

# **The Role of Local Government and Economic Development in Decentralization in China**

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# The evolution of decentralization in China

- Fiscal decentralization (1980-1993)
- Recentralization (1994-2002)
- Investment decentralization (2003-now)

# Fiscal decentralization (1980-1993)

- Economic reform in China since 1978 has been characterized by decentralization
- The decision-making power of the central government shifted and dispersed to local governments.
- Local governments have vigorously expanded their regional economies in response to this decentralization.

# Criticism of decentralization

- Fiscal decentralization gave excessive stimulation to local governments, resulting in misallocation of resources
- Local investments repetitive and excessive.
- Local governments' administrative protection, market segmentation
- Unconstrained expansion of local economies
- Resulted in investment overheating and macroeconomic fluctuation

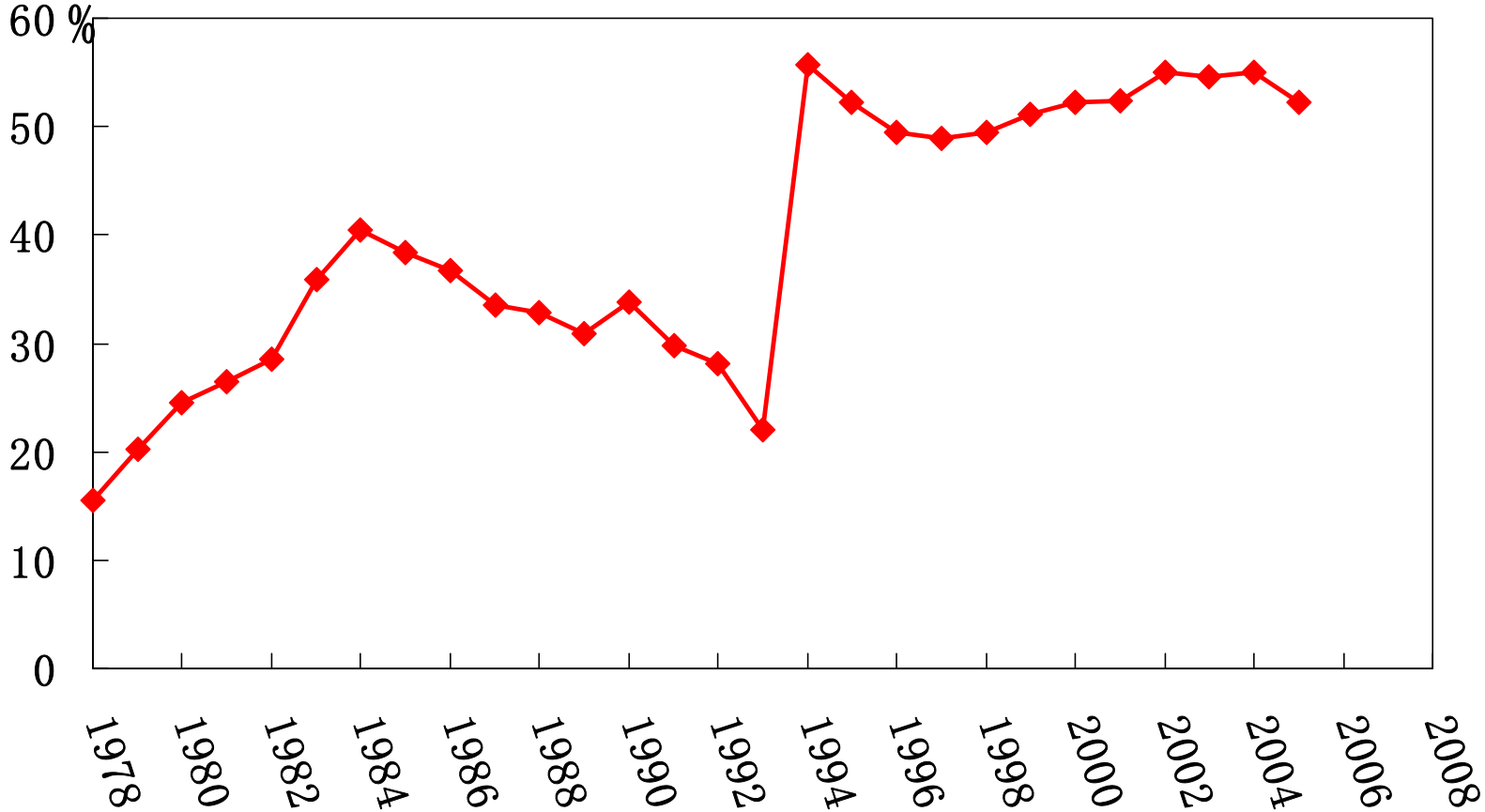
