Shanghai and the lower Yangzi Valley', in David S. G. Goodman and Gerald Segal, eds, *China Deconstructs: Politics, Trade, and Regionalism* (New York: Routledge, 1994), p. 236.

Table 3. Hypothesized effects of local autonomy (H2) on policy implementation in Guangzhou and Shanghai

	Locality	1984	1985	1986	1987	1988	1992	1993	1994	1995
Local autonomy compared to each other	Gz.	stronger	stronger	stronger	stronger	stronger	weaker	weaker	weaker	weaker
	Sh.	weaker	weaker	weaker	weaker	weaker	stronger	stronger	stronger	stronger
Likelihood to deflect revenue delivery	Gz.	more	more	more	more	more	less	less	less	less
	Sh.	less	less	less	less	less	more	more	more	more

First, from 1984 to 1987 the two factors competed with each other, leading only one of the two hypotheses to be true and the other to be false. Second, in 1992 and 1993 the two factors pointed in the same causal direction, entailing H1 and H2 to be both true or both false at the same time. Third, in three out of the nine years investigated here (1988, 1994 and 1995), fiscal incentive did not make any difference in affecting the two local states' implementation, because of the same marginal propensity of tax collection between them. This leaves H2 alone to be tested by empirical evidence. Taken together, the three patterns make up an internally consistent logic for testing H1 and H2. As Section III will show, in an inferential but not chronological sequence, the hypothesized effect of local autonomy (i.e. H2) comes to be verified first in the third pattern. Then with the effect of local autonomy being substantiated, the second pattern discloses that when this effect is congruent with that of fiscal incentive because of the localities' particular configuration on the two factors, H1 is verified. Finally, the first pattern reveals that under a different configuration the hypothesized effects of the two factors conflict with each other, and that when competing with each other local autonomy overrides fiscal incentive, falsifying H1 and lending even stronger support to H2.

Identifying these three patterns brings us to a fundamental question illuminating the first core theme in this article: what causes the three diverse patterns showing congruence or conflict between the two effects? The answer lies in the contradiction inherent in the dynamics of decentralization. The effects of fiscal incentive and local autonomy conflicted with each other in the first pattern from 1984 to 1987. During this period decentralization along both fiscal and power dimensions moved forward with the same regional priorities (of which the most salient priority was Guangdong), which helped nurture local initiatives for marketized reform. That is, when the two types of decentralization co-evolved in a coherent, synergistic manner to favor the same regions, they produced conflicting causal effects on a locality's implementation of tax policies. This intrinsic contradiction within decentralization as a whole, therefore, disproves the widely alleged homogeneity regarding similar effects of divergent types of decentralization raised in the beginning of the article.

The intrinsic contradiction disappeared only when the two types of decentralization did not progress hand in hand, as found in the second pattern during 1992–1993. Fiscal incentive and local autonomy pointed to the same causal direction, because Shanghai's fiscal regime then was still reminiscent of the 1988 arrangement, reflecting less preferential considerations than those bestowed on Guangzhou. Shanghai's local autonomy in 1992 and 1993, conversely, came to surpass that of Guangzhou incrementally, thanks to the new round of power devolution launched in 1992. Therefore, the diverging regional priorities designated by fiscal decentralization and power devolution manifested the disjointed and incoherent evolution within decentralization as a whole. Such incoherence disguised the above-mentioned contradiction during 1984–1987, which is ingrained in the logics between fiscal incentive and local autonomy. With respect to the case of 1994 and 1995 in the third pattern, the inherent contradiction between the two factors' effects was concealed as well. This was because local fiscal incentive was unified under FSZ, and thus did not cause by itself different implementation across

Table 4. Conflicting and congruent effects of fiscal incentive and local autonomy on policy implementation in Guangzhou and Shanghai

	Locality	1984	1985	1986	1987	1988	1992	1993	1994	1995
Likelihood of revenue deflection due to fiscal incentive (H1)	Gz.	less	less	less	less	same	less	less	same	same
	Sh.	more	more	more	more	same	more	more	same	same
Likelihood of revenue deflection due to local autonomy (H2)	Gz.	more	more	more	more	more	less	less	less	less
	Sh.	less	less	less	less	less	more	more	more	more

localities. Notably, the unified fiscal incentive across localities in 1994 and 1995 resulted from fiscal recentralization, striking a stark contrast with progressing power devolution at the same time. This is precisely the reality of bifurcation highlighted at the outset of the article, which also composed another type of incoherent evolution within decentralization.

Policy implementation of turnover taxation in Guangzhou and Shanghai

Turning to the second core theme in this article, some key points made earlier on collecting turnover tax payments from SOEs need to be reiterated. The policy issue here is essentially a zero-sum game between the central and local states. The more a local state collects from SOEs, the more taxes will ultimately be turned over to the Center, and the less will be left with the SOEs for the local state to tap as EBRs. In the comparison of policy implementation in Guangzhou and Shanghai below, this fact is key to understanding the local states' calculus in the first place. Guided by this calculus, from 1984 to 1995 the local states employed particular implementation strategies that helped deflect the revenue supply from SOEs to the Center. Accordingly, implementation strategies—the major dependent variable in the comparison—are conceived as the conscious choices of action made by local states to implement centrally framed policies. By making the choices, local states seek to maximize the relative gains of their own fiscal resources versus those of the central state. The varying degrees to which the two local states succeeded in revenue diversion during each particular period of time helps us test the validity of H1 and H2 through the three patterns shown in Table 4. Tables 5 and 6 demonstrate respectively the role of turnover taxes in budgetary revenue in Guangzhou and Shanghai.

Finally, the data supporting the empirical analysis in the comparison are composed of two major parts: documents and materials on the one hand, and intensive interviews on the other. The interviews were conducted in China from May to October 1995, with interviewees including local economic officials as well as managers and administrators from SOEs in both Guangzhou and Shanghai.

