POLICY RESEARCH WORKING PAPER

1408

WPS1408

Macroeconomic Management and Intergovernmental Relations in China

Jun Ma

Decentralization in China has been crucial in stimulating regional economic growth and reform, but local governments have attained de facto control over many policy instruments, seriously weakening the central government's ability to achieve and sustain macroeconomic stability. And in areas where the division of regulatory power is vaguely defined, local governments' protectionist behavior has led to a malfunction in resource allocation.

Summary findings

Over the past 15 years, China has gradually moved from a highly centralized to a decentralized system in almost all aspects of economic management. Decentralization has changed the role of each level of government in economic management, and has greatly complicated the relations between levels of government.

Ma analyzes three aspects of intergovernmental relations and their impact on macroeconomic management and market development, and suggests the implications for future reform. He addresses three main questions:

- How do fiscal relations between the central and local governments affect the central government's ability to use fiscal policy to achieve stabilization and equalization?

Localities have controlled effective tax rates and tax bases in two ways: they controlled tax collection by offering tax concessions, and they found ways to shift budgetary funds to extrabudgetary funds, thus avoiding tax-sharing with the central government. As a result, the center has had to resort to ad hoc instruments to

influence revenue remittances from local areas, which caused perverse reactions.

- How do monetary relations between the two levels of government affect the central bank's ability to control the money supply?

In the past 14 years, the economy has overheated several times because of an excessive money supply. Ma argues that blame for this should be assigned not to the central bank, but to the institutional structure of monetary relations between the central and local governments. The main source of trouble is the central government's inability to commit to a preannounced credit policy.

- How does the division of regulatory power between the central and local governments affect the functioning of the market system?

As the central government relaxed its control over the economy, local governments used the powers transferred to them to restrict market competition. What is needed is a legal framework (including a fair trade commission) that restricts local governments' ability to abuse power.

This paper—a product of the Public Economics Division, Policy Research Department—is part of a larger effort in the department to develop policies to reform fiscal systems in developing countries. Copies of the paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Carlina Jones, room N10-063, extension 37754 (77 pages). January 1995.

The Policy Research Working Paper Series disseminates the findings of work in progress to encourage the exchange of ideas about development issues. An objective of the series is to get the findings out quickly, even if the presentations are less than fully polished. The papers carry the names of the authors and should be used and cited accordingly. The findings, interpretations, and conclusions are the authors' own and should not be attributed to the World Bank, its Executive Board of Directors, or any of its member countries.

**MACROECONOMIC MANAGEMENT AND INTERGOVERNMENTAL
RELATIONS IN CHINA**

Jun Ma

**The World Bank
1818 H St., NW
Washington DC 20433**

This paper was prepared for the Public Economics Division of the World Bank while the author was working as a consultant to the division. The project was directed by Anwar Shah and Heng-fu Zou. The author wishes to thank Anwar Shah, Heng-fu Zou, Bert Hofman, Carol Rogers, Rajiv Lall, Anjali Kumar and Albert Kiedel for helpful comments and discussions on this and other relevant projects.

TABLE OF CONTENTS

I. Introduction	1
II. Fiscal Management	3
2.1. Central-local revenue-sharing relations	4
2.2. Division of central-local expenditure responsibility	6
2.3. Framework of analysis	8
2.4. Lack of policy instruments of the central government under the contract system	9
2.5. Impaired performance of central government's fiscal policy	14
2.6. 1994 reform: tax-assignment system	16
2.7. Implications of the 1994 fiscal reform	18
III. Monetary Management	30
3.1. Financial sector development before 1994	30
3.2. Role of the central bank and its instruments of monetary control	32
3.3. Framework of analysis	34
3.4. Does the central bank's monetary policy stabilize the economy?	34
3.5. Why cannot the central bank control money supply at a desired level: A central-local monetary game	36
3.6. Reform cycles: another consequence of the central-local monetary game	40
3.7. Monetary Reform in 1994	42
3.8. Assessment: Central Bank Independence, Policy Lending, and Indirect Monetary Control	43
IV. Regulatory Framework	48
4.1. Selected aspects of division of powers: who controls what?	49
4.2. Impact of decentralization on the market system	52
4.3. Defining the limits of local government power	62
V. Summary of Conclusions	68
Text Tables:	
Table 1: Ratio of Government Revenue to GNP and National Income, 1978-1991	23
Table 2: Change of Central-Local Relative Fiscal Status, 1981-1992	24

Table 3. Revenues and Expenditures of Provinces, 1983 and 1991	25
Table 4. Comparison of Actual Credit Supply and Planned Credit Supply	46
Table 5. Comparison of Actual Currency Issued and Planned Target	46

Figures and Boxes:

Figure 1. Deficit/GNP ratio and Real GNP Growth Rate	27
Figure 2. Intensity of Net Transfers from/to the Center: 1983	28
Figure 3. Intensity of Net Transfers from/to the Center: 1991	29
Figure 4: Growth Rate of Retail Price Index: 1979-1993	47
Figure 5. Growth Rate of Real GNP: 1979-1993	47

REFERENCES	71
-----------------------------	-----------

Macroeconomic Management and Intergovernmental Relations in China

Jun Ma

I. Introduction

China has a population of 1.2 billion and covers an area of 9.6 million square kilometers. Administratively, the country is divided into 30 provincial level localities, including 22 provinces, 3 municipalities directly under the central government, and 5 autonomous regions (unless otherwise stated, we hereafter refer to these provincial level localities as provinces).¹ The average population size of the provinces is 40 million, larger than most states and provinces in other large countries. Under the provinces, there are two administrative levels. They include: 2,183 county, autonomous counties, and cities at the county level; and townships and towns and city districts.² China's vast population and territory, as well as its geographical and economic diversity suggest the great importance of policy coordination between the central and subnational governments.

Over the past 15 years, China has moved gradually from a highly centralized planning system to a very decentralized one in almost all aspects of its economic management: taxation, government spending, credit allocation, production and investment planning, material allocation, wage and price control, international trade management, etc. This decentralization process has significantly changed the role of each level of government in economic management, and greatly complicated the relations between different levels of government. This paper analyzes three aspects of the central-local relations and their impact on macroeconomic management and market development, and draws implications for the direction of China's future reform. The three key questions discussed in this paper are:

(1) *On fiscal management*: how do the central-local fiscal relations affect the central government's ability to achieve the goals of stabilization and equalization through fiscal policies?

(2) *On monetary management*: how do the central-local monetary relations affect the central bank's ability to control money supply?

(3) *On regulatory framework*: how does the division of regulatory power between the central and local governments affect the functioning of the market system?

It is argued in this paper that as for fiscal policy, the central-local fiscal contract system adopted in the early 1980s has left the central government with very limited policy instruments.

¹ Taiwan Province of China is not included.

² China Statistical Yearbook 1992. There used to be 338 prefectural level governments between provincial governments and counties. They were abolished in the recent organizational reform.

The localities have obtained *de facto* control over effective tax rates and tax bases, while the lack of coordination between the decentralization of revenue collection and the decentralization of expenditure responsibility has restricted the center's flexibility in using expenditure policy. As for monetary policy, it is argued that the central bank has not been able to effectively control money supply as the localities could react strategically to the central bank's credit policy. The regions found ways to force the central bank to revise the credit ceiling upwards, thereby creating inflation. As for the regulatory issues, the paper points out that under the decentralized system local governments have tended to abuse their (vaguely defined) administrative and regulatory powers in order to protect local economies. Such local protectionist behaviors have severely restricted the role of the market in resource allocation. While some aspects of the above issues are being addressed by the 1994 reform package, solutions to some other aspects are yet to be developed. Although the design of a new framework of central-local relations is beyond the scope of this paper, we attempt to highlight selected elements of the needed reforms in the future.

The rest of this paper is organized as follows. Section II discusses China's fiscal management, detailing the current central-local fiscal relations and their impact on the effectiveness of central government's fiscal policy. The 1994 fiscal reform plan is described and assessed, and areas that require further institutional changes are discussed. Section III looks at China's monetary management. It covers an overview of China's financial system and a discussion on problems of the central-local monetary relations that lead to the central bank's failure to control money supply. An assessment of 1994 monetary reform is also offered. Section IV deals with the division of central-local regulatory power and its impact on market development. Various problems arising from local governments' anti-competition behaviors are identified and a new regulatory framework that aims at limiting local government powers is proposed. The last section summarizes the main conclusions and policy recommendations.

II. Fiscal Management

The evolution of central-local fiscal relations has been the most important element of China's decentralization process over the past 15 years. The objective of the decentralization of fiscal management, starting from 1980, was to increase the local governments' responsibility for local economic development and their autonomy in using fiscal instruments to achieve such goals, while preserving an adequate degree of fiscal control for the central government.

This section looks at the impact of China's fiscal decentralization on the central government's ability to use fiscal policies in achieving macroeconomic objectives. It is argued that, under the fiscal contract system introduced in the early 1980s, the localities obtained de facto control over the effective tax rates and tax bases. The local governments controlled the effective tax rates and tax bases in the following two ways. First, they controlled the tax collection efforts by offering varying degrees of tax concessions. Second, they found ways to shift budgetary funds to extrabudgetary funds, thus avoiding tax-sharing with the center. As a result, the center had to resort to various ad hoc instruments to influence revenue remittance from the localities, and these instruments led to perverse reactions from the localities. On the expenditure side, the center has failed to achieve corresponding reductions in expenditure when revenue collection has been decentralized. The center's flexibility in using expenditure policy is seriously undermined by the lack of centrally-controlled financial resources and the heavy burden of "capital constructions."

Due to the lack of fiscal resources and policy instruments, the central government has found itself in an increasingly difficult position to achieve the goals of macroeconomic stabilization and regional equalization. The adoption of the tax-assignment system in the 1994 fiscal reform is an important step taken by the central government to address these difficulties. Under the new system, the center will recentralize the administration of collection of shared-taxes and obtain a larger share of fiscal resources due to the new revenue-sharing formula. As a result, the center will significantly improve its ability to use tax and expenditure policies in macroeconomic management. Nevertheless, a number of issues, including the ownership-based tax assignment scheme, the division of expenditure responsibilities, and the design of intergovernmental transfers, are still left unaddressed and may continue to negatively impact the functioning of the center's fiscal policy.

The rest of this section is organized as follows. The first two subsections provide an overview of the evolution of China's central-local revenue-sharing relations and the central-local division of expenditure responsibilities. The third subsection sketches the analytical framework that provides guidelines for assessing the performance of China's fiscal management system. Subsection four looks at how, under the fiscal contract system, the localities obtained control over effective tax rates and tax bases, leaving the center with very limited tax and expenditure policy instruments. In subsection five, we examine the impact of the contract system on the center's ability to achieve goals such as macroeconomic stabilization and regional equalization. The 1994 fiscal reform and its implication are discussed in the last two subsections.

2.1. The central-local revenue-sharing relations

Before 1980, the fiscal system was characterized by centralized revenue collection and centralized fiscal transfers, i.e., all taxes and profits were remitted to the central government and then transferred back to the provinces according to expenditure needs approved by the center. Since the early 1980s, the central-provincial fiscal relation has gone through three major phases.³ In 1980, the highly centralized system was changed into a revenue-sharing system in which the central and provincial governments each began to "eat in separate kitchen." This system was named as the contract responsibility system, which emulated a similar system adopted in the rural reform in the late 1970s.⁴ There were three basic types of revenue under the reformed system: central-fixed revenues (those revenues and taxes accrue to the center), local-fixed revenues (those accrue to the localities), and shared revenues (those shared between the center and localities according to some agreed rules).⁵ During the period of 1980-1984, about 80 percent of the shared revenues were remitted to the central government and 20 percent retained by the local government. Almost all the revenues, except a few minor ones in the central fixed revenues, were collected by the local finance bureaus. The bases and rates of all

³ The following literature has described in detail the evolution of China's central provincial fiscal relations since 1980: The World Bank (1992), Oksenberg and Tong (1991), Agarwala (1992) and Wong (1991).

⁴ The central-local fiscal system adopted in 1988 was named The Big (comprehensive) Fiscal Contract System. In the rest of this paper, we broadly refer to all variants of the decentralized fiscal system adopted since 1980 as the "fiscal contract system."

⁵ The revenue-sharing system based on the three types of revenue continued since 1980, although the items in each revenue type have changed over time. Since 1985, the three types of revenue have basically maintained the following structure:

Central-fixed revenues mainly include: income tax, adjustment tax, and profit remittance of centrally-owned enterprises, business tax from railroads, banks and insurance company headquarters, fuel oil special taxes, income taxes, sales taxes and royalties from offshore oil activities of foreign companies and joint ventures, treasure bond income, 70 percent of the three sales taxes collected from enterprises owned by the Ministry of Industrial the Ministry of Power, SINOPEC, and the China Nonferrous Metal Company, all customs duty and all VAT and product taxes collected at customs, tobacco tax and business on tobacco, product tax on liquor and tobacco.

Local-fixed revenues include: income tax and adjustment tax of locally-owned enterprises, income tax from collectively-owned taxes, agricultural and animal husbandry tax, urban maintenance and construction tax, property tax, title trade tax, individual industrial and business tax, market tax, bonus tax, vehicle utilization tax, special tax on forestry and agricultural products, slaughter tax, personal income tax and salt tax, 30 percent of the three sales taxes collected from enterprises owned by the Ministry of Industrial the Ministry of Power, SINOPEC, and the China Nonferrous Metal Company.

The shared revenues include: all turnover taxes (including VAT, business tax and product tax) revenues from all enterprises (with some exceptions), natural resource taxes, construction tax, salt tax, industrial and commercial tax, and income tax, levied on foreign and joint venture enterprises, energy and transportation fund tax. Source: Agarwala (1992) and MOF.

the taxes, no matter shared or fixed, were determined by the central government.

Although the 1980-1984 fiscal relation initiated some localities' enthusiasm in collecting revenues, the uniform sharing formula created an undesirable surplus in wealthy provinces and deficit in poor provinces. In 1985, the State Council redesigned revenue-sharing arrangement by setting varying schedules based on localities' budget balance in the previous years. The central government allowed financially weak regions to retain more revenues, while continued to maintain a tight grip over regions, including Shanghai, Beijing, Tianjin, Liaoning, Jiangsu, and Zhejiang, that were the most important revenue sources of the central revenue. The revenues from these regions generally grew more slowly than the national average since the high share of remittance adversely dampened the localities' enthusiasm in expanding the tax bases. To mitigate this effect, in 1988, the State Council decided to adopt a new system in which six types of central-provincial revenue-sharing methods, each applied to a number of provinces, were introduced.⁶ These six types are:

1. Contracted Revenue Increase (adopted by ten localities): based on 1987 revenue figures, localities retain a specific proportion ranging from 28 percent to 80 percent of any revenue that is within a certain percentage growth (ranging from 3.5 percent to 6.5 percent; any revenue in excess of 6.5 percent growth is retained entirely by the localities;

2. Uniform rate of retention (adopted by three localities): a fixed share retained by localities (46.5 percent to 46.5 percent depending on the region);

3. Variable rate of remittance (adopted by three localities): a certain proportion is retained up to a quota, and then a different (usually higher) proportion of revenue is retained in excess of the quota;

4. Increased amount contracted to go the center (adopted by three localities): a specific amount is contracted to go to the center in the initial year; in subsequent years the amount was to increase at a contracted rate from 7 percent to 9 percent);

5. Fixed quota (three localities): a specific amount is contracted to be transferred to the center with no annual adjustment for high growth.

6. Contracted transfers to provinces (15 localities): a specific amount is contracted to be transferred from the center to the localities.⁷

⁶ See Agarwala (1992) for details.

⁷ These methods applied to 28 provinces, municipalities directly under the State Council, autonomous regions, and nine cities with independent planning status. The difference between expenditures and income of Hubei and Sichuan provinces was made up from income that Wuhan and Chongqing cities sent to the provinces.

This 1988 fiscal contract system further increased the revenue share retained by the localities, particularly those major contributors to the central government's revenue. However, the contracts were not strictly adhered to, and were revised repeatedly for some regions. In 1991, when the 1988-1990 system was supposed to expire, the central government found it unable to negotiate satisfactory replacements, as a result, the 1988-90 system was extended until the end of 1993, with limited modifications on revenue-sharing ratios and quotas.

Since 1978, both the total government revenue as a percentage of GNP and the share of central government revenue in total government revenue have declined rapidly. From 1978 to 1992, total government revenue/GNP ratio declined from 34 percent to about 17 percent; the central government revenue (after revenue-sharing) declined from 51 percent to 41 percent. These trends are clearly related to the fiscal decentralization process starting from 1980, and have serious implication in terms of the effectiveness of central government fiscal policy. These issues will be taken up later in this paper. Since the late 1980s, the central government has been increasingly concerned with the potential political and economic consequences of its weakening fiscal power, and has repeatedly expressed the intention to increase two ratios--the government revenue/GNP ratio and the ratio of central government revenue to total government revenue.⁸ Although this proposal was written into the 8th Five Year Plan for 1991-1995, the trend of declining two ratios continued between 1990-1993. At the end of 1993, the central government announced a major reform plan which was to change the fiscal contract system into a tax assignment system in 1994. The main objective of this reform is to reverse the trend of the declining two ratios, particularly the ratio of central government revenue to total government revenue, by replacing a negotiation-based system with a rule-based system.

2.2. Division of central-local expenditure responsibility

Before 1980, almost all revenues collected by the localities were submitted to the center and all expenditures were financed by central government transfers. Since 1980, as a part of the decentralization in fiscal management, the central government no longer stipulates individual items of expenditures in provincial budgets but continues to formulate the guidelines indicating the acceptable level of expenditure for each province.⁹ The allowed expenditure of each province is formulated based on the "base figure"--the expenditure of the province in a certain

⁸ A referee says that "the loss in revenue [declining revenue/GNP ratio] was most likely deliberate [a result of the center's deliberate effort]." This was true to some extent in the early stages of the fiscal decentralization. However, since the 1988, the revenue-sharing methods were largely designed for the purpose of increasing local revenue collection. The central government has repeatedly expressed concerns about the declining trend of revenue/GNP ratio and almost all the efforts made in the last few years to reform the central-local fiscal relations were aimed at correcting this trend.

⁹ "Provisional Regulations Concerning the Introduction of a Fiscal Management System by Which the scope of Revenues and Expenditures is Defined for the Central and Local Governments, Respectively, and Each is Responsible for the Balancing of Its Own Budget," issued by the State Council, February 1, 1980. See Economic Research Center of the State Council (1981).

base year--adjusted by factors such as changes in policy priority (e.g., the State Council's approval of a new development zone may increase this region's expenditure allowance) and inflation (e.g., inflation increases the payments of wages and other procurement), price reform (e.g., certain price reform requires the provinces to spend more on subsidizing food and housing), etc. The provinces are required to make their expenditure plans consistent with the central government guideline, but may augment expenditures if more resources are likely to be available to the province. On individual items of local government expenditure, the center has a set of detailed regulations restricting government employees' wages and the items that government agencies (at all levels) can purchase.

The state budget consists of central budget and local budget. The local budget includes the provincial, county, and municipal budgets. In principle, the division of expenditure responsibilities between the center and the local governments, in so far as they are limited to the budget, is broadly defined as the following. The central government's expenditure responsibilities include capital construction and technical upgrading centrally owned enterprises and outlays on their new product development; national defense; foreign aid and external relations; agriculture, forestry, and water conservation at the central level; industrial, transportation, and commercial operations; education, culture, health and social services; outlays on centrally obligated price subsidies; geological surveys; and financial of public debt. Local expenditure responsibilities include basic construction and technical improvement of locally owned enterprises and their new product development; rural production assistance and agricultural development and water conservation at the local level; urban maintenance and construction; education, health, culture, and social services; social welfare and pensions; administrative expenditures; and a range of price subsidies.¹⁰

There is substantial overlapping between the center's and the localities' responsibilities in actual expenditures. This overlapping is common in heavy industrial sectors (e.g., electricity and raw materials), as well as in transportation, telecommunications, education, science, and health care. For example, the central government finances electricity plants, railways, and telecommunication networks, and provinces are often required to co-finance these projects. There are both central and local universities, making education both a local and a central responsibility, and a hospital or a bridge can be financed by the central government, by the provincial government, or by the city government. Since a substantial part of investment outlays come from the central budget, the location of projects becomes a matter of importance. Provinces compete with each other to garner a greater share of these outlays. Both before and after the state budget plan is formally approved by the Congress, intensive lobbying from the local governments for allocating more projects in their own jurisdictions takes place. One typical form of such lobbying is that the local leaders seek help from a senior leader in the central government or the Central Party Committee, and this senior leader writes a note to the State Planning Commission or the Ministry of Finance suggesting consideration of a project in favor of this region. According to staff from the Ministry of Finance, virtually every project

¹⁰ See Agarwala (1992).

approved to be listed in the budget plan or added to plan later was backed by some kind of "note." Although there are official guidelines for allocating projects, such as achieving balance between production and consumption, between industry and agriculture, between heavy and light industry, and between coastal and inland areas, these criteria are usually very vague and the actual allocation mostly reflects the relative bargaining powers of the localities.