# Criticism from two sides

- Planned economy view:  
Decentralization weakened the central government's competence for centralizing fiscal resources and control of the macroeconomy
- Market economy view:  
The decentralization was administrative, not market competitive, deviating from the direction of market reform.

# Recentralization (1994-2002)

- In 1994, fiscal decentralization was cancelled.
- Central government share of revenue increased, local government share reduced
- Central government share increased greatly from 22% in 1993 to 56%
- Local decision power taken back by the central government

# The increased share of central revenue since 1994



# **The decision-making power concentrated in the central government**

- In 1998, the decision-making power of local branches of state-owned banks for loans was returned back to the banks headquarters.
- Decision-making powers for the key investments in the locals were concentrated in the central government.



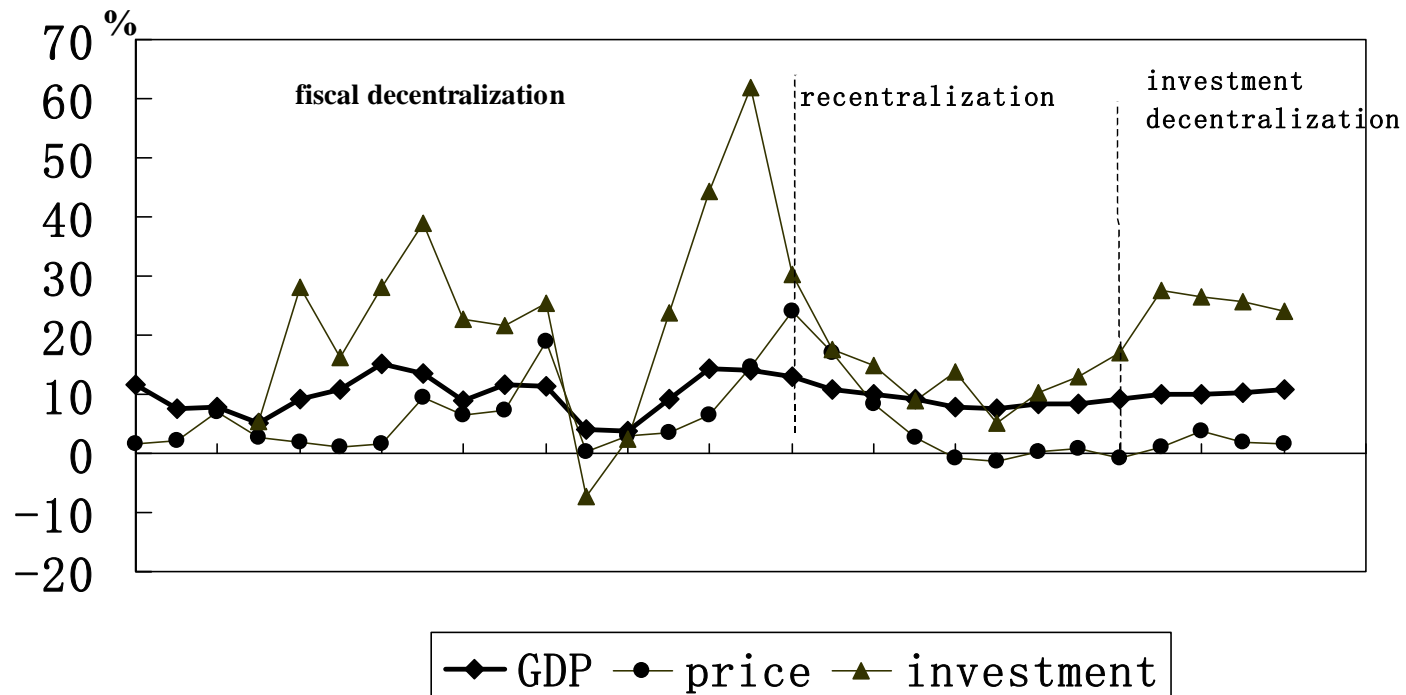
# The worst macroeconomic performance in recentralization