A brief overview of the evolving policy rules. As a legacy from the pre-reform period, China's major turnover tax on all enterprises in 1979 was the Industrial and Commercial Tax (ICT), which was installed in 1973. Increasingly unable to cope with new economic realities emanating from the marketized reform, the ICT was replaced during the second stage of the tax-for-profit (*li gai shui*, hereafter LGS) restructuring in 1984 by a new system. The new system comprised four categories of turnover taxes: the Product Tax (hereafter PT) applying to most industrial and agricultural products, the Value-Added Tax (hereafter VAT) applying to a selected pool of industrial goods, the Business Tax (hereafter BT) applying to services and trades, and the Salt Tax imposed on salt producers and distributors. The Salt Tax will not be discussed due to its minor role in raising state revenues from SOEs. For all three remaining types of turnover taxes before 1994, the revenues were first collected by local governments from those enterprises on which local governments claimed property rights, and ultimately shared upward with the Center according to specific formulas under fiscal regimes.

Table 5. The role of turnover tax revenues in total budgetary revenue in Guangzhou, 1979–1995 (in million *yuan*)

Source	Bud- getary revenue (BR)	Turn- over tax revenues (TTR)	TTR as % of BR	PT and VAT	PT and VAT as % of BR	BT	BT as % of BR
1979	1,162	N.A. ^a	N.A.				
1980	1,545	931	60.3				
1981	1,740	1,073	61.6				
1982	1,875	1,261	67.3				
1983	2,059	1,426	69.3				
1984	2,136	1,616 ^b	75.6	N.A.	N.A.	N.A.	N.A.
1985	2,932	2,321	79.2	N.A.	N.A.	N.A.	N.A.
1986	3,141	2,316	73.7	N.A.	N.A.	N.A.	N.A.
1987	3,445	2,638	76.6	2,025	58.8	612	17.8
1988	3,858	3,413	88.5	2,409	62.4	1,004	26.0
1989	4,521	3,984	88.1	2,708	59.9	1,276	28.2
1990	3,694	2,774	75.1	1,460	39.5	1,314	35.6
1991	4,163	2,937	70.5	1,509	36.2	1,428	34.3
1992	4,885	3,322	68.0	1,572	32.2	1,750	35.8
1993	7,446	5,031	67.6	2,326	31.2	2,705	36.3
1994	6,287	4,149 ^c	66.0	1,305 ^d	20.8	2,843	45.2
1995	9,268	6,185	66.7	1,545	16.7	4,639	50.1

Sources: Guangzhou Statistical Bureau, *Guangzhou Tongji Nianjian 1982–1995* [*Guangzhou Statistical Yearbook 1982–1995*] (Guangzhou: Guangdong Renmin Chubanshe); Guangzhou Jingji Nianjian Bianji Weihuanhui, *Guangzhou Jingji Nianjian 1982–1995* [*Guangzhou Economic Yearbook 1982–1995*] (Guangzhou: Guangzhou Nianjian Chubanshe).

Notes:

^aFrom 1979 to 1983, the turnover tax revenue remitted by SOEs was the Industrial and Commercial Tax (ICT).

^bFrom 1984 to 1993, the turnover tax revenues remitted by SOEs included the Value-Added Tax (VAT), the Product Tax (PT), and the Business Tax (BT).

^cFrom 1994 to 1995, the turnover tax revenues remitted by SOEs included the Value-Added Tax (VAT), the Consumption Tax (CT), and the Business Tax (BT). The VAT is shared between the Center and the locality with a 75:25 ratio, the CT is claimed totally by the Center, and the BT accrues totally to the locality.

^dIn 1994 and 1995, this column includes only the locality's share (25%) of VAT proceeds.

The 1994 FSZ reform eliminated PT and shifted some sectors from BT to VAT, expanding the scope of VAT to cover the manufacturing, processing, repairs, wholesale, retail, and imports of all industrial and agricultural products except those of real estate. The new BT after 1994 has been levied on transportation, construction, finance and insurance, postal services and communications, cultural and sports activities, entertainment, services, sales of intangible assets, and sales of real estate. In addition, the Consumption Tax was created to apply to 11 goods of which the consumption is to be discouraged or which require irreproducible natural resources. Yet this tax will not be discussed because of its limited role. As mentioned earlier, BT is completely a local tax, and VAT is a shared tax between the Center and provinces.

Table 6. The role of turnover tax revenues in total budgetary revenue in Shanghai, 1979–1995 (in million *yuan*)

Source Year	Bud- getary revenue (BR)	Turnover tax revenues (TTR)	TTR as % of BR	PT and VAT	PT and VAT as % of BR	BT	BT as % of BR
1979	17,016	N.A. ^a	N.A.				
1980	17,205	N.A.	N.A.				
1981	17,153	N.A.	N.A.				
1982	16,508	N.A.	N.A.				
1983	15,370	N.A.	N.A.				
1984	16,018	N.A. ^b	N.A.	N.A.	N.A.	N.A.	N.A.
1985	18,160	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
1986	17,593	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
1987	16,513	8,228	49.8	6,123	37.1	2,105	12.8
1988	15,354	9,715	63.3	6,809	44.3	2,906	18.9
1989	15,873	10,731	67.6	7,340	46.2	3,391	21.4
1990	16,273	12,002	73.8	8,055	49.5	3,947	24.3
1991	16,509	12,312	74.6	8,185	49.6	4,127	25.0
1992	17,885	13,368	74.7	8,689	48.6	4,679	26.2
1993	23,625	17,380	73.6	10,146	42.9	7,233	30.6
1994	17,530	11,051 ^c	63.1	4,328 ^d	24.7	6,723	38.4
1995	22,730	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.

Sources: Shanghai Statistical Bureau, *Shanghai Tongji Nianjian 1982–1995* [*Shanghai Statistical Yearbook 1982–1995*] (Shanghai: Shanghai Renmin Chubanshe); Shanghai Academy of Social Sciences, *Shanghai Jingji Nianjian 1982–1995* [*Shanghai Economic Yearbook 1982–1995*] (Shanghai: Shanghai Jingji Nianjian Chubanshe).

Notes:

^aFrom 1979 to 1983, the turnover tax revenue remitted by SOEs was the Industrial and Commercial Tax (ICT).

^bFrom 1984 to 1993, the turnover tax revenues remitted by SOEs included the Value-Added Tax (VAT), the Product Tax (PT), and the Business Tax (BT).