2.3. Framework of Analysis

Economic theories on fiscal management and intergovernmental relations have provided some important guidelines for assessing the structure and performance of the Chinese central-local fiscal relations. We adopt several basic propositions that are most relevant to the issues addressed in this paper.¹¹ These propositions are:

1. *Tax policy instruments of the central and subnational governments.* The central government should have effective control over adequate fiscal resources in order to perform its role of stabilization, redistribution, and provision of public goods and services. The tax policy instruments that belong to the central government should include tax rates and tax bases of the taxes assigned to the center, as well as public spending. The control over these tax policy instruments (tax rates and tax bases) should be realized through setting up the center's own tax collection machines. The subnational governments should be given the right to determine the rates of those taxes which are assigned to them.

2. *Expenditure responsibility of the central and subnational governments.* Public goods and services provided by the central government should be restricted to those whose benefits are of national scope. Private goods and services should be provided by the private sector, and public goods and services benefitting only a local community should be provided by the local government. In countries where the revenue collection function is decentralized to subnational governments, the expenditure responsibility should be decentralized accordingly.

3. *Rules rather than discretion in intergovernmental fiscal relations.* The revenue-sharing formula, the tax assignment method, and the division of expenditure responsibilities between the central and subnational governments should be relatively stable in order to avoid adverse incentives to the latter. If a subnational government makes a high tax collection effort and thereby faces a lower revenue retention rate or a higher expenditure responsibility, then its optimal reaction would be to reduce its tax effort. Therefore, ad hoc adjustments of the revenue-sharing formula, the tax assignment method, and the division of expenditure responsibility should be avoided.

These three results will serve as the general guideline for this section's evaluation of the effectiveness of China's fiscal management system.

¹¹ Discussion of the rationale for these propositions can be found in Oates (1972), Shah (1991), and Agarwala (1992), Ma (1993c), among others.

2.4. The Lack of Fiscal Policy Instruments of the Central Government

Many studies on China's central-local fiscal relations point out that the declining ratios of revenue to GNP and the central government revenue to total government revenue are a major problem of the fiscal contract system. They base this argument on a comparison of the Chinese figures with those in other countries¹². The Chinese government also stated clearly in the 8th Five Year Plan and the Decision of the 14th Party Plenum that the fiscal reform should proceed in the direction of increasing these two ratios. This section argues that simply looking at the two ratios is not enough for assessing the merit of a fiscal management. As countries differ vastly in size, population, level of development, as well as political and cultural background, the optimal ratios could be very different in different countries. To evaluate the performance of a fiscal management system, particularly the intergovernmental fiscal relations, the key is to look at whether the system enables the central government to effectively use fiscal policy instruments to perform its functions. This is the task of this and the next subsections.

The original purpose of introducing the fiscal contract system was to ensure the center's income while giving the regions more incentive to collect revenues. However, under the fiscal contract system, the localities have largely controlled the *effective tax rates and bases* through controlling tax efforts and the channels through which taxes are collected, although legally the center controls the rates and bases of all taxes. As a result, the center has to resort to various ad hoc instruments to influence revenue remittance from the localities, and these instruments often lead to perverse reactions from the localities. In addition, the center's flexibility in using expenditure policy is also undermined by the lack of centrally-controlled financial resources and the heavy burden of "capital constructions." This subsection will discuss these issues in order.

The first way in which local governments control effective tax rates and tax bases is to control their tax efforts, mainly reflected by their use of tax concessions. Nominally, all major taxes are controlled by the central government and tax rates are uniform across regions, except for those in special economic zones (SEZs) and certain open coastal areas. Tax rates and tax bases are set by the center, and only the center has the authority to abolish old taxes, introduce new taxes, or change tax rates. For central-fixed and shared taxes, only the center can offer tax concessions and exemptions. However, under the fiscal system before 1994, the only binding constraint that a locality actually faces is the fiscal contract with the level of government directly above. As long as the locality has fulfilled the revenue target specified in the contract, it tends to use exemptions as much as possible to keep the resource in the locality, even though many of the exemptions are illegal. The rationale is that, most of the efforts made for collecting revenues above the target will benefit not just the locality, but also the center. Moreover, there is no real, implementable, punitive measure against localities' illegal tax concessions.

¹² Among the most influential studies is Hu and Wang (1994). Also see Wang (1994).

In 1992-93, a large number of localities began to offer tax concessions that were not authorized by the center. All 30 provinces and thousands of counties and townships launched their own opening up program by establishing various "zones." By mid-1993, there were 1,800 zones (including special economic zones, economic development zones, economic and technology development zones, high- and new-tech zone, special zones for Taiwanese investors, border trade zones, etc.) at and above the county level.¹³ Most of these zones were set up by the provincial or county authorities, some even set up by towns and villages. There are no official statistics about "zones" lower than the country level, but the number is expected to be surprisingly large. Most of these zones offered preferential tax policies that previously applied in the SEZs, i.e., a 15 percent flat rate on corporate income, two year tax exemption from the first profit-making year and three year 50 percent tax reduction afterwards. Some zones offer even more aggressive tax reliefs, a standard form being five year tax exemption and five year tax reduction by half.¹⁴ While tax relief policies in many of these zones were offered only to foreign investors, however, there are many others, especially those at the county and township levels, that offered the same policy to domestic investment.¹⁵

Most of these tax exemptions and reductions are not approved by the central taxation authority and are considered illegal by the center. Since mid 1992, the central government has repeatedly claimed that tax relief policies offered by these locally-approved zones must be stopped. The circular issued by the center required each province to "clean" these unapproved zones and all promises made by the localities regarding tax concession can only be fulfilled using the localities' own budgetary funds. However, not until the State Council's September 1993 adoption of a serious austerity program to cool down the economy did these measures take effects.

In addition to "zones," many areas offer tax concessions under other names. These tax concessions include legal offers made according to state regulations and those violate state regulations. The current central-provincial revenue sharing system stipulates that provinces can only offer tax exemption and reduction only on the local-fixed items, while exemptions or reductions on the central-fixed and central-local shared items are subject to approval by the center, except for those areas where special policies apply. However, these special policies are

¹³ Source: Ministry of Finance. According to PBC, 233 development zones at and above county level were proposed in Sicken Province in the first half of 1992. By the end of 1992, Tai prefecture of Zhejiang Province has established 152 development zones, among which 134 zones were under the county level.

¹⁴ Examples are the development zones in Jinin City in Inner Mongolia and Taiyuan City in Shangxi Province.

¹⁵ Example is the special zone for Taiwanese investors in Lanxi county, Zhejiang Province, which offer the same treatment to all domestic investment. The MOF does not have a estimate about how many zones offered tax relief to domestic investment, but the number is significant according to their impression.

often abused by the local governments.¹⁶ Most of localities, if attempting to offer a tax concession, can always find some regulations that are "applicable." In addition to using the centrally announce policies, many regions offer tax relief simply under the name of implementing local industrial policy, or "subsidizing enterprises that are in difficulties."

The second way in which local governments control effective tax rates and tax bases is to control the channels through which the revenue is mobilized. If the revenue is collected in the form of a tax, the rate and base is subject to central government control, and the proceeds may be shared by the center. If the revenue is mobilized through tapping local extrabudgetary funds, it is totally immune from the center government's influence. When regions shift budgetary funds to extrabudgetary funds, the center's ability to control revenues and expenditures is seriously undermined. In other words, the extrabudgetary funds are fiscal resources circulating "outside the body"—i.e., beyond the control of the central government.

Local extrabudgetary funds include the following two categories. The first is a set of taxes and charges that are controlled by local finance bureaus (not a part of the state budget), the most important of which is the public utility surcharge—a 10 percent tax on the utility bills of consumers. There are also some minor tax surcharges in this category, including the surcharge on the agricultural tax, revenues received from public housing and public property, etc. The second category includes (1) the retained earnings by local state-owned enterprises in the form of technical transformation funds, depreciation funds, and special purpose funds; and (2) various incomes of government agencies, including road maintenance fee, agricultural-forestry-water income, income of enterprises attached to government agencies, real estate management fee, and school tuition.¹⁷ Nominally the funds as specified in the second category are controlled by the enterprises, but in recent years local governments have increasingly used various fees and charges to tap state enterprises' retained earnings for government expenditures.

Between 1978 to 1990, the ratio of local extrabudgetary funds to local budgetary funds rose from 66 percent to 84 percent, indicating an increasing/declining importance of extrabudgetary/budgetary funds. In 1993, local governments' tapping local enterprise resources through ad hoc charges became so widespread that one enterprise could face more than a hundred fees and charges. The effective tax burden¹⁸ (including the burden of ad hoc fees) was as high as 90 percent in some regions. The central government had to issued several directives

¹⁶ According to the state's industrial policy, enterprises in priority sectors (e.g., electronics and export sector) meeting certain requirements can enjoy income tax holidays. For example, enterprises that export more than 70 percent of its output value can enjoy income tax reduction. For newly established collectively-owned enterprises, tax exemption applies for the first two years. Enterprises established by educational units, certain mass organizations, and social welfare units can also exempt or reduce income tax.

¹⁷ See An et al (1981).

¹⁸ Defined as (taxes + fees)/(net income).

requesting local governments to cleanse those "unwarranted" fees and charges.

As the localities controlled effective tax rates and bases under the fiscal contract system, the central government has increasingly relied on a number of nonstandard fiscal policy instruments in order to influence revenue remittance by the localities. These instruments include the following. (1) Ad hoc revision of fiscal contract. These revisions are usually at the advantage/disadvantage of provinces with revenue deficits/surplus. (2) "Borrowing" revenues from the localities. These borrowed revenues were never returned. Since 1980, this type of borrowing occurred at least twice and the amounts borrowed were added into the regions' remittance requirement. (3) Reclaiming ownership of locally-owned enterprises in high-growth industry, so that revenues from these enterprises become part of centrally-fixed revenues. (5) Forcing the localities to "buy" centrally issued bonds at artificially low prices and repeatedly extending the term of the bond maturity.

These ad hoc instruments had serious negative effects on the regions's tax collection behavior. One of the most important reactions from the regions to such ad hoc fiscal contract adjustment is the under-provision of tax effort. This conclusion is shown rigorously in a game theoretical model in Ma (1993c). In this game, the center chooses a revenue-sharing schedule (the percentages of locally-collected revenues going to the center), while the regions decide the amount of revenue to collect (the tax effort). As the center is not able to commit to its pre-announced revenue-sharing schedule, i.e., it has various ad hoc instruments to adjust the revenue-sharing methods before the terms of the contracts expire, it tends to appropriate a higher percentage of the locally-collected revenue if a region's revenue grows fast. By doing so, the center can fulfill its objective of equalizing retained revenues across regions. Knowing that the center may renege on its pre-announced policy ex post, the regions will react strategically by reducing tax efforts in the first place. This type of strategic reactions explains, at least partially, the rapidly declining revenue/GNP ratio over the past 15 years.¹⁹

¹⁹ The picture is different if the center can commit to a pre-announced revenue-sharing schedule. Given the center's commitment, the regions will not react strategically and revenue collection will be higher than in the no-commitment case. The center and the regions will both be better off under the commitment regime. But why does the center not want to commit in reality, as manifested by China's experience? It is demonstrated that the nature of the problem is that the center's pre-announced optimal policy (revenue-sharing schedule) is time-inconsistent. Before the regions have collected the revenues, the center would set a revenue-sharing schedule that encourages the productive regions to correct revenues, since the center knows that the regions will react to its policy. This schedule is likely to be favorable to the productive regions. After the regions have collected their revenues, however, the center no longer worries about the reaction of the regions and the main objective becomes equalization of retained revenues. In almost all cases, the center will find it optimal to revise the revenue-sharing schedule.

The finding of the model suggests that certain mechanisms must be found to solve the center's time-inconsistency problem. For example, the Congress can legislate that any major revision of revenue-sharing methods must go through certain complicated legal procedures. This will substantially increase the cost of contract revision and hence reduce the center's incentive to do so. At the same time, the regions' legal rights with any fiscal contracts with the center should be protected by the law. In addition,

*While revenue collection has been decentralized, the center's expenditure responsibility has not been reduced accordingly. This leaves limited flexibility for the central government to use expenditure policy.*²⁰ The major cause of this problem is that the center is still burdened "capital constructions," i.e., investments in productive sectors. These investments are mainly distributed in the energy, raw materials, transportation, and agricultural sectors. In the 1992 budget, the share of capital construction in the central government expenditures still accounted for 32.8 percent.²¹ Many of these projects produce essentially private goods. In market economies, most of these investments are made by the private sector, and some by the subnational governments. From the viewpoint of standard public finance literature, there is no rationale that the center be involved in most of these projects, at least not to this extent. While some of these investments can be justified as generating cross-regional externalities (such as roads and railways), most of them are not.

The particular reasons for the Chinese central government to take up these projects include the following. (1) Some of these projects have to be financed by the central government because the center at the same time imposes price control which makes the sector unprofitable (such as coal mining). (2) Some industries are extremely profitable but the entry to such sectors is restricted by the government (such as the electricity sector). Due to administrative entry barriers, the shortage of production capacity is severe, and the center is forced to fund projects in these sectors. (3) The center still controls the major financing channels (it controls credit allocation and restricts bond and stock issuance and the development of private banks), forming another entry barrier to many sectors such as the steel, chemical and automobile industries in which projects need large initial fixed investment. Given these barriers, the center is again obliged to provide investment to fill the supply-demand gap in the "bottleneck" sectors. (4) the political setup in China mandates that the central government has to protect the employment in the state-owned enterprises, particularly those subordinate to the central government.

It is clear that most of the reasons that explain the center's engagement in private good production are related to distortions in areas other than fiscal policies, such as planning control, price management, banking system, and most importantly, state ownership of enterprises. Obviously, the reduction of central government expenditure through decentralization can only be achieved with the coordination of reforms in these areas. For example, price liberalization

the regions should be able to resort to certain institutions when their rights are violated by the center's discretionary policy change. See Ma (1993c).

²⁰ I do not claim that the central government expenditure should be further decentralized to local governments. My point is that the central government still spends a large portion of its budgetary funds on "capital construction," which produces essentially private goods. Ideally, this function should be performed by the private sector, not by any level of the government. But various institutional factors have forced the central government to take this responsibility.

²¹ World Bank staff estimate.

would increase the incentive for enterprises and local governments to invest in many "bottleneck" sectors; removing the state monopoly in certain sectors can solve the shortage problem and ease the burden of the center; liberalizing the financial sector may channel more private funds to large projects with high initial capital investment; and privatization and a hardened budget constraint would eliminate the need for the center to subsidize many SOEs.

2.5. Impaired Performance of Central Government's Fiscal Policy

This section discusses the performance of central government's fiscal policy with the focus on its link with the central-local fiscal contract system. We will argue that with declining fiscal resources due to the lack of control over tax rates and bases, and with little flexibility in manipulating expenditures, the central government's fiscal policy has been seriously constrained in achieving goals of macroeconomic stabilization and equalization across regions.

Fiscal policy and macroeconomic stabilization. Over the past 15 years, the government's fiscal policy had played virtually no stabilization role. From Table 1 one can see that the government revenue/GNP ratio shows a rapidly declining trend with no counter-cyclical pattern, an indication of the fiscal policy's lack of stabilization role. Since the deficit/GNP ratio is often used to measure the degree of fiscal expansion, we can compare the deficit/GNP ratio with real GNP growth rate to detect the correlation between the tightness of fiscal policy with GNP growth. A fiscal policy that stabilizes the economy can be reflected by a negative correlation between the two variables. However, Figure 1, which plots the real GNP growth rates and deficit/GNP ratio between 1979-1991, shows neither positive nor negative correlation between the two indices. For confirmation, we conducted a simple linear regression of deficit/GNP ratio on GNP growth rate. The R-square of this regression is only 0.17 and the t-ratio of the slope coefficient is insignificant.²²

In reality, the management of aggregate demand has been the task of the People's Bank of China (PBC, or the central bank), not the central fiscal authority. While the fiscal authority does not contribute to the economy's stabilization, in contrast, it shifts the burden to the monetary authority in a variety of ways. Many of the unprofitable "key" projects (such as the projects in agriculture, infrastructure, and energy sector) that are supposed to be financed or subsidized by the fiscal budget, are designated to the specialized banks. In addition, the government borrows from the central bank to finance part of its fiscal deficits. The Ministry of Finance's borrowing from the PBC has increased from 27.5 billion yuan in 1985 to 124.11

²² Looking at the relationship between deficit/GNP ratio and GNP growth rate has been a standard exercise for analyzing the role of fiscal policy in macroeconomic stabilization. The methodology can be found in several textbooks including Gordon (1990) and Prachowny (1994). A referee has correctly pointed out that, ideally, quasi-fiscal lending should be taken into account when measuring the actual fiscal deficit. But simply taking the sum of the budgetary deficit and total policy lending from the central bank as the consolidated fiscal deficit is not appropriate. A reasonable measure of consolidated fiscal deficit should be the sum of fiscal deficit and the implied subsidies of the policy lending, but the data of implied subsidies do not seem to exist.

billion yuan in 1992.²³ The 1992 borrowing is equivalent to 28 percent of the total government revenue.

The central-local fiscal contract system has affected the stabilization role of the center's fiscal policy in two ways. First, the contract system has built in a tendency of declining share of the center's revenue in total government revenue, while at the same time the center has not decentralized the expenditure responsibility to a similar extent. One reason for the center's declining share of revenue explained in the previous section is that the localities react strategically to the center's discretionary policy change by lowering their tax efforts and shifting budgetary funds to extrabudgetary funds. Besides this, the revenue-sharing formulae between the center and many provinces imply that the center's revenue growth must be lower than that of the provinces' retained revenues. For example, between 1988 and 1993, ten provinces adopted type I contract named "contracted revenue increase" (see Section 2.1), which let the provinces retain a specific portion of the revenue if the revenue growth rates range from 3.5 percent to 6.5 percent. Any revenue above the 6.5 percent growth is fully retained by the provinces. Such a contract says that the share the center receives will continue to shrink as long as the provinces' revenue growth exceeds 6.5 percent. While the share of fiscal resources available to the center has fallen rapidly, the center's has retained much of the expenditure responsibilities that are supposed to be decentralized to localities and enterprises, mainly in the form of "capital construction." The center's expenditure plan is always overwhelmed by short-term objectives other than stabilization, such as financing "key" investment projects, paying wage bills for rapidly expanding government employees, and subsidizing loss-making state enterprises. The center constantly finds itself in a very difficult position in balancing various demands for expenditures, and there is very little room for using expenditure policy to stabilize the economy.

Second, the central-local contract system determines that the center's revenue is unlikely to be strongly pro-cyclical. In the 1988-1993 fiscal contract (Type 5 contract) with Shanghai, the single largest revenue source of the center's revenue, the transfer from Shanghai to the center is fixed regardless of Shanghai's actual income (see subsection 2.1). Type I contract (contracted income increase), adopted by ten rich provinces (1988-1993), yields a less than unity elasticity of the center's revenue relative to the provinces' revenue collection. Although some other provinces share revenues with the center at a fixed proportion (Type 2 contract), the provinces' revenues themselves may not be clearly pro-cyclical due to their inadequate tax efforts for reasons discussed in the previous section. As a result, revenue growth rate has not always moved in the same direction as that of national GNP.²⁴

Fiscal policy and redistribution across regions. The central government's redistributive role has been substantially weakened over the course of decentralization, mainly due to the sharp

²³ People's Bank of China (1993).

²⁴ Using data from 1979 to 1992, a simple regression of GNP growth rate on revenue growth rate shows only mild correlation between the two variables. The R-square is 0.366.

decrease of the center's fiscal resources relative to that of the provinces. As the central government's share of revenue in total government revenue fell (for reasons related to regions' tax efforts under the contract system, see the previous section), both the net transfers from wealthy provinces to the center and the net transfers from the center to the poor provinces have declined rapidly. Table 3 shows 28 provinces' intensity of net transfer to/from the center, defined by $(\text{revenue} - \text{expenditure}) / \text{revenue}$, in 1983 and 1991.²⁵ The coefficient of variations (in absolute value) of this intensity dropped from 3.05 in 1983 to 1.89 in 1991. Figures 2 and 3 plot this index for each of the provinces in 1983 and 1991 respectively, showing a clear trend of increasing fiscal autonomy, or decreasing redistribution role of the central government. Shanghai, for example, remitted as much as 88 percent of its revenue to the center in 1983, but only 47 percent in 1991. Under a system with less intergovernmental transfers, provinces (such as Guangdong) capable of mobilizing large extra-budgetary funds and foreign investments naturally grew faster than others.

For revenue surplus provinces, the center sets different revenue-sharing formulae with different provinces to achieve equalization: financially weak provinces are allowed to retain more of revenues, while the opposite is true for financially strong provinces. However, shared revenues have been growing at a lower speed than actual fiscal capacity (e.g., measured by GDP). Consequently the center finds that changing the revenue-sharing methods becomes less and less effective in addressing the problem of fiscal disparity. For deficit provinces, the central government contracted subsidies (net transfers) to them. The relative size of these transfers have been decreasing over the past decade due to the center's increasingly difficult fiscal position. For most poor regions, the center has offered in recent years fixed subsidies in nominal terms, which implies declining subsidies in real terms. In 1985, the center began to increase earmarked grants relative to contracted subsidies. Among these earmarked grants, a large part went to rich regions such as Shanghai and Guangdong, mainly in the form of price subsidies and subsidies to loss-making state enterprises. This shift further reduced the redistribution role of intergovernmental transfers.²⁶

2.6. 1994 Reform: Tax-assignment System

In the beginning of 1992, the Chinese central government initiated the experiment of tax-assignment system in nine cities in an attempt to raise the "two ratios:" the ratio of government revenue in GNP and the ratio of central government revenue in total government revenue. In the early 1994, as a part of the comprehensive fiscal reform, the central government decided to extend this tax-assignment system to all thirty provinces. The main elements of this reform are

²⁵ Revenue figures are those before tax sharing.