- The expanding enthusiasm of local investments disappeared
- During 1998-2002, all indexes, including growth rate, investment, consumption, income, price, employment, worsen:
  - The rate of GDP increase was 8.2%, 2 percentage points lower than the past period 1978-1997.
  - The increase rate of investment below 10%.
  - The price index drop to negative.
  - The rate of unemployment rises to more than 4% from lower than 3%.

# **Local investments expansion during the conflict (2003-now)**

- Since 2003, local investments have been vigorously reviving.
- Local investments boom in steel, cement, aluminium, electricity, coal, etc.
- Scale and speed of local investments exceed central investment
- Macro-management department opposes strongly local investments expanding

# Macroeconomic performance



# The criticism from macroeconomic management department

- Local investments are expanding excessively, causing economic overheating and bottleneck tension
- Local investments expanding at a low level, causing industrial structure degradation.
- Local investments expanding blindly, causing a surplus of production capacity
- Local investments have been supported and protected by local governments, violating rules

# Arguments for local investments

- Not causing economic overheating
- Not expanding only at low levels
- Not blind
- Not violating rules
- Governance improved
- Self-restrained

# Local investments not causing economic overheating

- Macroeconomic performance has been good
- China's economy has been growing at more than 10% for 5 years continuously
- Bottleneck restrictions such as energy, transportation, steel, cement, etc. have eased
- No inflation
- Indicators such as residents income, consumption, employment have been the best since 1997.
- Efficient management of local governments, has undoubtedly played an important role.

# **Local investments not expanding only at low levels**

- Local investments have increased production capacity, for example, in steel: industrial, advanced, and high-quality technology
- High-standard product technology, conserving energy, using better material, environmental protection