^cFrom 1994 to 1995, the turnover tax revenues remitted by SOEs included the Value-Added Tax (VAT), the Consumption Tax (CT), and the Business Tax (BT). The VAT is shared between the Center and the locality with a 75:25 ratio, the CT is claimed totally by the Center, and the BT accrues totally to the locality.

^dIn 1994 and 1995, this column includes only the locality's share (25%) of VAT proceeds.

Guangzhou's diversion of the revenue delivery in 1984 and 1985. Facing the framework of turnover tax policy established in the second stage of LGS reform in 1984, Guangzhou immediately departed from the related policy rules in the same year, while Shanghai refrained from defying the policy rules at all. This differential between them verified H2 but rejected H1. In 1984, all the exports produced by Guangzhou's city-owned industrial SOEs, except those products specified by the tax codes (such as oil and petroleum), were totally exempt from PT and VAT. The exemption of PT and VAT was also allowed for those commodities verified by the Guangdong Economic Commission, or the Guangdong Science and Industry Commission, or the Guangzhou Taxation Bureau (GZTB) to be newly experimented products for production and marketing. The complete exemption lasted for

two years. As a result, the total exempted PT and VAT from this measure amounted to 9.6 million *yuan*.³⁷

The nature of the tax relief was largely in accordance with the relevant policy rules. Relief on exported industrial products and new products was allowed by the tax codes on PT and VAT. However, the relief on new products was stipulated to be only a reduction, but not total exemption as the case in Guangzhou. Furthermore, what qualified commodities to be such new products was the incorporation into the Center's state plan and not any local economic plan. According to Article 13 of the Regulations on the Product Tax of the People's Republic of China, such new products listed in the state new product plan had to be experimented for the first time in the nation, and to pass central ministries' tests on originality, novelty, utility, and efficiency.³⁸ It was unclear if all the new products approved by provincial and city officials were indeed listed in the state plan. Yet it was quite likely that very few, if any, of the products met the test requirement by central ministries.³⁹ Thus the measure on new products constituted an aberration from the policy rules of PT and VAT.

In 1985 the comparative result remained supporting H2 but rejecting H1, as Guangzhou continued yet Shanghai refrained from deviating from the policy rules. The Guangzhou Fiscal Bureau (GZFB) and GZTB resumed the permission for the financially strained SOEs to repay bank loans by remitting to the creditors what should have been PT and VAT payments. This practice, though an anomaly in enterprise finance, had been pervasive in many regions in China before LGS, but was suspended in 1984 when the LGS policy rules took effect. The resumption was pronounced to be for the sake of firms' technological updating. At the same time, new products continued to waive PT and VAT completely, running against the policy rule permitting a partial reduction only. Moreover, the need for technological renovation was invoked to grant a 20% reduction in PT liability for firms producing processed food and Chinese medicine, and a 35% reduction in BT liability for firms in the printing and packaging businesses.⁴⁰ While meeting the process requirement for preceding approval by the Center, the reduction rested on a quite shaky economic justifiability. Simply, in all these four industries, technological advancement has had trivial influence on firm profitability. It thus seemed implausible that the firms were really adhering to what the tax reductions were earmarked for.⁴¹

37. Guangzhou Jingji Nianjian Bianji Weiyuanhui, *Guangzhou Jingji Nianjian 1984* [*Guangzhou Economic Yearbook 1984*] (Guangzhou: Guangzhou Nianjian Chubanshe, 1985), p. 331.

38. Tan Chu, 'Yange kongzhi xingchanpin shuishou jianmian, zhengque liyong shuishou cujan jishu fanzhan' ['To strictly control tax reduction and exemption on new products, and to correctly use taxation to promote technology development'], *Zhongguo Shuiwu* [*China's Taxation*] 94, (19xx), p. 7.

39. None of the three local firms interviewed in Guangzhou which received tax relief of this kind from 1984 to 1988 had to go through any test as such administered by centrally authorized personnel during this period. Interviews #9504-0202, #9504-0209, #9504-0212.

40. Guangzhou Institute of Fiscal Research, 'Yunyong shuishou ganggan, cujan qiye huoli' ['Using tax levers to animate enterprises'], *Guangdong Caizheng* [*Public Finance in Guangdong*], (May 1985), pp. 25–26.

41. According to financial staff of a major plant manufacturing Chinese medicines in Guangzhou, during the 1980s the plant's reduced tax liability, profit remittance and turnover taxes alike, was used most of the time as disbursement of workers' bonuses. This was particularly true in years of drastic inflation, such as 1985 and 1988. Interview #9504-0202.

Shanghai's first deviation from turnover tax codes in 1986. Shanghai waited until 1986 to take its first action of deviant implementation by expanding VAT in place of PT beyond the scope delimited by the nationally revised statutes on PT and VAT. In February 1986, the Ministry of Finance (MOF) supplanted PT with VAT on a wide variety of commodities, including most textile products, machinery of daily use, household appliances, enamels, and thermos containers. In addition, more commodities, including most light industrial products, were under consideration to be shifted to VAT in 1987.⁴² In April 1986, the Shanghai Metropolitan Taxation Bureau (SMTB) promulgated that besides those products above designated by MOF, VAT would replace PT also on apparel, glassware, leather-made products, footwear, and chemical products of daily use, for a selected group of SOEs in the local economy. These additional products Shanghai picked out were either scheduled by MOF to shift to VAT on a nation-wide basis in the second half of 1987, or still under deliberation for the changeover in subsequent years. Notably, in making such an additional expansion of VAT, Shanghai acquired antecedent approval from MOF on the grounds of Shanghai's new strategy to develop regional economic integration.⁴³

Shanghai's pre-existing strategy had rested, among other things, on lateral joint operation (*hengxiang lianxi*), introduced in 1983, which linked together enterprises in neighboring areas for coordinated demand and supply of production inputs and outputs. In 1985 this strategy even took a more accented version through the establishment of the Yangtze River Delta Open Coastal Economic Zone, which designated Shanghai as the regional center for lateral joint operation.⁴⁴ Yet the intended integration of this strategy was by far undermined by the tenacious local protectionism from neighboring areas.⁴⁵ Hence Shanghai began in 1986 to gradually shift its focus away from linking material supply and demand to establishing a new pattern of division of labor in the region. The new strategy was to foster manufacturers of the same industry in different localities to specialize in different products that targeted various consumer groups in this industry (e.g. computers of varying data-processing capacities). At the same time, interpenetration between consumer markets of Shanghai and of the neighboring areas would be nurtured.⁴⁶ This transition marked a domestic parallel to the trend in international trade moving from 'inter-industry' to 'intra-industry' production and trade, a common pattern among countries undergoing rapid economic growth and homogenizing production as well as consumption structures.⁴⁷

The economic logic of intra-industry production and trade is based on decreasing costs and increasing returns made possible by greater than average economy of

42. *Shanghai Jingji Nianjian 1985* [Shanghai Economic Yearbook 1985], p. 493.