²⁶ I do not agree with the argument that the center provides the poor regions with less transfers because they are no longer as poor as before. All the central government officials that I have discussed with on this issue believed that the center intended to help the poor regions but did not have enough resources.

the following.²⁷

Expenditure. The division of taxes will be based on division of expenditure responsibility. The central government shall be responsible for expenditures of national defense, diplomatic affairs, the armed police forces, key construction projects, payment of principal and interests of the domestic and foreign debts of the central government, and the spending of the central government administrative departments, while other expenditures shall be undertaken by local governments.

Tax-assignment. As before, the taxes will be divided into central-fixed taxes, local-fixed taxes and shared taxes. The central-fixed taxes mainly include tariffs, consumption tax collected by customs, value-added taxes and income taxes of state enterprises owned by the central government, and turnover by railway, banks, and insurance companies, income taxes from financial institutions set up by the headquarter of People's Bank of China. Taxes collected by local governments, i.e., the local-fixed taxes, mainly include business tax (except for the turnover taxes by banks, railways, and insurance companies), income tax of local enterprises, and personal income tax. The shared taxes mainly include value-added tax, securities trading tax, and natural resources tax. The value-added tax will be divided at 75 percent for the central government, and 25 percent for the local governments. Securities trading tax, currently collected only on Shanghai and Shenzhen in the form of stamp duty, will be divided 50/50 between the central and local coffers. Natural resources tax will be mainly kept by the local governments for the time being.

One major difference between the new system and the old system is that, instead of letting the localities collect virtually all the taxes, the central government will set up its own tax collection agency, namely the national tax service, responsible for collecting both the central-fixed taxes and the shared taxes. The local tax service will collect only the local-fixed taxes.

It is stated as an objective of this reform that the center will gradually control over 60 percent of total revenue, of which about 40 percent will be the expenditure of the central government. The other 20 percent will be allocated to local governments through earmarked transfer grants.

Tax bases and tax rates. The bases and rates of various taxes are adjusted substantially in the new system. The tax reform will cut income tax rates for large and medium sized state-owned enterprises from 55 percent to a uniform 33 percent. This rate will be applied to all types of enterprises regardless of ownership.²⁸ The number of commodities that will be subject

²⁷ See "Vice Finance Minister Xiang Huicheng Speaks on Reform in Tax-Assignment System," People's Daily, November 23, 1993.

²⁸ However, this reduction will not significantly change the effective income tax rate for the SOEs. According to one estimate, the effective income tax rates (as implemented in the contract system) were about 32.5 percent. (Private Correspondence with staff of the Ministry of Finance).

to VAT will be substantially enlarged, and for most products the VAT rate will be 17 percent, a rate higher than those applied before. A sales tax of 3 to 5 percent will be applied to firms in the service sector, such as entertainment, food, insurance, financial and transport firms. A consumption tax will be levied on a dozen items, including cigarettes, liquor and gasoline. Tax on personal incomes will be progressive, beginning at 5 percent on salaries of 800 yuan a month and rising to a maximum of 45 percent. Foreigners and Chinese will be taxed at the same rates. The new tax system also introduces five additional categories of taxable income, including income from property transfer, freelance writing, gains from real estate and stock transaction, inheritance and donations.

Transitional arrangement. The current reform will be carried out in a progressive way. The vested interests (retained revenues) of the local governments under the old system will be guaranteed over the next two years' transition. The center will increase its revenue only from the increased shared revenues, mainly from the VAT. The retained revenues of a province in 1993 will be used as the base figure to calculate central government transfers in 1994 and 1995. If a province retains less in 1994 and 1995 than it did in 1993, the center will return the difference to the province.²⁹ The center also promises not to shift new expenditure responsibility to the localities.

The adverse reaction of the localities to this transitional arrangement (which was announced in November 1993) was to collect revenues as much as possible in order to increase the base for retained revenues over the next two years. Some localities have urged the local banks to make loans to enterprises to pay previously unpaid taxes. Some localities even collect taxes in advance, i.e., collect part of 1994's tax due. The last quarter of 1993 witnessed an increase in total revenue collection by 40 percent compared to the same period of 1992.³⁰ The central government believed that this type of excessive taxation for the purpose of bidding up the quota for future retention would increase the burden of the enterprises and reduce their growth potential. The center threatened that if the localities collect excessive taxes or collect taxes in advance, a circular would be issued to stop such practice and the regions' base figure would be recalled, the income confiscated, and those officials involved would have to take the blame.

2.7. Implications of the 1994 fiscal reform and the remaining problems to be addressed

It is still early to assess the overall consequence of the 1994 fiscal reform. However, a number of implications regarding the central government's ability to use fiscal policy are clear based on our analysis in the previous sections. This section briefly discusses the following questions: to what extent has the new reform addressed the problems arising from the center's lack of fiscal policy instruments? What are the remaining problems to be addressed?

²⁹ Conversation with Li Tianting, Vice Governor of Yunnan Province, and Yao Xitang, President of Pudong Development Academy. To be confirmed with MOF.

³⁰ Conversation with Mr. Yao Xitang, President of Pudong Development Academy, Shanghai.

1. *The new system will, to a large extent, eliminate the localities' de facto control over effective tax rates and bases, and provide the center with tax policy instruments immune from localities' strategic reaction.* Under the old contract system, the localities performed most of the tax collection function and then shared revenue "upward" with the central government. This system gave the localities an important instrument to play a game with the center: the tax collection effort. The localities therefore had substantial bargaining power in the center-local negotiations since they could react to the center's policy strategically by changing tax efforts and shifting budgetary funds to extrabudgetary funds. Mainly for this reason, the outcome of the contract system has been much less predictable than the center originally expected. In the new system, the national tax service will collect the shared revenue and then share the proceeds "downwards" with the localities. Since the center collects and controls the shared-revenues, the regions' strategic reaction by reducing efforts to collect the shared revenue will no longer exist. In other words, by centralizing the revenue collection of the shared revenues, the new system will eliminate an important source of the regions' incentive problem.

The 1994 reform is an important step moving the fiscal system towards a rule-based system from the current discretionary system, for there will be no more one-to-one contract negotiation. In the new system the ratio of revenue-sharing will be gradually unified across provinces. The fiscal gap will be addressed mainly by central government grants, which are, at least nominally, under the control of the center. The new revenue-sharing formula of 75 percent (center) versus 25 percent (localities) will substantially increase the center's share in total government revenue. With an effective control over revenue collection and an increasing share of resources available for intergovernmental transfers, the center will gain more flexibility in using tax and expenditure policies to achieve goals of stabilization and regional equality.

2. *Future reform should proceed in the direction of establishing rules for intergovernmental fiscal relations through national legislation rather than administrative intervention.* So far, the division of tax powers and expenditure responsibilities has largely determined by the central government, rather than through legislation of the National Congress. This allows the central government to frequently change the rules in its own interest. Without a commitment to a stable division of powers, the regions react strategically to expected policy changes, thereby leading to a very unpredictable outcome. In contrast to the case of China, local autonomy in many federalist countries and even unitary countries such as Japan has been guaranteed by the Constitution. The post-war Constitution of Japan has a chapter on local self-government. The chapter states that regulations concerning organization and operations of local public entities should be fixed by law in accordance with the principle of local autonomy.

Normally, the constitution cannot specify details of tax and expenditure assignment to each level of government. This task is left for laws on local taxation, such as the Local Finance Law in Japan and Local Tax Law in Korea. Among many laws regarding fiscal issues, Japan's Local Tax Law has been the main piece that governs the division of taxing power and expenditure responsibilities between the central and local governments. The rules specified in these laws have ensured the stability and predictability of local budgetary expenditure. They have also protected local governments from arbitrary burden-sharing requirements that might

otherwise have been imposed by the central bureaucracy. In addition, these rules have helped to develop local governments' trust in the national government. Once the tax and expenditure assignment are written in laws, they cannot be easily altered at the central government's discretion. This provides the central government with a device of commitment to a stable intergovernmental relation. With such a commitment, the local governments' behavior in taxation and expenditure become more predictable, as strategic reactions to possible changes in the central-local fiscal arrangement are eliminated. A predictable pattern of local fiscal behavior will, in turn, contribute to the central government's capacity of macroeconomic management.

3. Institutional protection of local autonomy should be established. A legal definition of the central-local fiscal relations is not sufficient to guarantee its strict implementation. Institutions representing the interests of the local governments in the national political arena must be established to counteract the strong tendency of central government agencies to appropriate fiscal powers from the localities. In Japan, this task is performed successfully by the Ministry of Autonomy. The local governments, although of a large number, normally do not have the incentive and the capacity to seek protection of local autonomy. This problem is mitigated once the Ministry of Autonomy, whose sole task is to protect local autonomy, is instituted.³¹

There are some doubts about how much the Ministry of Autonomy can do: since the Minister of Autonomy is appointed by the Prime Minister, can the Minister of Autonomy resist the pressure from the Prime Minister who may be favoring a proposal of centralization? This concern is certainly legitimate, but there exist mechanisms to prevent this from happening. The local governments, whose interests are represented by the Ministry of Autonomy, have the incentive to protect the Autonomy Minister once he/she is threatened by the top government leaders. The local leaders can express their concerns through direct communications with the Prime Minister, or through the local representatives in the national assembly. In other words, the Ministry of Autonomy is a representative of the localities when it negotiates with other ministries; at the same time it is backed by the local governments when facing threat from the Prime Minister. A stable equilibrium of power division can therefore be achieved.

4. Division of tax bases according to ownership is not desirable. For the purpose of minimizing revenue redistribution during the transition, the central government decided to retain the current division of fixed revenues from enterprise income taxes by ownership. As in the old system, the central government receives the income taxes from the centrally-owned enterprises, and the localities receive income taxes from the locally-owned enterprises. This division has two major flaws. (1) The income of the locally-owned enterprises is a large and dynamic tax base. Without a claim on the local enterprises' income tax, the center loses an important instrument in affecting enterprise behavior nationwide. For example, a progressive income tax on all enterprises may provide the center with an automatic stabilizer; and income tax credit on these enterprises during recession may be used as a stimulus to the economy. (2) The center will be tempted to reclaim the ownership of some local firms whenever its fiscal resources seem to be

³¹ See Ma (1994).

inadequate. This temptation will trigger a regions' incentive problem similar to that caused by contract renegotiation (see Section III). Without the center's commitment not to reclaim the ownership of any local enterprises, regions with well managed and profitable local enterprises face a high probability to be a victim. Recognizing this, regions may intentionally under-invest in these enterprises or underreport the profits in order to reduce the chance that their local enterprises' ownership be confiscated.

5. The division of expenditure responsibility is yet to be clearly defined. According to the reform plan, the expenditure responsibility is only divided into two broad categories, the center's and the localities'. However, in reality, there is substantial overlapping of expenditure responsibility between the center and the localities. The center has exercised discretion in assigning responsibility to regions when it faces fiscal difficulties. Regions have taken advantages of the center's involvement in most productive sectors by intensely lobbying for grants. The lack of a clearly defined expenditure responsibility has created incentive for both the center and the localities to direct more resources to bargaining. In addition, if a region that has a faster growing local revenues than others be assigned more expenditure burden by the center, this could become a disincentive for the region's tax collection.

6. The new system will be more transparent if the localities are allowed to determine the bases and/or rates of local taxes. The planned tax assignment system designates a number of local-fixed taxes to the localities, but the tax bases and tax rates are still determined by the center. From the viewpoint of the fiscal federalism literature, this is not an efficient decentralized system in which the localities can determine their optimal level of tax burden and level of public services in accordance with local conditions. Nevertheless, the localities in China may choose to vary their tax efforts to adjust the effective tax rates and tax bases. Since the enforcement of unified effective local tax rates and bases is difficult anyway, as manifested by the past experience under the contract system, the center's nominal control over local tax rates and bases only weakens the system's transparency, predictability and stability. We suggest that the center renders the tax power for local-fixed taxes to the localities. The center, as long as it controls an appropriate share of total fiscal resources and the instruments of intergovernmental transfers, has no reason to worry about the loss of control over local tax rates and tax bases. In contrast, the autonomy of localities in determining their local tax policies may enhance local welfare through establishing a tax structure well suited the local residents' preferences, industrial structure and technologies, and market conditions.

Between the federal system in which local governments have the rights to determine local tax rates and tax bases and the system adopted by many unitary countries in which local governments act only as tax collectors of the centrally determined local taxes, the Japanese system provides a somewhat intermediate case that reconciles the needs for central government control and local autonomy. Under the Japanese system, the central government sets fixed tax rates for a number of local taxes, and provides ranges for some other local taxes. The local governments and local assemblies are given the authority to propose new taxes and most of these proposals are approved by the center. The major advantages of such an arrangement are as follows: (1) by keeping uniform rates of certain local taxes and maintaining the right to approve

new taxes, the center can avoid or mitigate the problems of excessive local taxation by some local "leviathan" governments or inadequate taxation due to regional tax competition; and (2) the localities are given some flexibility to choose tax rates and bases according to their local conditions, including income levels, the preference of the local residents, and resource endowments.

7. How to design intergovernmental transfer is still an unaddressed question. According to the reform plan, the center will transfer about 20 percent of its revenues to the localities through central government grants. According to the Ministry of Finance, the Australian and the Canadian grant systems are being studied as potential models. However, no detailed plan of such transfers has been announced. We believe that, this is one of the most interesting areas that deserve more attention and careful research. A number of questions require serious answers: (1) What is(are) the objective(s) of the intergovernmental transfer? If one of the objectives of the transfer program is to address the problem of underprovision of local public services due to externality, what are these externality problems? (2) What types of intergovernmental transfer will be used to address each of the stated objectives? (3) If the objectives include equalization and reduction of the fiscal gap, how to measure fiscal capacity and expenditure needs in practice? If the formulae for such transfers are improperly designed so that it awards regions that exercise low local tax efforts, the system may provide disincentive for the localities to collect local taxes as before.³²

The experiences from most federalist countries show that a uniform and transparent formula for allocating central government grants to the localities is important for reducing wasteful lobbying activities and for encouraging local tax efforts. In addition, with a well designed formula, an increase in local tax revenue will reduce transfers from the center by less than the same amount, thus preserving the localities' incentive to collect local taxes.

³² Ma (1993c) provides an extension of the central-local fiscal game model to the "downward" revenue-sharing case.

Table 1. Ratio of Government Revenue to GNP and National Income, 1978-1992
(yuan billion)

Year	Government Revenue		Government Expenditure		Revenue/ GNP ^a (percent)	Deficit ^b	Deficit/ GNP (percent)
	Chinese Definition	Standard Definition	Chinese Definition	Standard Definition			
1978	112.1	124.8	111.1	123.8	34.8	-1.0	-0.3
1979	110.3	126.7	127.4	147.4	31.7	20.7	5.2
1980	108.5	130.1	121.3	147.1	29.1	17.0	3.8
1981	109.0	130.2	111.5	140.1	27.3	9.9	2.1
1982	112.4	140.9	115.3	152.3	27.1	11.3	2.2
1983	124.9	160.7	129.3	173.0	27.7	12.3	2.1
1984	150.2	184.3	154.6	196.5	26.5	12.2	1.8
1985	186.6	229.7	184.5	236.5	26.8	6.8	0.8
1986	226.0	244.6	233.1	265.6	25.2	20.9	2.2
1987	236.9	257.5	244.9	282.5	22.8	25.0	2.2
1988	262.8	280.4	270.7	315.3	19.9	34.9	2.5
1989	294.8	326.4	304.0	363.8	20.4	37.4	2.3
1990	331.3	351.5	345.2	403.1	19.6	51.6	2.9
1991	361.1	365.9	381.4	432.3	18.5	66.4	3.4
1992	415.3	368.8	439.0	483.4	17.3	114.6	4.7

Note: Standard definition of revenue means subtracting borrowing from Chinese definition and adding to the Chinese definition subsidies that were counted as negative revenue. Standard definition of expenditure means adding to the Chinese definition subsidies that were considered negative subsidies.

^a revenues using standard definitions.

^b expenditures minus revenues using standard definitions.

Source: McKinnon (1993) and State Statistical Bureau (1993).

Table 2. Change of Central-Local Relative Fiscal Status, 1981-1992

Year	Revenue ^a					Expenditure				
	Total (Y bil)	Central (Y bil)	Local (Y bil)	Central (%)	Local (%)	Total (Y bil)	Central (Y bil)	Local (Y bil)	Central (%)	Local (%)
1978	112.1					111.1	51.0	60.1		
1979	110.3	15.8	94.6	14.3	85.7	127.4	64.7	62.7	50.8	49.2
1980	108.5	17.4	91.2	16.0	84.0	121.3	65.1	56.2	53.7	46.3
1981	108.9	22.5	86.5	20.6	79.4	111.5	60.2	51.3	54.0	46.0
1982	112.4	25.8	86.5	23.0	77.0	115.3	57.5	57.8	49.9	50.1
1983	124.9	37.2	87.7	29.8	70.2	129.2	64.3	65.0	49.7	50.3
1984	150.2	52.4	97.7	34.9	65.1	154.6	73.9	80.8	47.8	52.2
1985	186.6	70.8	115.9	37.9	62.1	184.5	83.7	100.8	45.3	54.7
1986	226.0	91.7	134.4	40.6	59.4	233.1	96.2	136.9	41.3	58.7
1987	236.9	90.6	146.3	38.2	61.8	244.8	103.2	141.7	42.1	57.9
1988	262.8	104.6	158.2	39.8	60.2	270.7	106.0	164.6	39.2	60.8
1989	294.8	110.5	184.2	37.5	62.5	304.0	110.5	193.5	36.4	63.6
1990	331.3	136.8	194.5	41.3	58.7	345.2	137.3	207.9	39.8	60.2
1991	358.3	137.0	221.3	38.2	61.8	379.4	149.7	229.6	39.5	60.5
1992	415.3	164.9	250.4	39.7	60.3	439.0	181.8	257.2	41.4	58.6

^a Revenues collected by the center or localities (before tax-sharing), not revenues available to the center and the localities after tax-sharing.

Source: China Statistical Yearbook, various issues.

Table 3. Revenues and Expenditures of Provinces, 1983 and 1991
(yuan billion)

		Revenue		Expenditure		Revenue-Expenditure	
		1983	1991	1983	1991	1983	1991
Beijing	BJ	39.84	89.77	19.61	80.73	0.51	0.10
Tianjin	TJ	38.74	58.09	20.49	47.47	0.47	0.18
Hebei	HB	36.39	99.30	28.27	97.30	0.22	0.02
Shanxi	SX	24.15	72.76	24.01	76.89	0.01	-0.06
Inner Mongolia	NM	6.99	39.40	22.83	66.62	-2.27	-0.69
Liaoning	LN	67.88	161.54	34.17	151.45	0.50	0.06
Jilin	JL	14.12	62.46	19.41	79.12	-0.37	-0.27
Heilongjiang	HL	21.56	94.74	30.71	110.07	-0.42	-0.16
Shanghai	SH	153.70	191.88	19.03	101.52	0.88	0.47
Jiangsu	JS	74.61	143.29	32.29	128.18	0.57	0.11
Zhejiang	ZJ	41.79	121.26	21.94	97.32	0.47	0.20
Anhui	AH	22.39	54.23	20.38	84.97	0.09	-0.57
Fujian	FJ	12.37	69.70	17.55	78.13	-0.42	-0.12
Jiangxi	JX	13.53	50.55	17.27	64.68	-0.28	-0.28
Shandong	SD	51.30	142.97	32.41	141.95	0.37	0.01
Henan	HN	36.49	104.73	30.06	108.32	0.18	-0.03
Hubei	HUB	40.44	95.09	28.32	99.53	0.30	-0.05
Hunan	HN	29.27	96.13	25.31	101.84	0.14	-0.06
Guangdong	GD	36.33	192.09	37.65	182.48	-0.04	0.05
Guangxi	GX	13.89	61.47	18.84	75.89	-0.36	-0.23
Sichuan	SC	41.38	148.35	36.64	162.86	0.11	-0.10
Guizhou	GZ	8.27	45.62	15.55	55.88	-0.88	-0.22
Yunnan	YN	17.17	99.78	24.03	110.82	-0.40	-0.11
Shaanxi	SAX	14.54	54.17	18.81	67.31	-0.29	-0.24
Gansu	GS	10.90	39.98	15.53	51.32	-0.42	-0.28
Qinghai	QH	1.54	8.79	7.39	18.23	-3.80	-1.07
Ningxia	NX	1.78	8.30	6.95	17.20	-2.90	-1.07
Xinjiang	XJ	5.63	26.47	18.61	52.53	-2.31	-0.98
Mean		31.32	86.89	23.01	89.66	-0.37	-0.19
S.D.		18.43	48.39	8.34	41.89	1.13	0.36
C.O.V.		0.59	0.56	0.36	0.47	-3.05	-1.89

Note: Revenue means total revenue collected by a province before tax-sharing. It does not include transfers from

((0))

the center, nor exclude its transfer through tax-sharing to the center.

Expenditure means total occurred in this province. It equals local revenue collection + transfer from center - its transfer to the center.

S.D.: standard deviation; C.O.V.: coefficient of variations.

Source: Ministry of Finance (1988) and (1992).

Figure 1. Deficit/GNP ratio and Real GNP Growth Rate

Figure 2. Intensity of Net Transfers from/to the Center: 1983

Note: See Table 3 for abbreviations of the provinces.

Figure 3. Intensity of Net Transfers from/to the Center: 1991

Note: See Table 3 for abbreviations of the provinces.

III. Monetary Management

As mentioned in the previous sections, fiscal policy in China has virtually played no role in stabilizing the economy since the central fiscal authority has faced increasing fiscal imbalance and was overburdened by other objectives. During the course of the decentralization, the main task for macroeconomic control has been performed by the monetary policies. Unfortunately, the monetary policy has not functioned well enough: it has failed to stabilize the economy when necessary, and in many occasions, it became the cause of macroeconomic instability. Repeated inflationary pressures occurred during the 15 year reform period, with retail price index shooting up to 18.7 percent in 1989 and 14.5 in 1993. At the same time, output has also fluctuated significantly and frequently.

This section argues that the central bank per se is not to be blamed for the excess monetary growth that created repeated high inflation, rather, the institutional features of the current central-local monetary relations generate this result endogenously. A central-local monetary game is presented as a theory to explain how regions take advantage of the central bank's lack of commitment to a pre-announced credit policy by forcing the central bank to revise credit ceiling upwards, thus creating inflation. This game also explains how reform cycles--the alternating of decentralization and recentralization--over the past decade could be a consequence of the central-local monetary interaction, and why reform cycles have coincided with the monetary cycles.

This section will also examine the implications of the 1994 monetary reform. This reform has addressed a number of important drawbacks of the old system that led to the central bank's weak control over money supply. In particular, the establishment of the new central bank branch system, the centralization of personnel management of the central bank branches and specialized banks, and the separation of policy lending from commercial lending are all in the right direction. Nevertheless, further reforms toward a more independent central bank, the application of indirect measures to exercise monetary control, and the elimination of various structural distortions that led to conflicts of interests between the center and the localities, will be necessary for an effective monetary management system in the 1990s.

The first and the second subsections will describe the evolution of China's financial sector development and the central monetary control under the decentralized banking system. The third subsection presents the framework of analysis, drawing some general principles from macroeconomic literature. The fourth and fifth subsections discuss how the central-local monetary interaction under the decentralized banking system has substantially weakened the central bank's ability to control money supply. The sixth subsection extends the central-local monetary game to explain reform cycles. The last two subsections look at the 1994 monetary reform and its implications for the central bank's monetary control.

3.1. Financial Sector Development Before 1994

Along with the decentralization and market oriented reforms in other aspects of the economy, China's banking system has also changed significantly since the early 1980s. Before 1983, most investments in fixed assets were direct transfers or grants from the government budget. In 1983, direct grants were replaced with interest-bearing loans to agriculture, construction, and production enterprises in an attempt to solve the soft-budget problem of state enterprises. Consequently, the banking system gradually became the primary channel through which investments are financed and the central authority exercises macroeconomic control. At the same time, the importance of budgetary expenditure in economic adjustment has declined rapidly.

Various specialized banks were created or reestablished during the 1980s. The Agriculture Bank, the Construction Bank and the Bank of China were separated from the operations of People's Bank of China (PBC, or the central bank). Each of these institutions was to provide service to a designated sector in the economy. This approach prevented competition among the banking institutions and required the prospective customers--the peasants, the industrial enterprises, and the trade or foreign-invested companies--to deal with a single institution.

China's banking system now comprises a wide variety of specialized banks. Under the PBC, the major specialized banks and non-bank institutions are: (1) the Agriculture Bank; (2) the Bank of China; (3) the Construction Bank; (4) the Industrial and Commercial Bank; (5) Rural Credit Cooperation; (6) Urban Credit Cooperation; (7) the Bank of Communications; (8) the China International Trust and Investment Corporation (CITIC); (9) Guangda Finance Corporation; and (10) the Peoples Insurance Company.

The main duty of the Agriculture Bank is to manage the budget for agriculture -- receiving deposits and extending loans to agricultural production projects. The Construction Bank manages government grants for fixed assets investment and extends loans to fixed assets investment. The Industrial and Commercial Bank receives most of the deposits from urban and rural individuals and provides working capital for enterprises. The Bank of China has primarily focused on deposits and loans of foreign exchange and international transactions.³³ It operates a global correspondent and branch network. The scope of business for the Bank of Communications is not limited to a single line of commerce and the institution offers financial services throughout the world. As an universal bank, the Bank of Communications have competitive advantages over the four major specialized banks with mandated single functions.

Many nonbank financial institutions and local commercial banks also emerged in the 1980s and began to operate and compete with the specialized banks for financial resources. The major nonbank financial institutions include CITIC, Guangda Finance Corporation, the Peoples Insurance Company, and numerous investment companies established by specialized banks and

³³ Recently, foreign exchange business were allowed in many other specialized banks, such as the Agricultural Bank, the Industrial and Commercial Bank, and the Construction Bank.

large enterprise groups. Besides these non-financial institutions, many local commercial banks located in and serving provinces or the Special Economic Zones (SEZs) have been established since 1987. Examples include Guangdong Development Bank, Bank of China Merchants (Shekou), Shenzhen Development Bank, and Pudong Development Bank. Many small private banks (Siren Qianzhang) also operate in China. These banks are the result of entrepreneurs pooling their funds and borrowing additional money to begin operations. The private banks typically pay higher interest rates on deposits than the other major institutions, and they charge higher loan rates than the major banks. Although illegal, these private banks are not officially sanctioned by the government.

China's banking system expanded rapidly during the reform period. The annual aggregate deposits, loans, and assets of the banking system grew at strikingly high rates. During 1979-91, the banking system's loan, deposit and total assets grew at the annual average rates of 19.15, 25.88, and 20.24 percent, respectively. These rates far exceeded the record of most other developing countries during the same period. For this period, total deposits increased from Y 106.3 billion to Y 1,804.4 billion, while total loans increased from Y 106.38 billion to Y 1486.4 billion. In 1991, total loans from the banking system were 4.75 times government budgetary expenditure, reflecting the rapidly increasing role of banking system in the economy.

While the increasing magnitude of the banking activities in the course of decentralization reform provided a strong stimulus to the growth of the economy, the mechanism of effective macro control over money supply is far from being well established. The weak monetary control is largely responsible for the repeated economic overheating that characterized the reform period. The next section starts the discussion on this issue with China's monetary control mechanism.

3.2. The Role of the Central Bank and Its Instruments of Monetary Control

Officially, the central bank's role is to formulate and implement the monetary policy. However, since the People's Bank of China is only a ministry under the state council, all major monetary policies, including the credit plan and the cash issuance plan, are subject to approval by the State Council. The responsibility of the central bank is therefore to carry out the central government's monetary policy and police all the financial institutions according to the financial discipline of the government.

The relationship between the central bank and specialized banks and their local branches can be described as follows:

1. All specialized banks and their local branches are subject to the control of the credit plan formulated by the central bank. The credit plan determines the credit ceiling for each specialized bank and each of its local branches; a credit ceiling defines the total loans each specialized bank and each of its local branches can extend within a year. The specialized banks use the funds they control (the deposits they obtained, their own capital, plus the amount of money they are allowed to borrow from the central bank according to the credit plan) to make

loans.

2. The specialized banks submit a certain proportion of their deposits to the central bank as the required reserve. The central bank may change the reserve rate as an instrument of monetary policy. In 1985, the required reserve ratio was 10 percent. The ratio was raised to 13 percent in 1988; and in 1992 an additional excess reserve ratio of 7 percent was applied, bringing the total effective reserve ratio to 20 percent. However, the reserve ratios were not effective because specialized banks have generally held excess reserves. In most cases, the binding constraint that the specialized banks face is the credit plan.

3. The central bank strictly controls the interest rates for deposits and lending in all specialized banks. The rates are uniform across banks, and vary according to types of projects. In accordance with the industrial policy, lending to agricultural, infrastructure and energy sectors are in general subject to low rates. The central bank occasionally adjusts the official interest rates as an instrument for demand control. However, the effectiveness of this instrument is limited since the official interest rates are often negative and the state-owned enterprises' borrowing are often insensitive to interest rates.

4. The central bank extends credit to specialized banks which fall short of funds for local loans or meeting the reserve requirement. The lending rate for such credit is occasionally used as an instrument of money supply control.

The central bank's most important instrument to control money supply is the formulation and implementation of the credit plan. Although the central bank also formulates a cash issuance plan every year parallel to the credit plan, the cash supply is in effect endogenous as long as the total credit supply is determined. In particular, the demand for cash comes largely from wage payments and agricultural procurement. The former has to do with how much money loaned, and the latter is a "hard" demand, which is not at all at the central bank's discretion. We will therefore focus on the credit plan management in the following discussion.

The overall credit plan is formulated by the central bank under the direction of the State Council and in cooperation with the State Planning Commission. The process of making a credit plan can be summarized as: "From the top to the bottom, then from the bottom to the top." The first phase (from the top to the bottom) is a process of formulating the credit plan starting from the central bank. The money supply is calculated by the central bank according to the need of economic growth, price level and other factors like velocities of money and the monetization process. The tentative credit plan includes the total size of new loans and the allocation of the total credit among the specialized banks. The central bank then informs the specialized banks of this tentative plan and asks them for feedback. The headquarters of specialized banks allocate the quotas and required deposit targets to their provincial and regional branches. Then the provincial and regional specialized banks make their own plans.

The next phase is from the bottom to the top. The provincial branches of the central bank summarize the deposit and credit plans of all local specialized bank branches and formulate

the provincial plans for deposits, loans, and cash issuance. All provincial branches of the central bank submit their plans to the headquarter. The central bank headquarter revises its original plan and finalizes the overall credit plan. Once the plan is approved, it becomes the yardstick according to which the monetary policy is conducted.³⁴

3.3. Framework of Analysis

Macroeconomic theories have generally agreed on several important principles for an effective monetary management system in a large country with a multilevel government.³⁵ These principles can be applied in this section to analyze the China's monetary system and to develop policy recommendations. The principles that are most relevant to China's context include the following:

1. *Monetary policy instruments.* Monetary policy instruments should be concentrated in the hand of the central government. This is based on the notion that stabilization is a public good that benefits all members of the nation. In developed market economies, these instruments mainly include open market operations, legal reserve requirement, and discount rates. In some less developed countries like China, the main monetary instrument could be the direct control of credit.

2. *Separation of fiscal and monetary functions.* Fiscal policy should be separated from monetary policy. The central bank should mainly focus on fighting inflation, and should not be forced by the central government to serve a quasi-fiscal function. Otherwise, large amounts of policy-oriented loans will inevitably lead to inflationary pressures. This separation of fiscal and monetary functions can be achieved by granting the central bank independence from the central government.

3. *Rules rather than discretion.* Some mechanisms should be found to ensure that the central government's pre-announced monetary policy is credible. In the absence of the central bank's credibility, the strategic reaction of economic agents (firms or regions) will lead to a suboptimal outcome which is often characterized by lower welfare and high inflation.

These conclusions will be used in assessing the Chinese monetary system described in the previous sections.

3.4. Does the Central Bank's Monetary Policy Stabilize the Economy?

Since 1979 the Chinese economy has experienced a number of significant cycles. Two features of these cycles are notable. First, the cycles tend to be frequent. Between 1979 and

³⁴ See Yi (1992) for a detailed description for this process.

³⁵ See Kydland and Prescott (1973), Alesina and Summers (1992), Bomfim and Shah (1991b), and Ma (1994d).

1993, there were three expansions and four contractions in terms of GNP growth (see Figures 2)³⁶. Second, the magnitude of price and output fluctuation is large, compared to developed countries and China's past experience in general. In 1988, the retail price index went up by 18.7 percent, while the lowest price increase was 2 percent in 1983. Variations in output is also significant. The peak of GNP growth rate during the period of 1979-1993 reached 14.5 percent in 1988 while the trough was about 4 percent in 1989.

The output and price movements are largely created by fluctuation in money supply, rather than exogenously supply or demand shocks. The positive link between money supply and output growth is particularly clear, as pointed out by a number of articles (Walker, 1990; Feltenstein and Ha 1991, and Chen et al, 1992, etc). The price change is also positively correlated to money supply, but to a lesser extent. This is because some of the short term price increase, such as that at end-1988, were partly created by the consumers' expectation of price increase due to the government announcement of immediate price reform. Once the expectation of price increase is high, consumers rush to purchase consumer goods, and the velocity of money increases sharply. Nevertheless, some econometric analyses show that the long run relationship between price movement and growth of money supply in China is still rather clear (Chow, 1987).

The central bank's money supply decision seems not have stabilized the economy, rather, in most cases, were causes of the economic cycles. During all periods of economic overheating, the credit and cash issuance plan were not strictly adhered to, and were repeatedly revised upwards by substantial margins. When inflation rises to a level where political instability becomes obvious signals, the central authority turns to sharply reduce the credit and cash issuance. The economy then enters a period of recession. This type of stop-and-go cycles has been a stylized feature of the Chinese monetary controls over the past decade and a half, and has been well documented in the literature.³⁷

Many economists have analyzed the cause for China's economic cycles. Several explanations prevail. (1) Excessive investment. This is a opinion often heard from government officials and economists: excessive investment leads to excessive demand and creates inflation. However, it is easy to see from standard macro theory that excessive investment is only an indicator of economic overheating, rather than the cause. The question is, what caused the high growth of investment? As long as the central bank can effectively control money supply, where comes the excessive investment? (2) Excessive consumption. Many argue that enterprises, particularly state-owned enterprises, tend to pay their workers excessive wages and in kind benefits. According to them, these enterprises use various tricks to circumvent the government imposed restrictions on wage and bonus growth; in many of the overheated periods, wage

³⁶ An expansion (contraction) is roughly defined as a continued increase (decrease) in GNP growth (over the same period of last year) for four consecutive quarters.

³⁷ See The World Bank (1990) for a detailed description of China's money supply fluctuation during 1980-1989.

growth rate was higher than productivity growth, which caused inflation. This argument, similar to the one of excessive investment, has pointed to a result of the economic overheating, rather than the cause. Again, if the money supply is strictly controlled, there would not be an excessive wage growth. (3) Bad decision making of the central bank in term of money supply. This "bad decision" argument gets closer to the answer, but does the central bank understand that? If the central bank knows that the a high growth of money supply causes high inflation, why has it repeatedly failed to control the money supply at the desired level?

Our hypothesis is that the central bank's money supply decision is largely endogenous given the current institutional setup in China. Although a modest monetary growth may be optimal to the central bank in an ideal environment, it is not so when it faces various institutional constraints inherent in the system. In other words, the central bank itself should not be blamed for the excessive monetary growth we observed over the past years, rather, the suboptimal result is an equilibrium outcome of the Chinese monetary institutions. Without changing certain institutional arrangements, money supply generated economic instability will be likely to continue. The next section presents a theory that explains how excessive money growth is generated in a central-local monetary game.

3.5. Why Cannot the Central Bank Control Money Supply at the Desired Level: A Central-Local Monetary Game

As we mentioned above, the central bank may well understand that excessive money growth leads to a high inflation, so it does plan to control the total money supply at a desirable level. This intention can be seen from the comparison of the planned total credit target and the actual credit extension, as well as the comparison of planned cash issuance and the actual cash issuance. In many years, except those of recession, the planned targets were well below the actual figures (See Tables 4 and 5). In other words, the pre-announced credit targets and cash issuance targets were repeated revised upwards during the course of implementation. This indicates that although the central bank knows that a modest level of credit and cash growth rate is desirable when it makes the annual plan, there exists some mechanism that induces (or forces) the central bank to deviate from its pre-announced money supply decision.

We will argue that the credit ceilings are not respected because of a "monetary game" being played between the local banks (local branches of the specialized banks) that represent the interests of the localities and the PBC.³⁸ To see how this game can generate credit plan revisions, we first must state the five main institutional features of the current Chinese monetary system:

- (1) *The local banks represents the local governments (the regions).* Under the current

³⁸ For the full modelling of this game, see Ma (1993d).

decentralized Chinese system, the local banks are in effect controlled by the local governments. Although the appointment of a local bank governor is officially made by the central bank, the central bank has to consult the local governments before such an appointment. Evidence suggests that local governments provide enormous incentive for the local banks to allocate credit in the interests of the localities instead of those of the center.³⁹

(2) Under a decentralized banking system, *the local banks have the authority to allocate credit across projects (policy oriented or commercial oriented projects) within its jurisdiction.* That is, the policy lending function and the commercial lending function are mixed.

(3) The central bank determines a credit ceiling for each region. The region is not allowed to make loans exceeding the ceiling, but *the central bank can revise the credit plan.* That is, there are no legal procedures that restrict the central bank to revise its credit plan.

(4) *The existence of structural distortion.* These distortions include government imposed priced control in some sectors, administrative and financial barriers to entry in some sectors, and the regions' ignorance of externalities of some projects. These distortions result in low profitability or high entry barriers to certain sectors, such as the infrastructure, agriculture, and energy sectors.⁴⁰

As a result of the structural distortion, there are two types of projects in the economy. For expositional purpose, we call the first type of project the high yield project. The processing industries are an example of this type of project. The second type is called the essential project. Examples of essential projects include those in the agricultural, infrastructural and energy sector. The high yield projects are in general more profitable than the essential projects.

(5) *The lack of independence of the central bank.* The central bank is a minister under the State Council, so the central bank's objective is the same as the central government's objective. The central bank is not allowed to behave more "conservatively" than the central government. In the following discussion, the phrase of "center", "center bank" and "central government" are used interchangeably.

³⁹ Officially a provincial bank governor is appointed by the central bank, but such an appointment should be made upon consulting the provincial authority. In reality, there has never been a case where the central bank successfully appointed a local bank governor without the province's consent. A local bank governor, if performing in the interests of the province, often receives significant award by the provincial authority in the form of future promotion in the province. For example, a number of governors of provincial PBC branches were promoted to be deputy governors of the provinces after they have finished serving their terms in the banks. In addition, the local banks rely on local governments for the supplies of office facilities, staff's housing and utilities, children's education and other staff benefits (personal correspondence with PBC staff).

⁴⁰ Ma (1989) provides a detailed discussion on these structure distortions.

Under a decentralized system, the regions have the authority to allocate the credit and cash allowance across projects. They can therefore use this allocation to play a game with the central bank. The regions choose investment projects based on market values, i.e., they favor high yield projects rather than the essential projects. Unlike the regions, the center values different projects using shadow prices, so it tends to favor the essential projects more than the regions do. Knowing that the center values certain essential projects and *the center has the flexibility to revise the credit ceiling ex post*, the regions purposely under-invest in the essential projects and create pressures on the center to grant additional credit allowance.

It is shown rigorously in my model (Ma, 1993d) that if the center can commit to the pre-announced credit ceiling, the regions will restrict themselves from distorting the investment structure. The reasoning is that doing so would not induce additional credit. Therefore, under a system of the center's commitment, the total credit supply and inflation will be lower compared to the case of no-commitment. The interesting question is, knowing that a commitment to the pre-announced credit plan can improve the outcome, why does not the center commit? This is because after the regions have allocated the initial credit ceiling in the distorted way, the central bank will always find it optimal to grant additional credit to correct the distorted investment structure. Without some externally imposed restriction that prohibits the central government (bank) from revising credit ceilings, the only equilibrium of the game is "credit ceiling revision, high credit supply, and high inflation."

There are many anecdotal stories that reflect the spirit of this game. The famous story of "white notes" is an example. By the end of every year, many provinces reported to the central bank that they used up all the credit allowance and had no money to purchase grain. They had to issue "white notes"--IOUs--to the farmers in exchange for grains. This practice caused strong resentment from the farmers. To redeem the IOUs, the center was forced to offer additional credit to these regions. By the end of 1992, there were several accounts of regional unrest among farmers in a number of provinces, partly due to local governments' "white notes" issuance. This worried the central government a great deal, and the State Council vowed to "never allow the local governments to issue white notes again." Unfortunately, recently there were new accounts reporting that such practice reoccurred in 1993's grain procurement.⁴¹

By analyzing the structure of the game, several institutional factors that are responsible for these stylized facts can be identified. Two of them are most important. First, the conflict

⁴¹ Similar practices are used by enterprises to induce (force) the local banks to extend additional loans. Many enterprises divert loans designated for working capital to fixed investment. After these investments are made, they come to the bank to request additional loans for working capital. The shortage of working capital may immediately endanger the continuation of the firms' operation, and the bank has no choice but to give more loans. In other cases, many firms divert loans reserved for wage payments for long-term investment, and then ask the bank for additional loans for wage payments. Facing these pressures, the government, which cares about "stability," is forced to make additional loans. Through the local governments, these demands from the enterprises are transferred to pressures on the central bank.

of interest between the central and the local governments is the fundamental source of excessive credit supply. This conflict of interest arises because the center and the regions value the investment projects differently due to various structural distortions. Under a decentralized system, this conflict causes a biased investment structure and consequently imposes pressures on the center for granting additional credit to the underfinanced "essential" projects. Second, the lack of credibility of the central government also contributes to the suboptimal outcome. Since the center is unable to commit to the pre-announced credit ceiling, the regions strategically take advantage of this lack of commitment by distorting the investment structure even further in order to obtain additional credit or cash allowance from the center. In the game, the center's lack of commitment to a fixed credit plan yields a higher inflation rate.