43. Interviews #9502-0203, #9502-0207. See also Tu Jimo, 'Qiyue hengxing lianxi zaishang xintaijie' ['The lateral joint operation among enterprises steps up to a new terrain'], *Shanghai Caishui* [Public Finance and Taxation in Shanghai] 86, (March 1987), pp. 17–18.

44. Wang Yongjun, *Investment in China: A Question and Answer Guide on How to Do Business* (New York: AMACOM, 1997), p. 32.

45. Tian Gang, *Shanghai's Role in the Economic Development of China*, pp. 50–52.

46. Tu Shixi, *Zouxiang Ershiyi Shiji de Shanghai* [Shanghai on its Way to the Twenty-First Century] (Shanghai: Fudan Daxue Chubanshe, 1993), pp. 33–36; *Shanghai Jingji Nianjian 1986* [Shanghai Economic Yearbook 1986], p. 494.

47. Nigel Grimwade, *International Trade: New Patterns of Trade, Production, and Investment* (London: Routledge, 1989), pp. 15–27.

scale. Accordingly, bringing down firms' average costs while output level grows is a pivotal prerequisite for intra-industry trade, in order to secure the firms' sustainable competitive edge.⁴⁸ Propelled by such a concern, the metropolis switched to a new strategy for regional economic integration, thereby embracing the additional VAT expansion for the cost reduction. Simply, the VAT was in nature free from the cascading effect that characterized PT in China, and this effect imposed extra cost upon producers. The cascading effect denotes the double counting or the cumulative character of taxes levied on goods through the process of production. Double counting occurs when turnover taxes are charged on goods manufactured with inputs that have already been taxed. This is imputed to the fact that turnover taxes are imposed on goods and services at each stage of production and marketing normally without taking into account the taxed portion of producers' purchase of inputs.⁴⁹

Therefore, the additional VAT expansion in place of PT meant a substantially allayed tax burden for relevant SOEs in Shanghai, and facilitated their transition to intra-industry trade and production. Notably, only a selected group of SOEs whose output level exceeded the threshold of economy of scale set by SMTB qualified for the additional VAT expansion. The threshold varied among the products. Measured in the GVIO of each 100 *yuan* of fixed assets owned by enterprises, for instance, the threshold was 560 *yuan* for apparel, 150 *yuan* for glassware, 420 *yuan* for leather-made products, and 615 *yuan* for daily-use chemicals.⁵⁰ Each of these standards was higher than the average level of all SOEs in the industry in Shanghai in 1986 (540.92 *yuan*, 126.77 *yuan*, 346.98 *yuan*, and 585.12 *yuan* respectively). This pattern was consistent with the economic logic of intra-industry production that it required greater than average economy of scale. Therefore, this pattern reflected SMTB's relatively rigorous approach based on genuine economic considerations to lessening the SOEs' turnover tax remittance.

Riding on the same wave of national VAT expansion, Guangzhou also espoused in 1986 a similar measure as did Shanghai toward all the SOEs in relevant industries that did not enjoy the total exemption of turnover tax for goods used in continuous production through vertical integration. The industries covered in Guangzhou included sugar, apparel, Chinese medicines, glassware, footwear, and daily-use chemicals, differing somewhat from those in Shanghai. Guangzhou had allegedly, via Guangdong, reported to and attained approval by the MOF prior to carrying out the measure.⁵¹ Yet the magnitude of tax concession on these products

48. In intra-industry production and trade, since manufacturers in different geographical areas specialize in products that target different groups of consumers, the substitutability between their products is fairly low, which makes the price a more important factor than normal in determining the competitive ability of the products. See *Ibid.*, pp. 52–53.

49. World Bank, *China: Finance and Investment* (Washington, DC: World Bank, 1988), pp. 402–403.

50. Interviews #9502-0203, #9502-0207. See also Tu Jimo, 'Qiye hengxing llianxi zaishang xintaijie', pp. 17–18.

51. Han Ying, 'Qiwu qijian Guangzhoushi de caizheng zhuanbian' ['Transformations of Guangzhou's public finance during the Seventh Five-Year-Plan period'], *Guangzhou Caizheng Kuaiji* [Public Finance and Accounting in Guangzhou] 60, (September 1991), p. 20. This statement is a bit dubious, since no economic qualification of SOEs' eligibility for the shift seemed to be attached to the measure. It is not clear whether the measure's lack of economic credibility for promoting intra-industry production posed a problem in the MOF's reviewing of the measure.

was reasoned to be greater than that in Shanghai for two reasons. First, it was not only the outputs, but also the inputs used in manufacturing the products that were allowed to be levied with VAT rather than PT.⁵² Since the firms could deduct their input VAT liability from their output VAT liability, this measure enabled the manufacturers to further reduce their costs. Second, and more importantly, there was no indication that GZTB stuck to any explicit and objective economic criterion as did MTBS, in order to determine the SOEs' eligibility for the switch.⁵³

In essence, the comparison of 1986 corroborates H2 but falsifies H1. Evidence suggests that the pursuit of amplifying local EBR at the expense of the Center's fiscal claim was apparent from Guangzhou's implementation through VAT expansion. This was hardly the case in Shanghai, however, where the VAT expansion proved compelling to fulfill the policy innovation in regional economic integration, and thus hardly resulted in revenue deflection.