The positive analysis of China's monetary cycles gives rise to some normative implications regarding to institutional reform. By changing the institutional features of the monetary system, i.e., changing the rules of the games, the outcome will be very different. Carefully examining the roles of the institutional features mentioned above gives four major policy implications:

(1) Accepting the fact that regions value projects differently from the center, increasing the center's cost of revising credit plans will help reduce the regions' incentive to distort the investment structure, and hence bring down the inflationary pressure. This cost increase can be realized through legislation which complicates the administrative procedures required for a revision of the credit plan. In addition, an independent central bank which is more conservative (more inflation hating) than the central government is likely to restrict itself from excessive credit expansion.

(2) Eliminating structural distortions is one of the fundamental solution to the problem. This will resolve the conflict of interest between the center and the localities caused by price control. When macroeconomic conditions permit, continuing price reform should be one of the government's priorities. Eliminating various administrative and financial barriers to entry to the essential sectors should also be a part of the reform plan. Nevertheless, reasons that are not easy to deal with, such as cross-regional externalities, may still cause different objectives between the region and the center in selecting projects.

(3) In the presence of the conflict of interest between the center and the regions, recentralizing policy lending (lending to "essential" projects) from the localities may be necessary. By doing so the center can avoid the investment distortion that would have arisen had the credit allocation been made by the regions. However, this requires that the central fiscal authority bears more burden downloaded from the banking system.

(4) Separating local banks from local governments. Under the current system, most local bank branches are subject to controls of local authorities who value only local output value. Under these pressures, the local banks are representatives of the local governments to request as high a credit ceiling as possible. To reduce the intervention from local governments on local banks, two options can be considered. First, direct supervision of the central bank over its local

branches should be strengthened. Personnel arrangement, provision of necessary working facilities and staff benefits of the local banks should all be the responsibility of the central bank. Secondly, the current system that each province has its PBC branch should be changed into one where each PBC covers a few provinces.⁴² This arrangement may effectively reduce the influence of provinces on local PBC branches.

In 1992 and 1993, in addition to the "monetary game," a new problem emerged and contributed to the excessive monetary growth. Many specialized banks found ways of funnelling funds out of the state banking system, and thus avoided the ceilings altogether. In 1992, the growth rate of credit channelled through the state banking system was 20 percent, M2 (including cash, demand deposits, and time deposits) growth reached 31 percent mainly because the growth of lending by non-bank financial institutions (NBFIs—including trust and investment companies, urban cooperatives, rural cooperatives, finance companies) went unchecked. It seems that while reporting that the specialized banks were lending to the inter-bank market, they in fact channelled substantial funds to enterprises through NBFIs. This problem can be precisely described as one that the central bank failed to enforce its regulation that non-bank financial institutions are not allowed to deal with savings and loans.

3.6. Reform Cycles: Another Consequence of the Central-Local Monetary Game

Over the past decade, along with the monetary cycles, China also experienced a number of reform cycles. A reform cycle can be roughly described as a process in which decentralization is followed by recentralization, and recentralization followed by another round of decentralization. Interestingly, the reform cycles have in general coincided with the monetary cycles: a monetary expansion was usually accompanied by a wave of decentralization, while a period of monetary contraction was also a period of recentralization. Unlike many China observers who believe that the political struggle between reformists and conservatives determines China's reform cycles, I propose here an economic explanation of why reform cycles occur and why they coincide with the monetary cycles.

Under stable macroeconomic conditions (typically with low inflation), the central government's main concern is how to increase economic growth rate. Deng Xiaoping's call for rapid development in 1992 was a recent example. The intention for rapid development is quickly translated into decentralization which increase the localities and enterprises' autonomy as well as the incentive to expand local output. The decentralization measures include rendering more fiscal power to the localities, giving more authority to localities in project approval, credit and material allocation, and letting firms retain high shares of profits, reducing restrictions on firms' pricing and wage setting, giving more firms importing and exporting rights, etc. On one hand, with relatively better information at the local level, the localities can select and approve projects more efficiently than the center. Probably the management and operation of local

⁴² This setup is similar to the US Federal Reserve System under which 12 Regional Federal Reserve Banks do not belong to any states. Instead, each serves a number of states.

projects are also more efficiently conducted by local officials than by centrally designated ones. On the other hand, however, with the existence of the structural distortions, these decentralization measures allow the localities to play the game with the center, and consequently force the increases in credit and cash supply as well as government expenditure from the budget system (the same logic as credit plan revision). The increase in money supply inevitably leads to high inflation. Once faced with high inflation, the central government's first priority shifts from economic growth to maintaining economics and political stability. Because of the slow functioning or simply the nonexistence of indirect macro control measures (such as discount rate, open market operation and reserve ratios), the most convenient and efficient option for stopping inflation is to recentralize many of the powers that had been delegated to the localities and the firms.

This "monetary cycle led reform cycle" theory is confirmed by many accounts during the last few years. The 1987 expansion was accompanied by significant decentralization in most of the areas mentioned above. When inflation surged to 18.7 percent in 1988, the central government decided to reimpose controls over many freed commodity prices, to recentralize credit allocation rights, to force the regions to cut fixed assets investment by 20 percent uniformly, and to freeze wages in the state and collectively owned enterprises. As a result, inflation was brought down to 2 and 3 percent in 1990 and 1991 respectively, but GNP growth also dropped to 4 percent in 1990 and picked up only moderately to 7 percent in 1991. As inflation seemed not to be a pressing concern, 1992 witnessed another round of substantial decentralization, during which the central government allowed most provinces to render the provincial level project approval rights to the county level governments. A large number of commodity prices were also freed from government control, and firms are given more leeway in determining wages and bonuses. Supervision over banks' operations were also loosened, and consequently local banks poured a large amount of funds into real estate and the stock markets. When retail price index again rose to nearly 20 percent in 35 major cities during the first six months of 1993, the center government decided to launch an austerity program. While some of the policies were indirect measures,⁴³ many of them were still administrative recentralization. These administrative measures included: requiring the local governments to sell their allotted state treasury bonds by July 15; ordering banks to recall loans and ensuring they do not surpass loan limits set by the central bank; freezing most automobile imports for the next half year; dispatching work parties from Beijing to ensure the measures are being carried out; and ordering banks to retain sufficient funds to pay for this year's harvest. By the end of the 1993, the government reportedly announced measures to recontrol wage payments and the prices of 17 major commodities.⁴⁴

⁴³ These measures include: restabilizing the yuan by selling US dollars in the swap market; and raising bank interest rates on deposits, which fell far below the stock and bond returns and the black market rate.

⁴⁴ In October 1993, the government announced it is re-establishing control over company payrolls, apparently in an effort to reduce wage increases. According to the announcement, all enterprises, no matter whether state-owned or not, must submit their payroll budgets to local government labor

The implication of the above analysis is that without changing the institutional features of the current monetary system, the monetary cycles will be an inevitable phenomenon, and consequently reform cycles will continue to occur. Reforms in areas mentioned in subsection 3.4 are urgently needed if the monetary system is to play a stabilization role.

3.7. Monetary Reform in 1994

Recently, in an attempt to establish a well functioning monetary control system, the central government announced a reform plan to begin in 1994. The main points of this reform plan include:

1. *Central bank and its function.* The central bank's main function will be to formulate and implement monetary policy. "The primary objective of the monetary policy is to maintain the stability of the value of the currency, and on that basis, to support the growth of the economy." (FBIS, 1993) Other functions of the central bank include enforcing strict supervision over financial institutions, conducting clearance, and issuing banknotes.

At present, the central bank is a management organ as well as a profit-making body. It takes deposits from government agencies and makes loans to them. In the future, the deposit and loan function will be totally transferred to commercial banks.

2. *Central bank's relation with specialized banks and other commercial banks.* According to the plan, authority to formulate monetary policies must be concentrated in the hands of the PBC head office. To strengthen the central bank's hand in this task, powers previously given to PBC branches to control funds will be taken back to the bank's headquarters "to lessen the influence and interference of local governments in the central bank's macro-financial control." In particular, a system consisting of only 6 regional PBC branches will be established, and replace the old system in which each PBC branch located in an individual province. The heads of the regional PBC branches will be directly appointed by the PBC headquarter without consulting the provincial governments.

3. *Instruments to conduct monetary policies.* The PBC will gradually use more indirect means to control the money supply, such as open market operations, interest rates and discount rate adjustments, reserve ratios, operations in the foreign exchange market. The application of mandatory credit plan will be gradually reduced. The PBC will also regulate interbank lending.

Since the Ministry of Finance has not issued any bonds with terms less than 3 years (check), the PBC will issue short-term banknotes with maturities ranging from a few months to

departments for approval. The enterprises can decide for themselves how to divide the budgeted amount among the workers, though. This regulation reverses recent government policy, which had been to allow companies to make business decisions on their own. Only July 1992, the government gave state-owned companies the right to set their employees' wages instead of following a government wage scale.

3 years, in order to conduct open market operations. The treasury bond system will be developed so as to create the conditions for PBC to engage in open market operations.

4. *Deficit financing.* In the new system, deficit financing will mainly rely on selling bonds, while central bank financing through printing money will be prohibited. This reform is referred to as "increasing the central bank's independence."

5. *Policy lending and commercial lending.* Commercial lending and policy lending will be separated. The four specialized banks will be transformed into commercial banks that aim at profit-making while taking the risks themselves. Competition among the commercial banks will be encouraged by letting the specialized banks to conduct businesses formerly outside their designated scope. Investment, securities, and saving deposits institutions should be separate from the commercial banks.

The Agricultural Bank, the Bank of China, the People's Construction Bank, and the Bank of Industry and Commerce will become independent commercial banks, the Communications Bank of China and some other banks will be turned into joint stock banks, and localities will be encouraged to set up their own banks. The existing urban and rural cooperatives will be transformed into cooperative banks. Three policy lending banks--the Long-term Development and Credit Bank, the Import-Export Bank, and the Agricultural Development Bank--will be set up. They will grant policy loans to selected projects in accordance with state industrial policy. The capital source of these banks will be mainly social insurance, postal and investment funds.

6. *Interbank market.* The maximum length of time allowed for interbank loans will be shortened from three months to three days.

7. *Exchange system.* As a part of the reform plan, in January 1, 1994, the dual exchange rate system was unified into a single rate system. At the mean time, the central government decided to adopt a managed floating exchange rate system. Starting from January 1994, the central bank will announce the daily base rate according to the swap market rate and allow the banks to buy and sell foreign exchanges at rates within a certain band around the base rate. It is claimed that the unification of the dual exchange rates will create the condition for currency convertibility in the future.

3.8. Assessment: Central Bank Independence, Policy Lending, and Indirect Monetary Control

The 1994 reform has addressed a number of important drawbacks in the old system that led to the central bank's weak control over money supply. In particular, the establishment of the new PBC branch system, the centralization of personnel management of the PBC branches and specialized banks, and the separation of policy lending from commercial lending are all in the right direction and are very much in line with our previous analyses. These measures will, to some extent, reduce the regions' ability to bargain with the central bank for excessive credit supply. The central bank's independence from the Ministry of Finance will prevent easy monetization of fiscal deficits and will also contribute to a stable money supply.

However, several problems that are responsible for the excessive monetary growth in the past is still left unaddressed. These problems include central bank independence, structural distortions and indirect monetary measures. First, the central bank is still under the strictly control of the State Council. It is often the case that due to various political reasons, the State Council is more "radical" (in the sense that it favors rapid economic growth than inflation fighting) than the central bank, if the central bank is given the authority to express its own view. This distinction is confirmed from my interviews with several PBC officials. Under the State Council, the central bank is not likely to be able to commit to a prudent money supply (either credit ceiling, or reserve ratio, or others) since the State Council is often unable to resist the demands such as rescuing SOEs, maintaining "political stability," or solving bottleneck problems. Without such a commitment, the fundamental source of the monetary game still exists and excessive money growth may reoccur in other forms under the new system.

Under the pressures from local governments and/or enterprises, however, a central bank that is more conservative than the central government is less likely to be tempted to grant additional loans or increase cash issuance targets. This suggests a central bank that is independent from the central government. A number of cross-country studies have presented empirical evidence suggesting that a more independent central bank is usually associated with a lower inflation rate (Alesina and Summers, 1992) than a less independent central bank. We recommend that China places the central bank under the Congress, and grants the central bank independence in the following sense: its decisions are not reviewed by other bodies except the Congress or its standing committee; its governor is appointed for extended periods and cannot be removed without cause; it does not have to seek approval for its budget; and it is not subject to an external auditor. Unlike the government proposed "central bank independence"--independence from other ministries--which is only an administrative order and can be easily revoked by the central government itself, the independence that we propose must be written in the constitution and be protected by the legal system.

Second, although the separation of policy lending from commercial lending will eliminate the localities' major instrument in the monetary game--distorting the investment structure, how the policy lending projects will be financed is a big problem. It is claimed by the central government that the liabilities of the policy lending banks will include mainly social insurance, postal and investment funds. This is rather unrealistic. China does not have a social insurance system yet (check source), and the establishment of such a system is a long lasting task. Depositors in the postal deposit system and investors in investment funds require returns not lower than the deposit rates offered by the commercial banks. Therefore, if the sources are limited to the ones mentioned, no policy lending--which yields a return lower than commercial lending--can be actually made. No matter whether the central government is willing or not, the policy lending banks must be supported by fiscal resources, forms of such support being either interest subsidies or direct subsidies to the banks. Although in the medium to long run the tax assignment may increase the central fiscal capacity, given the current fiscal imbalance, whether the center can afford the creation of three policy lending banks immediately is still a question.

Third, the fundamental source of the problem of excessive money growth--structural

distortions—is not given enough attention. With the existing price distortions, the administrative and financial entry barriers to certain key sectors, the problem of investment distortion will continue to create pressure on the central bank for money supply. Although in the new system the regional PBC branches will no longer represent the interests of the localities, local government may find alternative ways to persuade the center for allowing high money supply growth. Therefore, continuing price reform, phasing out state monopoly in the sectors such as energy, electricity, telecommunication, road, railway and airport construction, and fostering a more efficient financial market that can facilitate large scale investment should go hand in hand with other reforms.

Finally, the reform plan does not mention eliminating interest rate control. In the presence of interest rate control, there always exist incentives for the commercial banks to divert funds from the banking system to black market lending. Problems similar to the illegal lending through interbank market in 1992-1993 will be difficult to eradicate without interest rate decontrol. Other benefits of liberalizing interest rates include increased investment rate and more competition among banks that can help improve efficiency. Nevertheless, strengthened central bank supervision and government supported insurance program protecting depositors are prerequisites for interest rate decontrol.

Table 4. Comparison of Actual Credit Supply and Planned Credit Supply

Year	Growth Rate in Volume (100 million yuan)		
	Planned Target (a)	Actual Volume (b)	(a)/(b)
1983	354	378	1.07
1984	423	988	2.34
1985	715	1486	2.09
1986	950	1685	1.77
1987	1225	1442	1.17
1988	...	1518	...
1989	...	1851	...
1990	1700	2757	1.60
1991	2100	2878	1.37
1992	2800	3864	1.38

Source: Fan Gang et al (1993).

Table 5. Comparison of Actual Currency Issued and Planned Target

Year	Growth Rate in Volume (100 million yuan)		
	Planned Target (a)	Actual Volume (b)	(a)/(b)
1983	60	90.7	1.51
1984	80	262.3	3.28
1985	150	195.7	1.30
1986	200	230.5	1.15
1987	230	236.1	1.03
1988	200	679.5	3.40
1989	400	210.0	0.53
1990	400	300.0	0.75
1991	500	535.0	1.07
1992	600	1158.0	1.93

Source: Fan Gang et al (1993).

Figure 4: Growth Rate of Retail Price Index: 1979-1993

Figure 5. Growth Rate of Real GNP: 1979-1993

IV. The Regulatory Framework

Over the past 15 years, China has made tremendous progress towards deregulating its old planning system. A major form of such deregulation has been the decentralization of regulatory authority to lower levels of government in the areas of taxation, government spending, credit allocation, investment project approval rights and procedures, price and wage control, foreign trade management, the formation of industrial policies, etc. While this form of deregulation has provided the localities with enormous incentives and autonomy in adopting policies for regional development, it has had a serious side effect as local governments have tended to abuse their administrative and regulatory powers to restrict competition in order to protect the local economies. These activities have impeded commodity flows and enterprise mergers and acquisition across regions and sectors, and exposed business transactions to the risks of ad hoc local government intervention.

Economic theories clearly make the case that the rules of the market critically affect the efficiency of resource allocation and the distribution of wealth. Without legal protection, the cost of market transactions will be very high. It is clear that as the Chinese central government withdraws from direct participation in many realms of the economy, it must engage itself in these same sectors in a new manner—as the maker and enforcer of the rules of the market. A legal infrastructure does not arise naturally from the dismantling of the planning system, however. This necessitates the construction of a new framework of regulation, or the modifications of present regulations, and a system enforcing these laws and regulations.

Rather than ambitiously attempting to address all of the problems of China's regulatory framework, this section focuses specifically on the issue of how China's existing intergovernmental power division has affected the functioning of the market system. Since the macroeconomic impact of decentralization has been discussed in detail in the previous two sections,⁴⁵ regulatory issues related to fiscal and monetary management are not repeated. Legal and regulatory issues pertinent to natural monopoly (anti-trust law), consumer protection, and producer protection (trademark, patent, contract law, securities law, etc.) are discussed only to the extent that they are relevant to our theme.

We argue in this section that, first, under the decentralized system, interregional trade and investment barriers set up by local governments have seriously undermined the role of market in resource allocation. Second, the de facto ownership of local governments over local enterprises has restricted enterprise mergers and acquisitions across regions and industrial sectors. Third, local protectionism prevailing in court disputes has thwarted the legal protection of business transactions. To address these problems, a new regulatory framework that can

⁴⁵ For example, the collusion of local governments with enterprise in tax evasion seriously undermined the effectiveness of central government tax policy. The credit game played by the regions undermined the center's ability to control money supply.

effectively restrict local governments' ability to engage in anti-competitive activities must be found.

The rest of this section is organized as follows. Subsection 4.1 briefly describes the current division of regulatory powers between the central and the local governments in the areas of investment project approval, industrial planning, pricing, marketing, international trade management, etc. Subsection 4.2 examines the three main areas where the decentralized central-local relations have negatively impacted the functioning of markets. Subsection 4.3 sketches a framework that can help limit the local governments' ability to restrict market competition. The three basic elements in this framework are: (1) a Interregional Commerce Clause and related laws that prohibit local governments' restrictions on resource flows; (2) a Fair Trade Commission that ensures all regulations issued by government agencies are competition compatible; (3) reform of the government' administrative structure in the direction of reducing anti-competitive government interventions.

4.1. Selected Aspects of Division of Powers: Who Controls What?

In China, state-owned enterprises (SOEs) and collectively-owned enterprises (COEs) account for about 89 percent of the total industrial output.⁴⁶ Each state-owned enterprise is administratively affiliated with a supervisory agency, or its "department in charge." Most COEs are supervised by the local governments. For example, the township and village enterprises, the bulk of COEs, are under the control of township or village governments. Whether an enterprise's "department in charge" is the central government or a local government largely determines who has the power to regulate the activities of the firm. If a firm's supervisory agency is a local government (usually represented by one of its industrial bureau), it is referred to be "owned" by the local government; if its supervisory agency is a line ministry under the State Council, it is referred to be "owned" by the central government. Over the past forty years, the ownership (referring to who supervises the firm) of the state enterprises have been decentralized and recentralized several times. Since the early 1980s, the main trend has been a decentralization of ownership from the central government to the local governments. By 1985, centrally-owned enterprises accounted for only 20 percent of the total industrial output from all enterprises at and above township level.

How do these ownership rights originate? The traditional rule is that investment confers ownership. The level of government that supplied the fixed capital for the enterprise obtains ownership rights over that enterprise. The customary rule summed up in the expression "shei jian, shei guan, shei yong" (who builds the enterprise, administers it, and has control over the output). Therefore, enterprises owned by the central government are those established with central government funds or those taken over from private owners after 1949. Regional levels

⁴⁶ See State Statistical Bureau (1992). The rest include foreign-invested enterprises, privately-owned enterprises, and jointly-owned enterprises.

of government obtain ownership rights in enterprises mainly through investment or historical tradition.

Although the supervisory agencies of the enterprises do not have the legal property rights of the firms, they have several major powers that make them the de facto owners. First, they have the control over the dispersement of the SOEs' assets. More specifically, they can determine whether to sell a firm, or implement a merger with other firm(s). Second, under the fiscal revenue-sharing system introduced since 1980, the most important implication of ownership is that "who owns the firms, who gets the taxes and revenue remittance from the firm."⁴⁷ Third, to varying degrees, a supervisory agency is responsible for approving the firm's arrangement of the management personnel, production plan, investment project, procurement, price and wage setting, marketing, etc. Under the contract responsibility system adopted in 1987-88, and the Regulations of Transforming Enterprise Mechanism promulgated by the State Council in 1993, most of these decision-making powers are supposed to be granted to the enterprise. In reality, however, many firms' supervisory agencies retained substantial control powers. This is particularly true in the inland areas where market-oriented reforms proceeded relatively slowly.