Local expansion of CMRS to turnover taxation in 1987 and 1988. The two localities' implementation in 1987 and 1988 keeps lending potent support for the effect of local autonomy, as Guangzhou attained greater revenue diversion. Guangzhou's implementation during the two years was epitomized by a dramatic head-on challenge to the policy rules of turnover taxes, under the influence of the Contract Management Responsibility System (CMRS) ushered in at the same time. Under CMRS the actual tax rates and tax base for SOEs' profit remission to the state were determined through bargaining between SOEs and their supervisory agencies as well as with local fiscal and tax authorities. Thus the particularistic contracting approach⁵⁴ characteristic of CMRS supplanted the universalistic approach that underpinned the uniform, standardized tax regime across the nation in the policy rules of LGS. The 'Provisional Regulations on the Tax-for-Profit Scheme for State-Owned Enterprises', which had governed SOEs' profit remission since 1983, were still technically effective in 1987. However, local governments and enterprises bluntly scrapped the statute and went ahead with CMRS, primarily because of the sponsorship of central elites (such as Zhao Ziyang) and ministries (such as the State Economic Commission).⁵⁵ By doing so, local cadres managed to jump on the bandwagon of the new policy line strategically at the critical juncture, a longstanding penchant continued from the prereform China.⁵⁶ Yet in 1987 and

52. Interview #9504-0213; Han Ying, 'Qiwu qijian Guangzhoushi de caizheng zhuanbian', p. 20.

53. The standard of the local tax authorities' decisions was referred to in an abstract manner as 'considering enterprises' actual needs' (*shi qiye shiji xuyao*). See Han Ying, 'Qiwu qijian Guangzhoushi de caizheng zhuanbian', p. 20. This is a term often used to denote tax officials' extensive exercise of discretion such as in the event of bestowing tax relief on firms in a financial quagmire.

54. This term is used in Susan Shirk, *The Political Logic of Economic Reform in China* (Berkeley: University of California Press, 1993).

55. For the political and economic dynamics driving central elites' and ministries' support for CMRS, see *Ibid.*, ch. 13.

56. For the political considerations driving local cadres' bandwagoning behavior, see Avery Goldstein, *From Bandwagon to Balance-of-Power Politics: Structural Constraints and Politics in China, 1949-1978* (Stanford: Stanford University Press, 1991), pp. 79-80, 82-90, 121-122, 151-153; Jae Ho Chung, *Central Control and Local Discretion in China*.

1988 the local cadres were driven by a set of motivations rather different from before, with much more emphasis now placed on local states' fiscal interests against the Center's than on joining particular central leaders' political alliance in the struggle against rival leaders.

Though intended for profit remission only, CMRS engendered a spill-over effect by encouraging local cadres to expand the contracting approach to turnover taxation. The LGS turnover tax laws had followed the standardization approach, the approach seen anachronistic against the policy line of contracting. Consequently, the LGS turnover tax laws could not be immune from the *de facto* repudiation. In February 1987, the GZFB and GZTB jointly issued Document No. 3 to formalize the decision on expanding CMRS to the PT, VAT, and BT on SOEs. According to the document, the expansion was launched on an 'experimental' basis, to cover large and medium-sized province- and city-owned industrial and commercial SOEs in certain sectors. The industrial SOEs included those producing textiles and clothing, electrical and electronic appliances, machinery, steel and metallurgical products, building materials, tobacco and wines, organic chemicals, and rubber and plastic products. The commercial SOEs included those in retail, wholesale, transportation, construction, and public utilities. In the vein of CMRS, each of the industrial SOEs covered was committed to a baseline figure of PT or VAT remittance, primarily based on their 1986 level, plus an annual progressive rate of 6, 8, or 10%, contingent on their average growth rate of turnover tax remittance from 1981 to 1985. Likewise, the commercial SOEs remitted BT with a committed baseline amount plus a flat annual progressive rate of 10% SOEs. For each of the SOEs, the baseline figure and progressive rate were documented as an agreement with the corresponding district office of GZFB and GZTB, which was attached to its main contract for profit remission under CMRS.⁵⁷

This local initiative was put into effect for two years, before the Center forced Guangzhou to abrogate it amidst the post-Tiananmen economic rectification in 1989. The initiative required the SOEs to pay a flat and pre-determined amount of turnover taxes, which did not change in response to the values of the SOEs' purchases and sales. To the extent that the total values of purchases and sales by SOEs in Guangzhou continued increasing together with the persistent growth of the local economy (as had been the case prior to 1987), one could reasonably infer that the initiative would diminish the sum of turnover taxes directly collected by Guangzhou and subsequently transferred to the Center. Above all, such an effect was vastly amplified by the remarkable inclusiveness of the initiative in terms of the varieties of industries covered. Indeed, the nominal 'experiment' was in fact carried to a heretofore unseen breadth, compared to what an experiment normally applied to. The large and medium-sized SOEs in the industries covered by the initiative contributed as a whole over 80% of all turnover tax proceeds in Guangzhou from 1981 to 1986.⁵⁸ In brief, the alleged local experiment became in effect an across-the-board tax concession, and amounted to a virtual re-designation of the turnover tax rates in the overall local economy.

57. Interviews #9504-0104, #9504-0109, #9504-0202, #9504-0207, #9504-0213.

58. *Guangzhou Jjingji Nianjian 1988* [Guangzhou Economic Yearbook 1988], p. 55.

Like Guangzhou, Shanghai also applied in 1987 and 1988 the contracting approach to the collection of turnover taxes, but in a much more moderate way in that its measure turned out only on a very limited number of trial points (*shidian*). Before the State Administration of Taxation (SAT) demanded Shanghai to repeal the measure in 1989, it had never covered more than 40 SOEs in only four industries—paper-related products, footwear, pesticides, and construction. By virtue of this limited scale, Shanghai also took a low profile by not issuing any official document to formalize the decision.⁵⁹ Each of the SOEs incorporated was committed to a baseline figure of remittance in turnover taxes, plus an annual progressive rate of 6% for PT and VAT, and 8% for BT.⁶⁰ The progressive rates were lower than those adopted in Guangzhou because they were based on Shanghai's average annual growth rate of turnover tax revenues from 1981 to 1985 which was not as high as that of Guangzhou. Despite this minor gap, the fact that Shanghai's CMRS expansion was far more restrained in magnitude than that of Guangzhou indicates that Shanghai diverted much less revenue flow to the Center than did Guangzhou.

The comparison above indicates that in 1987 and 1988, Guangzhou, having greater local autonomy than Shanghai, deviated farther away from the policy rules. This result verifies H2 but falsifies H1 in 1987. It verifies H2 but does not bear on H1 in 1988, when only local autonomy but not fiscal incentive was at work to distinguish between the localities' implementation strategies. That H2 is verified in 1988 indicates that local autonomy is indeed positively correlated with the extent of revenue deflection.

Revived tax concession after 1992. As the nationwide recentralization accompanying the post-Tiananmen austerity program died away after Deng Xiaoping's 1992 tour in southern China, local governments were also ready to launch a new round of concessions on turnover taxes. The striking feature of local implementation in 1992 was that unlike in the past, Shanghai swiftly and fully took advantage of its new preferential status to implement the tax policy in a way that deflected the revenue no less effectively than did Guangzhou. Above all, in granting turnover tax concession, SMTB targeted two of the industries prioritized by the same initiative of the Pudong project that also laid the institutional foundation for Shanghai's newly acquired local autonomy. In automobile production, all the domestically produced parts were given a 50% cut in their PT or VAT rates. In telecommunications, the consumer goods for daily use were totally exempt from VAT.⁶¹ In contrast, the sectors Guangzhou focused on in bequeathing tax relief were either labor-intensive or based on natural resource extraction, much the same as those targeted prior to 1992. These included oil refinery (reduced PT rate for dissolvent oil and lubricating oil), rubber products (reduced PT rate for all whole rubber

59. Interviews #9502-0102, #9502-0205, #9504-0208.

60. 'Benshi yipi shidian qiye gaixing liuzhuanshui xinzhì' ['A bundle of trial-point enterprises in the municipality shifted to a new scheme of turnover taxes'], *Jiefang Ribao* [*The Liberation Daily*], (5 March 1987), p. 2.

61. Pu Dengxian, 'Lun Shanghai Fazhan Gaoxin Jishu Chanye de Jingji Xiaoyi' ['On the economic efficiency of high- and new-technology industries developed by Shanghai'], *Shanghai Jingji* [*Shanghai's Economy*] 151, (June 1994), p. 33.

footwear, foam rubber products, and re-created latex products), and textiles (reduced VAT rate).⁶² This indicated that Guangzhou's implementation in 1992 was reminiscent of its local autonomy lingering from the past, as opposed to Shanghai's exercise of its new privileges.

Apart from tinkering with turnover tax rates, Shanghai also devolved the authority to review and approve tax concession from SMTB downward to its district and county offices. Guangzhou, however, refrained from doing this. Local power delegation as such had been banned across the nation during the economic rectification of 1989–1991, since it had proved in the 1980s conducive to dispensing undue tax relief by local governments.⁶³ The abuse was more likely because collusion between those who authorized tax relief and the enterprises took place more easily with a much shortened administrative distance.⁶⁴ In addition, administrative monitoring from above became more costly and less effective at the lower rather than the higher level of the bureaucratic hierarchy.⁶⁵ Immediately after the rectification program receded, the SMTB authorized in 1992 the district offices to review and approve up to about 100,000 *yuan* for PT and VAT, and 10,000 *yuan* for BT. The county offices were allowed to make decisions up to 50,000 *yuan* for PT and VAT, and 10,000 *yuan* for BT.⁶⁶ The ceilings above all exceeded what these offices at the lower echelon had been entitled to as stipulated by the codified rules for the implementation of regulations on PT and VAT.

In the midst of economic overheating in 1993, the State Council issued Document No. 50⁶⁷ to demand that local governments revise illicit tax reductions and exemptions. Under pressure, Guangzhou conformed to the demand, albeit appearing somewhat ambivalent about it. Shanghai met the Center's demand only half way. Guangzhou launched a campaign to clamp down on tax evasion and illicit tax relief without invoking the Center's demand outright. The crackdown was introduced in the name of propagating the 'Law of Tax Collection and Management' (*Shuishou Zhengguan Fa*), which had been newly passed by the National People's Congress.⁶⁸ Shanghai abolished the change in the PT and VAT rates for domestically produced automobile parts, but not in the VAT rate for telecommunications. Moreover, though suspending the approval of any tax relief for the sake of financial expediency, SMTB did nothing to take back the power devolved to lower levels of offices in 1992.⁶⁹

62. *Guangzhou Jingji Nianjian 1992* [*Guangzhou Economic Yearbook 1992*], p. 337.

63. For an overview based on various local cases of such a problem emanating from egregious power delegation in the 1980s, see Shuishui Zhengguan Ketizu [Study Group of Topics on Tax Collection and Management], 'Quanguo shuishou zhengguan gaige ji youguan Qingkuang' ['The reform of tax collection and administration in the nation and related situations'], *Shuishou Yanjiu Ziliao* [*Materials for Taxation Research*] 53, (October 1992), pp. 9–10.

64. Zhou Shaojun, 'Shuishou zhengguan moshi de tansuo' ['An exploration of the models of tax collection and administration'], *Shuiwu Yanjiu* [*Taxation Research*] 29, (January 1987), p. 37.

65. Huang Yasheng, 'Administrative monitoring in China', *The China Quarterly* 143, (1995), pp. 831–834.

66. *Shanghai Jingji Nianjian 1992* [*Shanghai Economic Yearbook 1992*], p. 404.

67. The document was titled 'Circular regarding the strengthening of tax management and strictly controlling tax reduction and exemption' ['Guanyu Jianqiang Shuishou Guanli Yange Kongzhi Jianmian Shui de Tongzhi']. See *Shanghai Jingji Nianjian 1993* [*Shanghai Economic Yearbook 1993*], p. 403.