Enterprise activities regulated by agencies other than the firm's supervisory agency mainly involve investment. Investment projects with costs below 30 million yuan for technical innovation and 50 million yuan for basic construction are subject to the approval by local planning commissions; those with costs above the thresholds are subject to approval from the State Planning Commission. As for the source of funds, each level of government controls the spending of their budgetary funds and extra-budgetary funds, and the local branches of specialized banks control the credit allocation between firms, given the credit ceiling assigned by upper level bank branch. The allocation are influenced by each localities' industrial policy, which ranks the priority of each sector.

In the areas of production, material distribution, price and wage setting, the central government now retains only limited control over some key enterprises or products. In 1994, about 4.5 percent of the total industrial output is produced according to a production plan formulated by the State Planning Commission; in 1993, 13 major products (steel, coal, cement, etc.) were distributed by the Ministry of Materials and Equipments under the coordination of the State Planning Commission; by the end of 1992, the prices of about 5.9 percent of total retail sales and the prices of 18.7 percent of industrial raw materials in the country were controlled by the State Price Bureau.⁴⁸ The State Labor Department still stipulates that total wage growth of all state-owned enterprises be limited to either productivity growth or the growth of gross profits. All local state planning commissions, local bureaus of materials and equipment (abolished in mid-1993), price bureaus, and labor departments, impose similar controls over

⁴⁷ Except for a number of minor central-fixed taxes that must be submitted to the center exclusively. See Section II for a description of central-fixed taxes.

⁴⁸ See "State Planning Commission Changes its Function," People's Daily, May 10, 1994.

locally-owned enterprises. Although the degree to which such controls are exercised vary greatly across regions, the general trend is that they tend to be less restrictive than the central government control over the centrally-owned enterprises. This is because controls over production, material allocation, prices, and wages are usually based on considerations of spill-over effects across sectors or across regions and concern the central government more than the local governments. According to many locally-owned enterprises, "Local governments are more interested in receiving revenues than controlling our operations."⁴⁹

In terms of international trade, the central government reserves its control over import and export rights granted to individual firms. After 10 years of decentralization, by the end of 1980s, there were about 4,000 provincial and county level foreign trade corporations (FTCs) and several thousands production enterprises which were granted the right of direct foreign trade without going through FTCs. All firms without direct export rights must be represented by a designated FTC in export business. Another mechanism through which the center controlled trade was the foreign exchange retention system, which stipulated that certain percentage of foreign exchange earnings must be sold to the central government at the official exchange rate. Similar to the central-local fiscal relations, the Ministry of Foreign Economic Relations and Trade (MOFERT) signs contracts with each provincial level bureau of foreign economic relations and trade (FERT) on quotas of foreign exchange earnings. This foreign exchange retention policy was abolished in January 1994. MOFERT also allocates import quotas for many goods subject to import control. Given the import quotas allocated by MOFERT, the provincial FERT bureaus reallocate them to lower level FERT bureaus and firms. For importing goods subject to restrictions, the firms must apply to the FERT at the appropriate level (locally-owned apply to the local FERT, centrally-owned firm apply to the MOFERT).

As a major characteristic of the transitional period, there are numerous grey areas where the division of power between the central government or local governments are not clearly defined by any law or regulation. In these cases, the rights retained by the local governments are de facto, and the center empirically recognizes the rights that the local governments claim. This often leads to power abuses by the local governments who take advantage of the lack of written laws or regulations. The center will then be forced to stipulate that certain rights do not belong to local governments, and decisions in certain areas must be subject to approval of certain departments under the State Council. Two examples best illustrate such learning-by-doing experience. The first case is the cleaning of locally-approved development zones. In 1992 and early 1993, there emerged nearly 1,800 development zones approved by various levels of local governments, including county, township and village level governments. Many local governments offered foreign-invested enterprises with tax exemptions and tax reductions that were more aggressive than those in the special economics zones approved by the State Council. Tax competition arising from the "zone fever" had a serious impact on government's revenue.⁵⁰ By mid-1993, the State Council announced that no local government below provincial level has

⁴⁹ Interview with enterprise managers in 1993.

⁵⁰ See Ma (1993).

the authority to establish such zones offering tax concessions.⁵¹

Another case is about local governments' unauthorized transfers of "land use rights." During 1992-93, all levels of local governments started contracting land use rights for commercial use, as an attempt to attract external investment and increase local revenues. In most deals the land was undervalued, and corruption and speculation spread widely. From January 1992 to July 1993, only 0.78 percent of land transfer deals were made through bidding, 0.32 percent through auction, while nearly 99 percent of the deals were through free administrative transfer or contract transfer. In the late 1993, the State Council stipulated that transfer of land use rights should in general be made through auction and bidding; in exceptional cases, contract transfer is permitted but the deal must be approved by the State Council or the government above the level conducting the transaction. The main elements of the State Council regulation on land use rights will be standardized in the "Urban Real Estate Law," which is being reviewed by the National People's Congress (NPC).⁵²

Recognizing the importance of a legal framework, the NPC has moved quickly in making new laws over the past few years. In 1993 alone, the NPC Standing Committee passed 20 laws and 13 provisional regulations, and deliberated over eight other draft laws, surpassing all recorded figures in its history. So far China has established a system of laws and regulations that mainly include: various tax laws and regulations, The Anti-Unfair Competition Law, The Contract Law, The Patent Law, The Trademark Law, The Copyright Law, The Law of Foreign Investment, The Corporate Law, regulations regarding consumer protection, securities trading, and futures markets. Laws regarding government budget, central banking, foreign trade, social security and insurance, foreign banks and financial institutions are still under review or discussion. Nevertheless, it seems that inadequate attention has been paid to the serious impact of local governments' anti-competitive behaviors on the functioning of the market. Accordingly, the legal system lacks an umbrella law that defines or helps define the limits of the local governments' regulatory powers. The next two subsections will turn to these issues.

4.2. Impact of Decentralization on the Market System

During the decentralization process, the goal of promoting the function of the market in resource allocation was not fulfilled satisfactorily. One major reason is that the many administrative powers that were supposed to be rendered to enterprises were in effect retained by different levels of local governments, and were exercised, and often abused, with great discretion. This subsection discusses the negative impacts of decentralization on the functioning a market system in three areas: (1) interregional commodity trade has been restricted by regional governments; (2) inter-enterprises assets transfers (including mergers and acquisitions) are often opposed by the firms' supervisory agencies, most of which are local governments' industrial

⁵¹ See Section II.

⁵² See People's Daily, May 6, 1994.

bureaus; and (3) legal protection of interregional transactions is undermined by local government intervention. Central government policies adopted to address these issues are also examined.

4.2.1. Barriers to interregional trade

At the same time as the administrative decentralization, significant progress was made towards marketization in China. The important elements of this process were the relaxation of central government's control over prices and the reduction of central government's mandatory procurement. It was envisaged that the reduction of government intervention in commodities circulation would help form an efficient market system.

However, a free and unified market did not automatically emerge. Rather, the problem of regional market segmentation arose. Since 1985, as the economy became overheated, competition over raw material supplies intensified among regions. Using the administrative powers obtained from decentralization, local governments set up various forms of interregional trade barriers to stop the export of materials to other regions. These barriers were observed at both the provincial and the county levels, and consequently the national market was segmented into little pieces. A large number of anecdotal evidence were found in newspapers during 1985-88, among which the most famous were "cotton war," "wool war," "tobacco war," "tea war," "silk war" and "grain war." During these wars, prices of these commodities surged, a large proportion of production capacity in the coastal processing industries were wasted due to lack of materials, and exports and imports of raw materials increased simultaneously. When the economy went through a period of monetary contraction during 1989-90, trade barriers blocking finished products from entering local markets also emerged.

Typical forms of trade barriers set up by local governments include the following:

(1) *Export Embargo*. In some areas, regional barriers took the form of local authority organizing government officials or even local military force (Minbin) to blockade the transport which took the commodity out of their district. During the tea war, government cadres from Sheng county, Zhejiang Province were sent out along the county border to block peasants' trading with buyers from neighboring counties.⁵³ According to some accounts, it was these actions which led to the coining of the term "commodity wars."

(2) *Transport License*. When producers are tempted to sell their products to outsiders who offered market prices higher than the government procurement prices and the government

⁵³ On May 1, 1986, on the stretch of road linking Sheng and Shaoxing counties, several factories had despatched people out onto the side of the road to open their sacks, lay out bamboo hoarding and jack up their purchasing prices. On the other side of the road, twenty or so cadres from the government departments in Sheng county formed up a human chain. Along the road came 400 to 500 farmers with their tea. When they arrived at the county line the farmers observed that they were being blocked in front, and from behind people were calling out "whoever's price is high, come and sell over here!" (Forster, 1991)

procurement plans were hardly fulfilled, local authorities attempted to regain control over all purchase channels. For example, during the "tea war," Zhejiang Provincial Government issued a notice stating that the government-controlled Market and Supply Cooperatives were the only designated purchasers of tea, and all exports of tea to other provinces were subject to approval from the provincial government. To enforce these policies, both Zhejiang and Yunnan introduced transport licenses to exclude buyers from other provinces.

(3) *Levy on Exporting Products.* Some provinces impose charges or fees on exporting products. Xinjiang, for example, placed a levy of 30 yuan per ton on exported raw wool.⁵⁴ This practice was also applied to commodity trade between counties and other levels of authority within a province.

(4) *Request for Rewards in Exchange for "Exports."* During the cotton war, cotton producing regions refused to supply raw cotton at the state planned price without receiving some other rewards, such as foreign exchange, low interest loans or goods at a reduced price (e.g., fertilizer at the planned price).⁵⁵

(5) *Strengthened Enforcement of Production Quota.* In some areas, local authorities set local production and procurement quotas on enterprises, with fines or budget cuts for those who fail to meet their target. If these enterprises failed to meet the quota, alternatives are to suspend the supplies of steel, cement, and timber, or withhold cadres' wage and even summon them for investigation.⁵⁶

(6) *Integration of Material Supply with Processing Industry.* Local governments prefer to see rents created by the price distortion (high market prices and low procurement prices) captured by local processing enterprises in their jurisdiction, rather than see them captured by outside producers. One option to recapture some of the rents is for the raw material makers to integrate forward into processing. During the wool war, new policies for local processing were introduced by the governments of the main wool-producing areas (Gansu, Qinghai, Xinjiang and Inner Mongolia), which were anxious to expand their own wool-processing industries as a means of increasing their income. The policy became known as "own production, own use and own sale." In Qinghai, Xinjiang, Gansu and Inner Mongolia, new investments were taking place at both provincial and county level. In 1986, for example, Gansu added 16,384 spindles and Xinjiang built 25 textile factories and some 15,000 spindles. These increases meant that most of the local wool production would be needed to satisfy local processing capacity. Inevitably, this led to increasing local reluctance to supply outsiders. Purchased wool was held in local stores and not sold to outsiders despite the storage costs involved. To promote the growth of small local factories, some local authorities offered tax relief advantages. Though producing low

⁵⁴ Waston and Findlay (1992).

⁵⁵ Zhang et al (1991).

⁵⁶ Waston and Findly (1992).

quality products, these factories were able to offer lower product selling prices to compete for the raw materials.

There are two main reasons why local governments were interested in setting up trade barriers. The first motivation was to fulfil the central government procurement plan under the multi-tier price system. During the commodity wars, the central government retained some price control and mandatory procurement plans while secondary markets (markets outside the government procurement plan, including free markets) emerged. As a result of the partial marketing reform,⁵⁷ many agricultural and raw material products became subject to a range of prices, including the planned (base) price, negotiated prices (also for government procurement), and free market prices. Raw material producers, mostly peasants, were tempted to evade the price control by selling to outsiders who offered market prices, instead of fulfilling procurement plans. With different enterprises and trading units offering various inducements and incentives directly to the producers, the government procurement plans could no longer be guaranteed. Local authorities had to resort to administrative means, including various interregional trade barriers, to fulfill the mandatory procurement targets.

The second motivation for local governments to resort to trade barriers is to meet revenue quotas set by the fiscal contract with the center and/or to increase locally-retained revenues. Under the decentralized system, local authorities are given the incentives and the administrative means to collect more revenues. Trade barriers, whenever appropriate for generating revenues or preventing outflows of local revenue, would be used. When the prices of agricultural and raw material products were controlled at artificially low levels, the local authorities' first reaction was to stop these products from "exporting" to other regions. Low priced materials, once retained in the home area for producing final products, means higher profitability of the local manufacturing industry. Even if the prices of some raw materials were free in the market, many local governments still attempted to block material outflow in order to protect its high cost manufacturing sector. By limiting material outflow, the local price of raw materials is kept low and the less competitive local industries can survive. In most regions, industrial enterprises are the main source of government revenues while agriculture, which provides raw materials, is a less important source. In addition, the financial losses of agriculture are usually less visible to

⁵⁷ Prior to the early 1980s, the state was the only purchaser of most agricultural and raw material products. The situation that triggered the "commodity wars" was the abolition of the unified purchasing system during 1984-1985. In the case of cotton, in 1985, the old centralized marketing and price system was replaced by one in which the government purchases through contracts. After meeting certain quota, cotton producers were allowed to sell at higher prices for above quota output or at the free market. The case was similar with tea, as its procurement was monopolized by the central authority before 1984. The central government relaxed control in 1984, allowing various trading units to procure tea at negotiable prices. Provincial trading companies were also permitted to export tea directly, as opposed to the previous case when only the central Tea Import and Export Company was designated to trade internationally. Although these reforms intended that the state contracts would be filled before the products entered the free market, commercial departments, processing enterprises and private dealers all competed for supplies.

the local governments since the producers are mostly poorly organized peasants.

The cost of market segmentation is substantial. The trade barriers increased the scarcity of the raw materials and boosted the prices outside the producing regions. As a result, the profitability of those technically more productive manufacturers outside the material producing areas fell drastically. Between 1985 and the first half of 1988 the profit rate of four major wool textile factories in Beijing dropped from 19.16 percent to only 0.19 percent and the wool textile industry of the city as a whole was expected to make a loss. A similar prospect faced Tianjin while Shanghai was only avoiding losses because it still had stocks of 1987 wool.

Many of the most efficient and modern factories simply could not get supplies because of the competition from the large number of small enterprises established by local governments in material producing regions. Production shifted from these efficient enterprises to local small factories where costs were higher, quality was poor and pollution was not controlled. Moreover, the sharply increased local production capacity quickly exceeds the market demand as the market turned sluggish at the end of 1988. During the 1989-90 recession, an estimated 2.26 million spindles were operating with an annual capacity of around 220,000 tons against domestic output of the level of around 50,000 tons.

Trade barriers also induced inefficiently high amount of material imports. For example, the wool war led to a rapid increase in wool imports, particularly significant for the coastal processing industries. Imported wool, though until 1990 more expensive than the domestic product, was supplied in reliable and standard qualities and thus still enabled a good profit to be made. In addition, the state commonly subsidized the price of the imported wool to the processors so that the price differential was less significant than it might have been. There are also examples of one province (Hunan) restricting the supply of its raw material (silk) to another locality (Shanghai), preferring instead to export it abroad (Hong Kong), and the deficit locality (Shanghai) must then import the raw material from abroad (Hong Kong).⁵⁸

Since the early 1990s, regional trade barriers have been substantially reduced, particularly in the coastal areas. Several factors have contributed to this encouraging change. First, the prices of many agricultural products were gradually liberalized during this period and the state discontinued its mandatory grain procurement in most regions. For example, grain price in about 90 percent of the counties was freed by the end of 1993. The price and marketing liberalization eliminated an important incentive for local governments to set up trade barriers, i.e., they no longer need to meet state procurement plan. Hunan Province, which originally was famous for restricting grain outflow to Guangdong, is now actively promoting the marketing of grain to other provinces. Second, in many coastal provinces, where government organizational reform⁵⁹ has proceeded relatively fast, some bureaus that had the power to erect trade barriers were streamlined or abolished. For example, in Guangdong, there is no longer a Bureau of

⁵⁸ Agarwala (1992).

⁵⁹ See Section 4.3.

Grain. Such reforms directly eliminated the instruments that many regions used to restrict interregional trade. Third, many regional leaders began to realize that the trade restriction may be harmful to their local economies. Some of them admitted that they made mistakes in the late 1980s by restricting raw materials from flowing out: they ended up with huge stocks of unmarketable materials when the market turned sluggish.⁶⁰

However, there are continued accounts about trade barriers in many inland provinces. For example, a report said that until recently Sichuan's pork was not allowed to enter the market of Hunan and Hunan's cigarettes could not be sold in Hubei.⁶¹ In these inland areas, price liberalization is relatively slow, local governments are more eager to retain their power to intervene into firms' daily operation, and are more reluctant to streamline their governmental functions. It is important to note that a number of factors that caused regional trade barriers still remain in place, although to a lesser extent compared with those in 1985-1990. First, the nature of the current central-local fiscal sharing system still provides the localities with incentives to protect local enterprises that generate revenues. Second, the administrative powers retained by the local authorities, particularly in less developed regions, are still extensive. The local governments can easily intervene in enterprises' investment, production and commodity circulation. Third, while many prices of raw materials are being liberalized or adjusted closer to market prices, some are still under control and the plan-market price differential may again explode when demand surges. The coexistence of different marketing systems, i.e., the state procurement system and the free market system, still implies continued competition for supplies.

4.2.2. Barriers to industrial reorganization

One of the major elements of the decentralization in the 1980s was the transfer of the de facto ownership of most state-owned enterprises from the ministries under the State Council to local governments. The de facto ownership of state enterprises by regions and their industrial bureaus dictates that new investments as well as industrial reorganization (including mergers and acquisitions) are largely confined to the administrative boundaries. This created the problem of duplication of investment (lack of specialization), and small scale of enterprises (lack of economies of scale). To address these issues, the central government adopted a number of measures to promote the formation of enterprise groups since the early 1980s. The stated objectives of this policy include: to promote mergers and acquisitions among enterprises; to reduce the regions', ministries' and industrial bureaus' monopoly powers; and to increase enterprises' management autonomy.

The origin of enterprise groups was the "horizontal linkages" initiated in the early 1980s. In 1980, the State Council issued a circular stating that "we should reorganize the industrial structure to avoid the problem of large number of small scale investments, duplication and

⁶⁰ Interview with Mr. Chen Gongyan, Researcher at the Development Research Center of the State Council, PRC.

⁶¹ See "Inter-provincial Market Established," *Beijing Review*, December 27, 1993-January 2, 1994.

blinded investments, according to the principle of specialization and inter-enterprise cooperation."⁶² It called for cross-region and cross-sector inter-enterprise cooperation in terms of technology transfer and assistance, investments and long-term procurement contracts.

Based on the development of the "horizontal linkages," enterprise groups emerged in 1986, and have gone through three stages. The first stage started in March 1986, when the State Council issued "The Regulation of Selected Issues Regarding Further Promoting Horizontal Linkages."⁶³ At this stage, economic linkages between enterprises were largely confined to marketing cooperation between suppliers and purchasers, technology transfers from technologically advanced firms to other firms, contractual relations between assemblers and parts-suppliers, etc. The second stage started in March 1987, marked by the announcement of "The Interim Regulations of Independent Planning Status of Large Industrial Joint Enterprises."⁶⁴ Since then, a number of enterprise groups were granted independent planning status. The third stage began with the 1988 document, "Views on Developing Enterprise Groups," issued jointly by the Economic System Reform Commission and State Economic Commission.⁶⁵ A number of measures to promote mergers and acquisitions among enterprises, such as contracting, leasing, and corporatization have been experimented with since then.

Forming enterprise groups was aimed at breaking the administrative barriers and promoting resource reallocation among firms. However, it often faces opposition from the local governments and their industrial bureaus who have the de facto ownership of the enterprises. A typical case is as follows: there is a strong firm and a weak firm, subordinating to different local governments or different industrial bureaus under the same local government. The strong firm has market products and better technology, while the weak firm has abundant labor and/or equipments but lacks market due to either substandard technology or poor management. These two firms are willing to merge, but the supervisory agency of the weak firm objects such merger.⁶⁶ Without an appropriate compensation, the weak firm's supervisory agent will not allow its subordinate to be merged by firms outside its jurisdiction because it means a loss of revenue and ownership.

The central government policy adopted to circumvent this difficulty was named the "three-no-change policy": if one firm wants to join an enterprise group, there should be no

⁶² The State Council's Interim Regulation of Promoting Economic Cooperation, 1980. See Gu et al (1992).

⁶³ Ibid.

⁶⁴ Ibid.

⁶⁵ Ibid.

⁶⁶ Law Daily(Fazhi Ribao), November 11, 1993, presents such a case.

change in the firm's administrative supervisory agency, no change in the channel through which the firm remits its profits and taxes, and no change in the firm's ownership. This policy is a compromise of the central government's intention to break administrative barriers to industrial reorganization and the existing interests of the regions and industrial bureaus. This compromise has enabled the reform to proceed without encountering much opposition from the local governments. Without such a policy, forming enterprise groups across regions or industrial bureaus would have been impossible in many cases. The three-no-change policy made this transaction possible. To see this, suppose firm x in region X wants to merge firm y in region Y while y still generates profits. Y is likely to reject the merger proposal since it means a loss of profit from y. Under the three-no-change policy, however, x can sign a management contract with Y, promising to submit certain amount of profits to Y in exchange for acquiring the management rights and the residual profits (but not the ownership) of y.