68. Interviews #9504-0106, #9504-0108.

69. Interview #9502-0101.

The evidence above displays that in 1992 and 1993 Shanghai started taking advantage of the new local autonomy granted by the Center, thanks to the status of the metropolis as the new center of gravity in the nation in terms of power devolution. In the revived tax concession of 1992 each of the two localities targeted those sectors designated by the distinct round of decentralization which favored itself by granting more local autonomy. Shanghai also made an additional move in 1992 conducive to revenue diversion. Thus in 1992 Shanghai for the first time deflected the revenue flow more effectively than Guangzhou. Susceptible to the same pressure to reverse their deviation from policy rules in 1993, Shanghai acted with less compliance than did Guangzhou. The outcome during 1992–1993 reveals that when fiscal incentive and local autonomy were both at work and pointed in the same direction, both H1 and H2 are verified.

State taxation bureaucracy under enduring local pressures in 1994 and 1995. As localities have been unified in their fiscal incentives to collect marginal revenue since FSZ in 1994, their discrepancy in local autonomy becomes the single factor to differentiate between the localities' varying degrees of deviation from policy rules. In order to aggrandize local EBRs, Shanghai entertained in 1994 and 1995 the implementation strategy of dispensing VAT rebates to selective SOEs matching the sectoral priority underlined by the new wave of reform beginning after 1992. Since the Center had a 75% claim on VAT proceeds, the rebate in effect caused revenue diversion. By contrast, no evidence demonstrates that Guangzhou acted similarly. This reality verifies H2 with no implication for H1, as local autonomy but not fiscal incentive was at work during this period.

To understand Shanghai's implementation strategy as such, a key starting point is the reorganization of the initially unitary tax bureaucracy headed by SAT into two separate subsystems when FSZ began in 1994. One of the subsystems is responsible for collecting all central and shared taxes (such as VAT), with such functions exercised by the General Bureau of State Taxation (GBST) and its local offices. The other one is in charge of collecting all local taxes, as implemented by bureaus of local taxation at the subnational levels. The reorganization was an attempt by the Center to solidify its capacity of revenue mobilization by tackling the lingering problem of precarious local compliance with tax policies since 1980. The State Council and MOF deemed the problem to be associated with the subservience of local tax officials at all administrative levels to local governments' pressure and demand.⁷⁰ In the old unitary system of tax administration, these officials were supposed to act as agents of the central state and subject to the administrative oversight of SAT. Yet in reality they were also subordinate to the legal authority of local governments in certain areas (such as personnel appointments and job evaluation), and dependent on local governments for material well-being (such as wages, organizational budgets, and housing). This was the practice of dual leadership (*shuangchong lingdao*), or coexistence of the vertical commanding lines of state bureaucracy and the horizontal, enveloped blocks of

70. Roy Bahl and Christine Wallich, *Intergovernmental Fiscal Relations in China*, Policy Research Working Paper No. 863 (Washington, DC: World Bank, 1992), p. 8.

localities (*tiaotiao kuaikuai*). Consequently, local officials under almost all line ministries constantly faced a dilemma of dual loyalty, being caught between often conflicting interests of the Center and the locality where the officials were stationed.

The functional differentiation between the two systems has been supplemented by adjustments in organizational operation. All the cadres in GBST's subnational offices are required to answer to the headquarters only, and all personnel decisions regarding them are controlled by the headquarters through various means. In addition, part of the subnational offices' operating budgets, except those related to individual rewards (wages and bonuses) and infrastructure maintenance, have been at the mercy of the Center.⁷¹ With these arrangements, the Center expects to insulate tax administration on the revenues it claims from undue local interference as much as possible.

Yet the way the Shanghai Bureau of State Taxation (SHBST), supervised directly by GBST, handled the VAT rebate for SOEs displayed that the Center's goal as such was scuttled in 1994 and 1995, despite the reorganization of tax bureaucracy. To determine local SOEs' qualifications for a VAT rebate in order to nurture high technology, SHBST worked in 1994 and 1995 jointly with the Shanghai Science and Technology Commission (SHSTC) and the Shanghai Economic Commission (SHEC). As a policy tool to encourage certain exports by literally waiving the producers' VAT payment, the VAT rebate has been widely adopted by national governments around the world. The particular type of VAT rebate in Shanghai had been initiated locally in 1992 and tailored to products of high and new technology, at a time when the promotion of high-tech industries consorted with the rise of Shanghai in the new wave of reform. The VAT rebate was renewed in 1994 under the new tax system, but with some modification of the conditions for rebate. Since the Center now had a direct claim on 75% of VAT proceeds, the conditions for VAT rebate also changed—contingent on whether the rebate would be made in full or in part. For those new products featuring high and new technology prioritized by any central ministry, the corresponding VAT payments were rebated in full, including the fraction of 75% accruing to the Center. For those new products prioritized by the local agencies only, the rebate was confined to the portion of 25% of the payment captured by the local treasury.

For the sake of administrative efficiency, however, the decision regarding whether a particular product was ranked in Shanghai as centrally or locally prioritized was made by SHSTC and SHEC; the SHBST was responsible only for confirming the qualifications of such new products for VAT concession.⁷² The two variations of rebate above evidently created different revenue consequences for the Center. The full rebate meant the Center's loss of the VAT remittance, while the rebated funds in the hands of local SOEs was susceptible to the local EBR claim.

71. Yi Benhang, 'Shuiwu jigou fenshe hou qidai jie jue de jige wenti' ['Several problems needing prompt solution after the organizational division between tax agencies'], *Shuiwu Yanjiu* [Taxation Research] 116, (January 1995), p. 62; Yang Rongxue, 'Shuiwu jigou fenshe hou ruhe xietiao youguan fangmian guanxi de tantao' ['A discussion on how to coordinate relations between institutionally differentiated tax agencies'], *Shuiwu Yanjiu* [Taxation Research] 121, (November 1995), p. 37.

72. *Shanghai Jingji Nianjian 1995* [Shanghai Economic Yearbook 1995], p. 494.

The partial rebate caused no such loss for the Center, but converted the rebated funds from local budgetary revenues into a potential source of local EBR.

The VAT rebate in a widely noticed case of a major automobile manufacturer unraveled how SHBST, much the same as their predecessor in Shanghai's tax bureaucracy, was subject to the heavy influence of the local government. As a local enterprise specializing in sedans and related parts, the manufacturer operated with an emphasis on technological transfer from its foreign partner. In both 1994 and 1995, the enterprise was among the top five local firms receiving the largest volume of full VAT rebate, due to the leading status of its sedans among innovative products in the nation's automobile industry.⁷³

Apparently, the firm's full VAT rebate would not have been possible had the sedans not been ranked as a nationally prioritized product. Yet the credibility of such status actually underwent vital change from 1994 to 1995, when sedan manufacturing was unlikely to remain a top national priority in 1995. By the end of 1994, the State Council and the State Planning Commission (SPC) had projected ballooning domestic supply which would soon satiate the segment of domestic market that the firm's sedans targeted, and thus encouraged the diversification in the technological levels and features of similar sedans. Accordingly, the SPC adjusted at the same time its relevant industrial policy by dropping sedans of this class from the products bequeathed with various incentives for the sake of technological advancement.⁷⁴ This means that the firm no longer qualified for the favored status of VAT rebate in 1995. Therefore, its VAT rebate benefit was actually an undue extension of its 1994 status authorized directly by the SHSTC and SHEC.

More importantly, the implementation of the VAT rebate, of course, would not have been possible without the collaboration of the cadres at SHBST. The cadres were supposed to refrain from granting the unjustified rebate, since legally speaking they were exclusively the central government's employees. In fact, however, these cadres were still on the payroll of the government of Shanghai. As mentioned earlier, the GBST only financed part of subnational offices' operating budgets. Local GBST officials still relied upon local governments for wages and the comprehensive supply of goods and services covering basic living needs (e.g. housing, health care, and education).⁷⁵ This explains why SHBST lacked real operational independence, as shown by its collusion with SHEC and SHSTC to address local EBR concerns instead of safeguarding the Center's fiscal extraction.

73. Hai Peng, 'Shanghai qiche gongye xushi daifa' ['The automobile industry in Shanghai is ready to take off'], *Shanghai Jingji* [*The Economy of Shanghai*] 174, (August 1996), p. 17.

74. Kuang Baoqiang, 'Chuangzao qiche gongye de guanghui yuanjing' ['Creating the brilliant future of the automobile industry'], *Jingji Lilun yu Jingji Guanli* [*Economic Theory and Economic Management*] 46, (October 1995), p. 24.

75. Interview #9502-0108.

IV. Conclusion

The currently prevalent view on decentralization in China's state hierarchy during the reform era makes only nominal differentiation, and only on a limited scale, between fiscal decentralization and power devolution. This article argues that the intricacy congenital to decentralization cannot be fully grasped without deconstructing the notion by looking into the diverse effects of the two distinct types on local state behavior. This article unveils the unique causal mechanism of each type through a theoretical reasoning in the policy area of revenue extraction. Applying the hypothesized effects to the actual divergences in the two types between Guangzhou and Shanghai, this article uncovers that when decentralization evolves ostensibly as an internally coherent entirety, as the prevalent view always presupposes, the diverse effects of the two types inevitably conflict. This is so in the sense that when the two types follow the same contour by proceeding in the same pace as well as direction, and by dispensing preferential treatments with the same regional priority, they produce opposite effects on local compliance with centrally imposed policy rules during policy implementation. The two effects do not conflict only when the internal consistency is undermined either by dissimilar regional priorities in preferential treatments designated by the two types, or by reversal of decentralization in one type combined with continuation of it in the other. This paradox highlights the contradiction inveterate in the dynamics of decentralization.

The theoretical reasoning is substantiated by the comparative analysis of policy implementation in Guangzhou and Shanghai from 1984 to 1995. In an inferential but not chronological sequence, this article first verifies that the greater the local autonomy derived from power devolution, the more likely local implementation will depart from policy rules and deflect revenue flows. Then when this authenticated effect of local autonomy and the hypothesized effect of fiscal incentive were both present *and* pointed in the same direction, the comparative outcome verifies the latter as well. It is verified that *under this particular circumstance*, the stronger fiscal incentive of a local state to collect marginal revenues under fiscal decentralization, the less likely deviation from policy rules and revenue diversion will be. Finally, when the two effects were both present *and* pointed in the opposite direction, which precisely evinced the contradiction inveterate in decentralization, local autonomy overrides fiscal incentive.

For China's central-local fiscal relations *per se*, this study yields two implications. First, to better understand the actual central-local distribution of fiscal resources, attention ought to be extended from fiscal regimes within the state hierarchy to how local states as the 'gatekeeper' affect revenue flows from the economy to the state hierarchy in the first place. Second, the role of local states is in fact even more noteworthy, despite the Center's creation of its own agents *vis-à-vis* those of the local states in the tax bureaucracy after 1994. The state taxation agencies, at least according to the findings here, are not totally immune from local states' influence when the Center's tax revenue is at stake. To what extent the Center can overcome this problem of local encroachment is an issue requiring further research.

For China's central-local relations in broader terms, this article offers three implications. First, echoing other works of implementation studies in recent years, this article shows that given the interactive and dynamic character of central-local relations, policy implementation is no less consequential than policy formulation to explain actual policy outcome. Second, given the issue-specific nature of central-local relations, the zero-sum interaction in the area of tax revenue remained unchanged all the way throughout the time period covered here, and has conceivably continued ever since. This continuity points to a crucial qualification on the increasingly appealing view of central-local relations as non-zero-sum, a view based on an evolutionary approach to cooperation among actors. Third, by showing the diverse degrees and ways of local defiance to centrally imposed policy rules, this article suggests that China's central-local relations are better understood as an amalgamation of a variety of distinct interactive patterns. Each locality maintains a particular pattern of interaction with the Center that does not necessarily correlate with those of the other comparable localities. In brief, a view embracing diversification grounded in micro-level analysis may be an indispensable complement to the perspective focusing on one aggregate, macro-level pattern in the nation as a whole. All three implications above, while not sufficiently able to be representative of all local cases in China, are intended to suggest new avenues of research that would enable us to better *approach* a fuller overall picture of China's central-local relations.

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