Since firms' ownership is not transferable under the three-no-change policy, enterprise groups with tightly-linked members through cross-shareholding are rare. Members of most groups are loosely-linked and the relations between members are often based on management contracts, procurement-supply contracts and technical assistance. Financially very few groups are consolidated, and management and production plans of most member firms are independent. The impossibility of ownership transfer greatly restricts the degree to which the groups can reallocate internal resources and achieve the goal of greater specialization and economies of scale.

While the current enterprise group policy was aimed at promoting resource reallocation among firms, many measures adopted to achieve such a goal may be harmful to market competition for a number of reasons. First, currently most mergers and acquisitions are administratively initiated, rather than market-based ownership transfers. A typical form of such mergers is an industrial bureau instructs two firms both "owned" by the bureau to merge. These administrative mergers are often opposed by the firms involved.⁶⁷ During the recent government organizational reform, many industrial bureaus that are to be abolished rename themselves as "enterprise groups" and force their subordinate firms to join the groups. The motivation of these transformations was obviously to retain the powers that used to be in the hands of the industrial bureaus. Many of the newly established groups (transformed from old industrial bureaus) recentralized the management powers from the member firms, eliminated the member firms' legal person status, and imposed various arbitrary charges on them. It is recognized by the central government that such practices are monopolistic in nature and are detrimental to the development of the market.⁶⁸

Second, many large and successful enterprise groups enjoy various special policies

⁶⁷ In Xiangtan City (Hunan Province), a firm which was forced to join an enterprise group declared to "withdraw" from the group. See Economic Daily, May 8, 1993.

⁶⁸ See "A State Council Leader Says 'Changing Name' Companies Is Not A Reform, But A Retreat from Reform," Guangming Daily, March 2, 1993.

granted by the central and local governments. These policies include the following. (1) Preferential profit retention and credit policy.⁶⁹ Many enterprise groups with preferential policies also enjoy low interest loans; (2) Preferential procurement policies. The government offers most large enterprise groups procurement contracts, and guarantees the supply of certain materials and energy products. (3) Independent planning status granted to certain enterprise groups. The State Planning Commission granted 25 large enterprise groups such a status in 1993. Many regional level enterprise groups are also given similar treatments by the local authorities. These policies in effect discriminate against other firms or groups that are not on the government list. Furthermore, it cannot be justified by industrial policy since these policies are determined on firm-by-firm basis.

4.2.3. Local Protectionist Intervention in Legal Cases

China has enacted many business related laws in the 1980s, including The Contract Law, The Trademark Law, and The Patent Law. Recently, new laws and regulations on securities trading, anti-unfair competition law, and copyright were promulgated; the Contract Law, the Trademark Law and the Patent Law were revised to extend coverage. Speaking generally, the goal of these laws is to safeguard legal business transactions by defining the rights of buyers/sellers or producers/consumers and the penalty on behaviors that violate the laws. Without protection by laws, costs of business transactions would be prohibitively high and the transactions actually taking place would be inefficiently low.

While the promulgation of these laws are no doubt important, they are only a part of the legal system. Unfortunately, in China, respecting other party's legal rights in a business transaction has more of a sense of moral obligation than absolute rights in China--there is very little concept that the laws are binding. Over the years after many business laws was issued, they were poorly implemented. Practices that violate the Contract Law, the Patent Law, the Copyright Law and the Trademark Law are common, and most of these violations are not settled through legal channels. Among various reasons, one of the most important up to now has been local protectionism.

In some cases, the local courts may unreasonably rule in favor of local parties. In 1991, Ziyuan Textile Factory in Ziyuan county of Guangxi Province signed a sales contract with Youfang Company of Hunan Province, a textile product retailer. Until 1993, Youfang still owed Ziyuan Textile 82,580 yuan. To settle this debt problem, the two parties reached an agreement according to which Youfang should pay Ziyuan 15,000 yuan, and send 65,542 yuan worth of

⁶⁹ For example, the "No.2 Automobile Group" was designated to submit less than 30 percent of its profits according to its contract with the government. Capital Steel Company's profit retention rate is as high as 80 percent. While on average, large and medium state enterprises retain only about 20 percent of their profits. A comparison made between Capital Steel Company (with a 80 percent profit retention rate) and Shanghai Metal Bureau (with a profit retention rate less than 20 percent) indicates that the Capital Steel Company's performance (growth of output and profits) critically depended on the formula of profit division between the state and the enterprise.

products to Ziyuan. When the check and the products arrived Ziyuan, the director of Ziyuan Textile Factory declared that the agreement was invalid, and then he confiscated Youfang's truck. The director of Ziyuan then applied to the court of Ziyuan county for property protection for the truck. The county court ruled in favor of Ziyuan and imposed a penalty of 15,000 yuan on Youfang. Representatives of Youfang appealed to Guangxi Provincial Supreme Court, which later overruled the court judgement of Ziyuan. Under the pressure from the provincial court, the county court issued a ruling asking Ziyuan Textile to return the truck to Youfang. However, the county court did not enforce this ruling, letting Ziyuan Textile keep the truck. The chief judge of the county court said that he was not able to release the truck because the county leaders did not want to do so. He added, "now power is bigger than law, and I can do nothing."⁷⁰ Since appealing to the court did not help, some workers of Youfang Company seized a car from Ziyuan county government in return. A simple business deal led to a chaos.

In other cases, the local judges refuse to take action on cases against domestic parties. One major foreign bank lent a state-owned enterprise the funds to help build a joint venture hotel in Tianjin. Months after the loans become overdue, the bank still had not been repaid. The bank wanted to recover the money, but the enterprise wanted concessions. The bank quickly learned that the outcome of the contract disputes is more a question of agreement than the application of principles. Intent on recovering its loan, the bank's lawyer approached the government. But the government and the state enterprise "sit together on same side of the fence." An officer of the bank said, "the attitude of the whole town was, it's our hotel and you are not going to take it away from us." Going to court did not help either. Reluctant to execute an order that would enable the bank to assume control of the hotel, the presiding judge refused to take quick action. As the months dragged on, the bank eventually restructured the loan.⁷¹

Also, a local court may refuse to cooperate with a court from another jurisdiction in executing the latter's decisions. A district court in Beijing Municipality ruled that a firm in Jiangsu Province violated the Trademark Law and caused financial losses to a firm located in Beijing. The Jiangsu firm is ordered to pay the Beijing firm for compensation. According to the Trademark Law, the Beijing district court can request the local court in Jiangsu Province to enforce this ruling. However, the Jiangsu court simply refused to do so. The Beijing district court had to send its staff to Jiangsu to get the money.⁷²

The pressures of local interests on lower level courts is one of the chief factors detrimental to the Chinese judicial system. Offenders often ignore court judgements with complete impunity. Many people have informal channels to resolve disputes, even though a court may have already tried. Local power groups—business run by government officials or their associates—are particularly adept at protecting their interests. In many cases, this takes the form

⁷⁰ See Wu and Li (1993).

⁷¹ See Sender (1993).

⁷² Interview with Ms. Rong Mao, a lawyer with Reichler and Soble at Washington, D.C..

that local firms lobby a local government leader and he expresses his/her "opinion" on how to resolve the case to the local court. Sometimes lobbying translates into outright bribes and poorly paid judges make easy marks. Local court judges who rule in favor of the local parties are often considered, by the local leaders, as acting in the interest of "our people." Besides, local courts are subject to various subtle controls from the local governments: much of the local court staff's housing, utilities, and their children's education are provided by the local governments.

The problem is compounded by the fact that many judges are retired military officers with little or not legal training. The central and local governments have taken halting steps to address the problem, starting training programs for some judges. The more severe problem is the shortage of lawyers. Currently there are more than 5 million enterprises across the country, of which only 140,000 have legal advisors, accounting for 2.9 percent of the total. In 1992, China's courts handled 690,000 economic cases, of which only 26.4 percent were represented by lawyers.⁷³

But there are encouraging signs of change. One is the broad effort to boost the role of lawyers in China's legal system. The Ministry of Justice has mapped out its general target--by the end of 1995 and this century, the number of qualified lawyers should increase to 75,000 and 150,000 respectively; notary personnel should reach 20,000 and 30,000 respectively; and legal service people should increase to 130,000 and 200,000 respectively. To achieve this goal, the ministry plans to establish a complete system of examination, training and professional technical standards for legal personals, and to hold one lawyer qualification exam each year, replacing the every-other-year routine. Administratively, the ministry also calls for setting up non-government funded law agencies. In some areas, government notary organizations will be transformed into non-governmental and non-profit organizations.

4.3. Defining the Limits of Local Government Power

The above subsection has argued that for the sake of protecting local interests local governments have the strong tendency to exercise/abuse their (vaguely defined) regulatory and administrative powers in a way that restricts the functioning of the market system. Realizing this, the central government has adopted a number of measures over the past years. However, many of these measures appear to be in the direction of administrative recentralization. For example, the industrial policies announced in 1989 was partially aimed to address the issue of investment duplication and lack of economies of scale resulted from regional protectionism. It attempted to restrict or discourage investment in certain sectors that are favored by regional governments, such as small scale textiles, cigarette, and household electric appliance, at the same time to encourage the sectors that are of "national importance," such as energy, raw materials, and high tech industries.⁷⁴ While tax incentives and interest rate differentials were

⁷³ See Wu (1993).

⁷⁴ See the State Council (1989).

used as instruments to achieve these goals, an important measure was to recentralize the investment project approval rights for projects to be discouraged. Such recentralization policy brings with it the old problems in the planning system: complicated procedures, insensitivity to consequence of decision-making, and rent-seeking behavior.

Among the policies promoting enterprise grouping, one of the most important is that the center grants the large enterprise groups independent planning status. This measure raises the administrative ranks of the groups which may help them break administrative barriers erected by governments and industrial bureaus at lower administrative levels. This type of policies, although conducive to breaking interregional barriers, may in effect foster administratively-backed monopoly by high rank enterprise groups. Often, these new groups with independent planning rights are at ministry or semi-ministry levels; their behavior will not be very much different from those of the line ministries.⁷⁵

Rather than using administrative means, this subsection proposes a framework to remedy the protectionist behavior of local governments. This framework involves laws that define the limits of local government regulatory powers and institutions to enforce these laws. The three basic elements of this proposal are: (1) the Interregional Commerce Clause and related laws that prohibit local governments' restrictions on resource flows across regions; (2) the Fair Trade Commission that ensures all regulations issued by government agencies are competition compatible; and (3) reform of government administrative structure in the direction of reducing anti-competitive government interventions. The next three subsections will discuss these questions in order.

4.3.1. Legislation on interregional commerce

The situation of interregional trade barriers in today's China is very much like that in the early years after the American Revolution. During the period of confederation (1781-1787), protectionist state restrictions on interstate trade were common. Each state was free to pass tariff laws taxing goods from other states. New York, for instance, taxed firewood from New Jersey. To address this issue, the new constitution passed in the Philadelphia Convention granted the Congress the power to regulate commerce between states. Under federal control, no state might levy tariffs on goods from another states. Section 10 of Article 1, the Commerce Clause, of the constitution formally stated as follows:

"No state shall, without the consent of the Congress, lay any imposts or duties on imports or exports, except what may be absolutely necessary for executing its inspection laws; and the net produce of all duties and imposts, laid by any states on imports or exports, shall be for the use of treasury of the United States; and such law should be subject to the revision and control of the Congress."

⁷⁵ A line ministry is a specialized ministry in charge of an industrial sector.

Congress's power to regulate commerce among the states has played an important role in the early years of the US economic development. Over time, this "Commerce Clause" has come to have two main thrusts. First, in accordance with the original purpose, it is an independent check on state regulations that unduly restrict interstate commerce.⁷⁶ Today, the Commerce Clause is effectively an all-purpose federal police enabling Congress to regulate all sorts of activities within a state's borders (intrastate matters). Although the literal language of the Commerce Clause simply gives Congress the power to regulate commerce among the states, the Supreme Court has established the power of Congress to regulate intrastate matters by concluding that the power to regulate interstate commerce includes the ability to reach intrastate activities that have some impact on commerce among the states. In a highly interdependent society, it is difficult to find intrastate activities without some impact on interstate commerce. As a result, very few intrastate matters are outside the reach of the commerce power today.

In today's China, adding an Interregional Commerce Clause into the constitution, which emulates the US Commerce Clause, may be an important first step to construct a legal framework that limits local governments' power abuses. The legislation should prohibit any government activities or regulations, at both the central, provincial, county, and lower levels, that impede economic transactions between regions. Based on this Clause, the law-makers should devise an Interregional Commerce Act, or provisions of the forthcoming Anti-Trust Law, to explicitly stipulate that any form of tariff or non-tariff barriers to interregional commodity flow, such as those listed in Section 2.1, are unlawful, and are subject to legal prosecution by a designated central government agency. In the short-term, the emphasis of promoting interregional commerce should be placed on commodity flow rather than on capital or labor mobility due to the enormous complications of the latter. The impediments to capital flow due to central bank's region-based credit allocation cannot be removed before the reform of the monetary management system based on credit allocation. Labor mobility will be limited for an even longer period of time due to the various urban-rural policy differentials. In the long-run, however, the objective of a common capital and labor market should also be pursued as a part of the legislative effort.

The Interregional Commerce Clause can serve as an umbrella legislation in defining local governments' administrative and legislative powers. Any regulation or administrative decision made by local governments that will be or can potentially be harmful to interregional commerce should be banned, even if such a decision is seemingly a "domestic issue." The Clause will thus have a far reaching power in protecting the formation of a common market system.

4.3.2. Fair Trade Commission

⁷⁶ One famous case under the commerce clause is: *Gibbon V. Ogden* (1824) concerned the New York state legislature's grant of exclusive rights to Livingston and Fulton to operate steamboats in New York waters. This grant of monopoly clearly restricted open market competition. *Brown v. Maryland* (1827) invalidated a \$50 license fee imposed by the state for selling of imported goods. State power of this sort would have allowed significant regulation of the economy to local advantage in the form of non-tariff barriers. (Weingast, 1993)

Simply writing a clause in the constitution is only a first step to limiting local government powers. Institutionally, a central government agency must be set up to monitor the use of administrative powers at various levels of government, especially at the local levels. This agency would operate under the legal framework centered on the Interstate Commerce Clause and other laws related to Anti-Trust/Competition. At the same time this agency enforces competition related laws, its important role should be to restrict the promulgation of, and to remove the existing, government policies that restrict competition or lead to unfair trade practices.

The experience of Korea in this regard provides some useful lessons. Over the past ten plus years, Korea's Fair Trade Commission lists "reform of anti-competitive government regulations" as the first item in its list of major activities. The commission reviews draft regulations to prevent the introduction of restrictive elements and every ministry which intends to issue regulations must consult the commission. For example, there were 2,640 applications for international agreements between 1981 and 1985, of which 931, or 35.3 percent, were judged by the Fair Trade Commission as containing provisions restricting competition or using unfair trade practices and were revised accordingly. There were 1,850 applications for agreements on importing technology, the most common kind of agreement, and 811, or 43.8 percent, of these applications were ordered to make revisions.⁷⁷

In China, the State Administration of Industry and Commerce (SAIC) is designated by the State Council to enforce the recently enacted The Anti-Unfair Competition Law⁷⁸ and other forthcoming competition related laws, such as the Anti-Trust Law. However, past experience has shown that due to its low administrative rank—it is a semi-ministry level government organ—SAIC has virtually no influence on any administrative decisions made and regulations promulgated by ministry level government agencies, such as the line ministries under the State Council and the provincial level governments. At the local level, the situation is similar: the power of local SAIC branches is very limited. Over the past fourteen years, the main duty of the SAIC has been limited to the supervision of the distribution of goods by private proprietorships, the administration of local consumer goods market for daily necessities, and enterprise registrations.

It is hardly conceivable that the SAIC can be relied upon, with its present status, to undertake the task of preventing competition from being negatively impacted by anti-competitive policies of other government agencies. We suggest that a Fair Trade Commission, similar to that in Korea, be created, or transformed from the current SAIC. This new commission should

⁷⁷ See Lee et al (1992).

⁷⁸ China's National People's Congress recently passed the Combating Anti-Unfair Competition Law. With only a brief mentioning of the prohibition of abuses of administrative powers, the law emphasizes the regulations on conduct of individual enterprises. The law is particularly concerned with violations of patent law and trademark law, false or misleading advertisements, lottery sales, forced underselling, catalling and molesting of competitors' businesses.

be at the full-ministry level, and is empowered by the Congress to review and approve all regulations enacted by government agencies at and below the ministry level. Charges against any government policy on the basis on violating Interregional Commerce Clause and other competition laws will be handled by this commission. Examples of cases that the commission should handle include: policies directly restricting interregional trade; local government protectionist procurement policy in favor of local producers and discriminating against outsider producers; licensing and technical standards discriminating against producers outside a government agency's jurisdiction; discriminative tax and financial policies not justified by central government promulgated industrial policy; administrative intervention into court decisions related to interstate business; and government policies restricting enterprise mergers and acquisitions.

Needless to say, the coordination of economic policies between different government agencies and between different levels of the government is a very difficult task, especially in China which is experiencing rapid changes in almost all aspects of the management system. However, it is warranted that a high priority be given to protecting market competition and be supported by a visible effort of the decision-makers through out the reform process.

4.3.3. Government organizational reform

As indicated previously, the de facto ownership of state enterprises and most collectively-owned enterprise belong to their supervisory agencies. Such a relationship has enabled these agencies to adopt various administrative measures that restrict the functioning of the market. In the presence of these agencies, any reform attempting to render more management autonomy to the enterprises encounters resistance as the reform means less economic rents to government officials. The legal framework proposed above will also face serious challenge from these government agencies. Therefore, a government organizational reform to streamline and/or abolish some line ministries at the central level and the corresponding industrial bureaus at the local levels will be an essential step towards the establishment of a well functioning market system.

China currently has a huge government with 40 million employees (this number swells by 1 million every year. In 1993, The State Council drafted the Government Organizational Reform Program and it was passed by the National People's Congress. The program stipulates that the size of government staff will be cut by some 20 percent in a year. The State Council will reduce the number ministries and commissions from the current 86 to 59, and each level of local government should follow suit.

According to this program, reform of specialized ministries (in charge of specific industrial sectors) will take place within the following three categories: (1) The Ministry of Aeronautics and Astronautics will be transformed into the China Aerospace Industrial Corporation and the China Aviation Industry Corporation. These corporations will be purely business entities with no administrative function. (2) The Ministry of Light Industry and The Ministry of Textile will become industrial associations subordinate to the State Council. These associations and their local counterparts (former local Light Industrial Bureaus and Textile

Bureaus) will no longer control enterprise production planning, pricing, and investment project approval. The main functions of the two associations are to improve trade planning, implement trade policies and provide enterprises with information services. (3) Other former specialized ministries will carryover or merge into newly created ministries. Local counterparts of all these reformed ministries will make similar changes according to the new structure at the central level. The new ministries and local bureaus will feature streamlined administrative structures and management functions.

The direction of the government organizational reform is undoubtedly consistent with our proposal in this paper. However, the coverage of the reform should be extended to many other ministries and their local counterparts. To ensure a better functioning of the market, most specialized ministries and local industrial bureaus managing specific industrial sectors should be streamlined in the short-term and abolished in the long-term. In addition, during the organizational reform, special restrictions should be imposed on transformations of industrial bureaus into corporations with monopoly powers.⁷⁹ For example, provisions of government organizational transformation should stipulate that new companies transformed from original bureaus cannot claim ownership of the enterprises formerly subordinated.

⁷⁹ See Section 3.3.

IV. Summary of Conclusions

This paper examines several major aspects of China's economic decentralization and its implications for the central government's ability to exercise macroeconomic control and for the functioning of the market system. The three broad areas discussed are: fiscal management, monetary management and the regulatory framework. The general conclusion of this paper is that while decentralization has been crucial in stimulating regions' economic growth and reform initiatives, the local governments obtained, to a large extent, the de facto control over many macro policy instruments, and thereby seriously weakening the central government's ability to perform macroeconomic stabilization. In addition, local governments' protectionist behavior in many areas where central-local division of regulatory power is vaguely defined has led to the malfunction of the market system in resource allocations.

Section II looks at the impact of China's fiscal decentralization on the central government's ability to use fiscal policies in achieving macroeconomic objectives. It is argued that, under the fiscal contract system introduced in the early 1980s, the localities have controlled the effective tax rates and tax bases in the following two ways. First, they controlled the tax collection efforts by offering varying degrees of tax concessions. Second, they found ways to shift budgetary funds to extrabudgetary funds, thus avoiding tax-sharing with the center. As a result, the center had to resort to various ad hoc instruments to influence revenue remittance from the localities, and these instruments led to perverse reactions from the localities. On the expenditure side, the center has failed to achieve corresponding reductions in expenditure when revenue collection has been decentralized. The center's flexibility in using expenditure policy has been seriously undermined by the lack of centrally-controlled financial resources and the heavy burden of "capital constructions."

Due to the lack of fiscal resources and policy instruments, the central government has found itself in an increasingly difficult position to achieve the goals of macroeconomic stabilization and regional equalization. The adoption of the tax-assignment system in the 1994 fiscal reform is an important step taken by the central government to address these difficulties. Under the new system, the center will recentralize the collection of central government taxes and central-local shared-taxes and will obtain a larger share of fiscal resources due to the new revenue-sharing formula. As a result, the center will significantly improve its ability to use tax and expenditure policies in macroeconomic management. Nevertheless, a number of problems should be addressed in future reforms: (1) the division of tax bases according to ownership is not desirable for reasons related to stabilization and the center's ability to commit to the ownership division; (2) future reform should proceed in the direction of establishing rules for intergovernmental fiscal relations through national legislation rather than administrative intervention; (3) institutional protection of local autonomy should be established; (4) division of tax bases according to ownership is not desirable; (5) the division of expenditure responsibility is not yet clearly defined; (6) the new system still lacks transparency and predictability because the localities are not allowed to determine the bases and/or rates for local taxes; and (7) how to design intergovernmental transfer is still an unaddressed question.

Section III turns to China's monetary management system. Over the past 14 years, the economy has experienced several periods of overheating and the direct cause was the central bank's excessive money supply. The paper, however, argues that the central bank per se is not to be blamed for the excess monetary growth that created repeated high inflation, rather, the institutional features of the current central-local monetary relations generate this result endogenously. A central-local monetary game is presented as a theory to explain how regions take advantage of the central bank's lack of commitment to a pre-announced credit policy and force the central bank to revise credit ceiling upwards, thereby creating inflation.

The game assumes the following stylized facts in the Chinese monetary system. Under the decentralized banking system, the regions have the authority to allocate the credit and cash allowance across projects. The regions choose investment projects based on market values, i.e., they favor high yield projects rather than the essential projects. Unlike the regions, the center values different projects using shadow prices, so it tends to favor the essential projects more than the regions do. Knowing that the center values the essential projects and the center has the flexibility to revise the credit ceiling ex post, the regions purposely under-invest in the essential projects, and creates pressures on the center to grant additional credit allowance. The paper identifies that the source of the problem is center's inability to commit to a pre-announced credit policy.

The 1994 reform has addressed a number of important drawbacks in the old system that led to the central bank's weak control over money supply. In particular, the establishment of the new PBC branch system, the centralization of personnel management of the PBC branches and specialized banks, and the separation of policy lending from commercial lending are all in the right direction. However, several problems that are responsible for the excessive monetary growth in the past years remain unaddressed. These problems are: (1) The central bank is still under the strict control of the State Council. (2) Although the separation of policy lending from commercial lending will eliminate the localities' major instrument in the monetary game--distorting the investment structure, how the policy lending projects will be financed is a big problem. (3) The fundamental source of excessive money growth--structural distortions--has not been given enough attention. (4) The reform plan does not mention interest rate decontrol, which will eliminate the incentives for the commercial banks to divert funds from the banking system to black market lending--an important cause of the 1992-1993 monetary expansion.

Section IV looks at the impact of decentralization on the market system. It is argued that as the central government relaxed its control over the economy through decentralization, local governments turned the transferred powers to restrict market competition. Reasons for such local government behaviors include: to fulfil fiscal contracts or increase local revenue retention; to meet central government procurement quotas under a dual-track price system; and to protect local industries and employment. The de facto ownership of local enterprises by local governments enables the latter to realize these objectives through protectionist measures.

A legal framework designed to restrict local governments' power abuse is therefore necessitated. Currently, the division of regulatory power between the central government and

local governments is poorly defined: there are so many grey areas where no guideline restricting local governments power exist. This section proposes that an umbrella legislation of Interregional Commerce be enacted and a Fair Trade Commission be created to ensure that government policies at all levels be pro-competition. As an institutional prerequisite, the government organizational reform should be extended to more sectors of the economy.

REFERENCES

Agarwala, Ramgopal, 1992, "China: Reforming Intergovernmental Fiscal Relations," World Bank Discussion Paper, No.178.

Alesina, Alberto, and Lawrence H, Summers, 1993, "Central Bank Independence and Macroeconomic Performance: Some Comparative Evidence," Journal of Money, Credit, and Banking, Vol.25, No.2, (May), pp.151-162.

An, Tifu, Zhou Shenye, and Zhu Yifeng, 1991, Overview of Fiscal and Monetary (Policies)(Caizhen Jinrong Gailun), China Financial Economic Press.

Bahl, Roy, Christine Wallich, 1992, "Intergovernmental Fiscal Relations in China," Policy Research Working Paper No.863, The World Bank, Washington DC.

Barro, Robert, and David Gordon, David, 1983, "Rules, Discretion, and Reputation in a Model of Monetary Policy," Journal of Monetary Economics, (July), No. 12, pp.101-122.

Blejer, Mario I., 1993, "China: Prolonged reforms and the Weakening of Fiscal Control," in Vito Tanzi ed., Transition to Market: Studies in Fiscal Reform, International Monetary Fund, Washington DC.

Bomfim, Antlio N, Anwar Shah, 1994, "Macroeconomic Management and the Division of Powers in Brazil: Perspectives for the 1990s," World Development, Vol.22, No.4, pp.535-542.

Canzoneri, Matthew, 1985, "Monetary Policy Games and the Role of Private Information," American Economic Review, Vol. 75, No.5. pp.1056-1070.

Chen, M.W. Luke, Richard Deaves, and Cheng Wang, 1992, "An Analysis of Money and Output in the Industrial Sector in China," Journal of Asian Economy, Vol.3., No.2., pp.271-280.

Chow, Gregory C., "1987, "Money and Price Level Determination in China," Journal of Comparative Economics, Vol.11., pp.319-333.

Clarke, Donald C., 1993, "Regulation and its Discontents: Understanding Economic Law in China," Stanford Journal of International Law, Vol 28. pp.283-322.

Economic Reserach Center of the State Council, 1981, China Economic Almanac 1980, Economics and Management Press, Beijing.

Economic System Reform Commission, 1992a, Proposed Norms of Limited Liability Stock Companies, May 15, in People's Daily (June 20, 1992).

Economic System Reform Commission, 1992b, Standards for Limited Liability Stock Companies, May 15, in People's Daily (June 20, 1992).

Fan, Gang, Zhang Shuguang, Wang Limin, 1993, "Dual-Track Transition and Dual Track Regulation and Control--A Study of the Characteristics of Economic Fluctuations in China Since the Beginning of the Reforms (Part I)," Economic Research, No.10 (October).

FBIS, 1993, "Bank Official Views Upcoming Monetary Reform," FBIS-CHI, Daily Report China, (December 13).

Feltenstein, Andrew, and Farhadian Ziba, 1987, "Fiscal Policy, Monetary Target, and the Price Level Determination in a Centrally Planned Economy: An Application to the Case of China," Journal of Money, Credit, and Banking, Vol.19, No.2, pp.137-156.

Findlay, Christopher, Will Martin, and Andrew Watson, 1992, "Policy Reform, Economic Growth and China's Agriculture," University of Adelaide and The World Bank, Mimeo.

Forster, Keith, 1991, "China's Tea War," Chinese Economy Research Unit, The University of Adelaide, Mimeo.

Fujiwara, Toshihiro, 1992, "Intergovernmental Fiscal Relations in Japan: Lessons from post-War Reform and Evolution Thereafter," Draft, Africa II Department, The World Bank.

Gordon, Robert, 1990, Macroeconomics (5th), Scott' Foresman-Little, Glenview Illinois.

Henry Sender, 1993, "Party of the First Part," Far Eastern Economic Review, February 11.

Huang, Yashang, 1990, "Web of Interests and Patterns of Behavior of Chinese Local Economic Bureaucracies and Enterprises During Reforms," The China Quarterly, No.123 (September).

Hu, Angang, and Shaoguang Wang, 1994, China: Report of Government Capacity (Zhongguo Guojia Nengli Baogao), Liaoning People's Press, Liaoning Province.

Kydland, F. and E. Prescott, 1977, "Rules Rather Than Discretion: The Inconsistency of Optimal Plans," Journal of Political Economy, Vol.85, 473-490.

Labor Department and Economic System Reform Commission, 1992, "Tentative Regulations of Labor and Wages in Trial Stock Companies" People's Daily (July 13, 1992).

Lee, Kyu-Uck, Shujiro Urata, and Inbom Choi, 1992, "Industrial Organization: Issues and Recent Developments," in Vittorio Corbo and San-Mok Suh (eds.), Structural Adjustment in a Newly Industrialized Country, the John Hopkins University Press.

Li, Yingming, 1992, "Local Forces Will Dominate Economic Reform in China," Central Daily, October 23.

Lown, Cara S., 1988, "The Credit-Output Link vs. the Money-Output Link: New Evidence," Economic Review: Federal Reserve Bank of Dallas, (November).

Luo, Binsheng, 1992, "From Contract Responsibility System to People's Ownership," Economic Research, No.5.

Ma, Jun, 1989, "Problems in Industrial Structural Change and the Direction of Reform," Economic Theory and Economic Management (Jinji Lilun Yu Jinji Guanli), No.1 (January).

_____, and Gang Zou, 1991, "Regional Aspects of Industrial Development in China," Management World(Guan Li Shi Jie), No.3, May 1991.

_____, and Micheal Bell, 1992, "China: Regional Policy and Its Macroeconomic Implications," International Monetary Fund, Central Asian Department, Mimeo.

_____, and Yong Li, 1994, "China's Regional Economic Policy: Effects and Alternatives," forthcoming in Journal of Asian Economy, Vol. 8, No.1.

_____, 1993a, "Regional Fiscal Policy Differentials," Mimeo, China and Mongolia Department, The World Bank.

_____, and David Walker, 1993b, "China's Financial Development in a Reform Era," Draft, Georgetown University.

_____, 1993c, "Modelling Intergovernmental Fiscal Relations in China," Draft, Georgetown University Economics Department.

_____, 1993d, "China: Government Credibility, Monetary Cycles and Reform Cycles," Draft, Georgetown University Economics Department.

_____, 1993e, "China: Interbank Market Activities," The World Bank, China and Mongolia Department, Mimeo.

_____, 1994, "Intergovernmental Fiscal Relations in Japan and Korea: the Implications for China," Paper prepared for the Senior Policy Seminar on Intergovernmental Fiscal Relations in China, jointly sponsored by the Ministry of Finance of China and the Economic Development Institute of the World Bank, September 12-17, Dalian, China.

Metzger, Michael B., Jane P. Mallor, A. James Barnes, Thomas Bowers, Michael J. Phillips, 1989, Business Law and the Regulatory Environment: Concepts and Cases, IRWIN, INC.

McKinnon, Ronald I., 1993, "Gradual versus Rapid Liberalization in Socialist Economics: Financial Policies and Macroeconomic Stability in China and Russia Compared," Stanford University, Paper for the Annual Bank Conference on Development Economics.

Michael Bell, Hoe Ee Khor, Kalpana Kochhar, Jun Ma, Simon N'guiamba, and Rajiv Lall, 1993, China at the Threshold of a Market Economy, Occasional Paper, No.107, International Monetary Fund, Washington DC.

Ministry of Finance, 1988, China Fiscal Statistics 1952-1987, China Fiscal Press, Beijing.

Ministry of Finance, 1992, China Fiscal Statistics 1987-91, China Fiscal Press, Beijing.

O'brien, Kevin, J. 1992, "Bargaining Success of Chinese Factories," The China Quarterly, December, No. 132.

Oksenberg, Michel and James Tong, 1991, "The Evolution of Central-Provincial Fiscal Relations in China, 1971-1984: The Formal System," The China Quarterly, No.125, pp.1-32.

Oates, Wallace E., 1972, Fiscal Federalism, Harcourt Brace Jovanovich, Inc.

Pechman, Joseph A., 1985, Federal Tax Policy, 5th edition, the Brookings Institute, Washington D.C..

People's Bank of China, 1993, People's Bank of China Annual Report 1992, Beijing.

Persson, Torsten, and Guido Tabellini, 1990, Macroeconomic Policy, Credibility and Politics, Harwood Academic Publishers.

Persson, Matte, Torsten Persson, and Lars E.O. Svensson, 1987, "Time Consistency of Fiscal and Monetary Policy," Econometrica, Vol.55, pp.1419-1432, (November).

Persson, Torsten, and Guido Tabellini, 1993, "Federal Fiscal Constitutions: Part I: Risk Sharing and Moral Hazard," Memio.

Prachowny, Martin, 1994, The Goals of Macroeconomic Policy, Routledge, London and New York.

Rogers, Carol, 1987, "Expenditure Taxes, Income Taxes, and Time-Inconsistency," Journal of Public Economics, Vol. 32, 215-230.

The State Council, 1989, "Decisions of Industrial Policy," People's Daily, March 18.

Sender, Henry, 1993, "Party of the first part," Far Eastern Economic Review, February 11.

Shah, Anwar, 1991, The New Fiscal Federalism in Brazil, World Bank Discussion Paper 124, Policy Research Department, The World Bank.

_____, 1991, "Perspectives on the Design of Intergovernmental Fiscal Relations," Policy

Research Working Paper No. 726, The World Bank.

_____, 1994, The Reform of Intergovernmental Fiscal Relations in Developing and Emerging Market Economies, World Bank Policy and Research Series No. 23.

Shen, Liren and Dai Yuancheng, 1990, "On the Formation, Effects and Causes of China's Lords Economy," Economic Research (Jinji Yanjiu), March.

Singh, Inderjit, 1992, China: Industrial Policies for an Economy in Transition, World Bank Discussion Paper No.143, The World Bank, Washington DC.

State Council of People's Republic of China, 1989, "The State Council's Decision Concerning the Main Points of Current Industrial Policies," People's Daily (March 18).

State Council of People's Republic of China, 1992, "Rules of Transforming Management of State Enterprises," People's Daily (July 24).

State Property Management Bureau, Ministry of Finance and State Industrial and Commerce Administration Bureau, 1992, "Trial Measures of State Assets Registration," People's Daily (July 5, 1992).

State Property Management Bureau, Economic System Reform Committee, 1992, "Provisional Regulations State Assets Management in Enterprises Experimenting Joint Stock System," People's Daily (July 27, 1992).

State Statistical Bureau, 1989, Forty Years of China's Development, China State Statistical Press, Beijing.

State Statistical Bureau, 1991, China's Finance Yearbook 1990 (Zhongguo Jingrong Ningjian 1990), China State Statistical Press, Beijing.

State Statistical Bureau, 1991, China's Statistical Yearbook 1991, China State Statistical Press, Beijing.

State Statistical Bureau, 1992, China's Statistical Yearbook 1992, China State Statistical Press, Beijing.

State Statistical Bureau, 1993, China's Statistical Yearbook 1993, China State Statistical Press, Beijing.

The World Bank, 1989, World Development Report 1989: Financial System and Development, Oxford Press.

The World Bank, 1988b, China: Finance and Investment, The World Bank, Washington, D.C.

The World Bank, 1990, China: Financial Sector Policies and Institutional Development, The World Bank, Washington, D.C.

The World Bank, 1991, China: Macroeconomic Stability and Planning Under a Decentralized System, The World Bank, Washington, D.C.

The World Bank, 1992, China: Revenue Mobilization and Tax Policy, The World Bank, Washington, D.C.

Wang, Shaoguang, 1994, "Central-local Fiscal Politics in China," in Jia Hao and Lin Zhimin (eds.), Changing Central-local Relations in China, Westview Press, Boulder.

Watson, Andrew and Christopher Findlay, 1992, "The 'Wool War' in China," in Christopher Findlay ed. Challenges of Economic Reform and Industrial Growth: China's Wool War, Allen & Unwin, Australia.

Weimer, Calla, 1992, "Price Reform and Structural Change: Distributional Impediments to Allocative Gains," Modern China, Vol.18, No.2, pp.171-196.

Weingast, Barry R., 1993, "The Political Foundations of Antebellum American Economic Growth," Hoover Institution, Stanford University.

Welch, Susan, John Gruhl, Michael Steinman, John Comer, Harry Basehart, 1993, Understanding American Government, 2nd edition. West Publishing Company.

Wu, Binyang and Li Yong, 1993, "The Truck Incident," in Law Daily (Fazhi Ribao). December 11.

Wu, Mingyi, 1990, "Thoughts on Local Government Behavior," Economic Research, No.7.

Wu, Naitao, 1993, "Legal Service For Economic Order," Beijing Review (August 9-15).

Yi, Gang, 1992, "The Money Supply Mechanism and Monetary Policy In China," Journal of Asian Economics, Vol.3, No.2, pp.217-238.

Zhang, Xiaohe, Lu Weiguo, Sun Keliang, Christopher Findlay and Andrew Watson, 1991, "The 'Wool War' and the 'Cotton Chaos': Fibre Marketing in China," Chinese Economy Research Unit, The University of Adelaide, Working Paper No 14.

Zhu, Jialiang, and Wu Mingyi, 1992, "Management of Central and Local Government: Barriers and Choices," Economic Research, No.8.

Zhu, Min, 1993, "The Mechanics and Consequences of China Revenue Contract System," Mimeo, Policy Research Department, The World Bank.

Zou, Heng-fu, 1993, "Optimal Design of Federal Grants to Localities," Mimeo, Policy Research Department, The World Bank.

Policy Research Working Paper Series

	Title	Author	Date	Contact for paper
WPS1384	Fiscal Decentralization and Intergovernmental Finances in the Republic of Albania	David Sewell Christine I. Wallich	November 1994	G. Langton 38392
WPS1385	Fiscal Federalism Dimensions of Tax Reform in Developing Countries	Robin Boadway Sandra Roberts Anwar Shah	November 1994	C. Jones 37754
WPS1386	EU Bananarama III	Brent Borrell	December 1994	G. Ilogon 33732
WPS1387	Fiscal Decentralization and the Size of Government: An Extension with Evidence from Cross-Country Data	Jaber Ehdaie	December 1994	C. Jones 37699
WPS1388	Does Voice Matter? For Public Accountability, Yes	Samuel Paul	December 1994	B. Moore 35261
WPS1389	Ruble Overhang and Ruble Shortage: Were They the Same Thing?	Patrick Conway	December 1994	L. Suki 33974
WPS1390	Regional Integration and the Baltics: Which Way?	Piritta Sorsa	December 1994	J. Ngaine 37947
WPS1391	Where in the World Is Population Growth Bad?	Jeff Kling Lant Pritchett	December 1994	S. Fallon 38009
WPS1392	Some Economic Consequences of the Transition from Civil War to Peace	Jean-Paul Azam David Bevan Paul Collier Stefan Dercon Jan Gunning Sanjay Pradhan	December 1994	C. Jones 37699
WPS1393	The Interface of Trade, Investment, and Competition Policies: Issues and Challenges for Latin America	J. Luis Guasch Sarath Rajapatirana	December 1994	J. Troncoso 37326
WPS1394	Macroeconomic Reform and Growth in Africa: <i>Adjustment in Africa</i> Revisited	Lawrence Bouton Christine Jones Miguel Kiguel	December 1994	R. Martin 39026
WPS1395	A Typology of Foreign Exchange Auction Markets in Sub-Saharan Africa	Janine Aron Ibrahim Elbadawi	December 1994	R. Luz 39059
WPS1396	Foreign Exchange Auction Markets In Sub-Saharan Africa: Dynamic Models for Auction Exchange Rates	Janine Aron Ibrahim Elbadawi	December 1994	R. Luz 39059

Policy Research Working Paper Series

	Title	Author	Date	Contact for paper
WPS1397	Are Private Capital Flows to Developing Countries Sustainable?	Uri Dadush Ashok Dhareshwar Ron Johannes	December 1994	J. Queen 33740
WPS1398	The Cost of Air Pollution Abatement	Raymond S. Hartman David Wheeler Manjula Singh	December 1994	E. Schaper 33457
WPS1399	How Important to India's Poor is the Urban-Rural Composition of Growth?	Martin Ravallion Gaurav Datt	December 1994	P. Cook 33902
WPS1400	Technical and Marketing Support Systems for Successful Small and Medium-Size Enterprises in Four Countries	Brian Levy with Albert Berry, Motoshige Itoh, Linsu Kim, Jeffrey Nugent, and Shujiro Urata	December 1994	D. Evans 38526
WPS1401	Colombia's Small and Medium-Size Exporters and Their Support Systems	Albert Berry Jose Escandon	December 1994	D. Evans 38526
WPS1402	Indonesia's Small and Medium-Size Exporters and Their Support Systems	Albert Berry Brian Levy	December 1994	D. Evans 38526
WPS1403	Small and Medium-Size Enterprise Support Policies in Japan	Motoshige Itoh Shujiro Urata	December 1994	D. Evans 38526
WPS1404	The Republic of Korea's Small and Medium-Size Enterprises and Their Support Systems	Linsu Kim Jeffrey B. Nugent	December 1994	D. Evans 38526
WPS1405	Growth and Poverty in Rural India	Martin Ravallion Gaurav Datt	January 1995	WDR 31393
WPS1406	Structural Breaks and Long-Run Trends in Commodity Prices	Javier León Raimundo Soto	January 1995	R. Luz 31320
WPS1407	Pakistan's Agriculture Sector: Is 3 to 4 Percent Annual Growth Sustainable?	Rashid Faruquee	January 1995	F. Willie 82262
WPS1408	Macroeconomic Management and Intergovernmental Relations in China	Jun Ma	January 1995	C. Jones 37754