# Local governments and local investments not blind

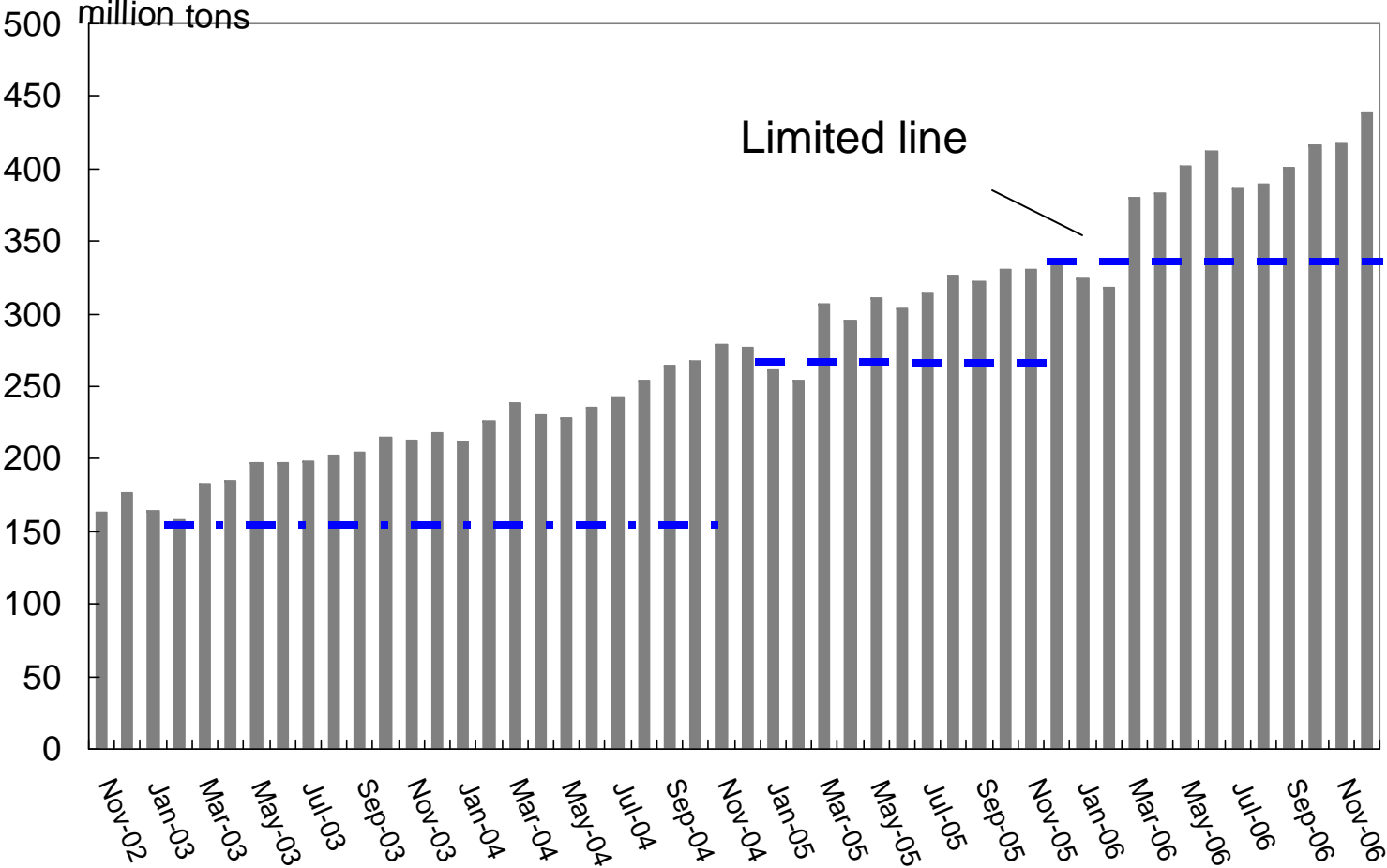
- Local governments support local investments, gauging market dynamics, and swiftly seizing development opportunities.
- Pay more attention to the long-term investment project and strategic meaning.
- Expect to get steady, continuously, high-efficiency development, occupying the forefront in categories such as scale, technology, quality, benefit, etc..



# Local investments not causing production surpluses

- The total amount of steel production countrywide break yearly targets set by the management department, from 150 million tons to 450 million tons.
- Electric, coal, cement, aluminium etc. similar.
- The output of products increased in a large amount has covered the shortage. Local investments have made the contribution.

# Amount of steel production



- Local investment enterprises and local governments pay attention to market trends and the overall situation of industries more than the department of central government.

# Opinion differences on local investments in hot industries

- Central department: producing or aggravating production surplus and vicious competition.
- Local governments: efficient exceed the inefficient in competition, favorable to development of the industries.

# Local enterprises regulated by central department, from limited to accepted

- Local enterprises expanding, growing into leading enterprises
- Central department warning and limiting at first, accepting finally
- TV: Changhong (长虹)

Car: Cherry (奇瑞), Jili (吉利)

Mobile phone: Bird (波导)

Steel: Sha steel (沙钢), Jian Long (建龙),  
Laigang (莱钢), Hualing (华凌)

# Local investments not violating rules

- In the interest of local development and environment
- Local governments supervise and control illegal and low quality investment strictly, initiatives exceed the capability of the central government.
- Local governments do not provide the protection for investments with low efficiency and high pollution.

# Investment in rules compliance

- Local governments ask local investments to comply with the rules
- A tragic case: Central government punished severely Tieben Steel Plant (铁本) for violating rules in 2004.
- Local governments have understood, do not grossly violate the rules.
- The costs of violating the rules for large-scale investments are enormous.
- Local investor consciousness for following the norm is very strong

# Rationality and efficiency of local government's decision

- Local governments support local investments warmly, is rational.
- Wishing eagerly to improve public service ability through local industries' development.
- As sharp as entrepreneurs, courageous and resolute, swift, efficient
- Rationality and efficiency of local government's decision in supporting investments are far higher than central departments



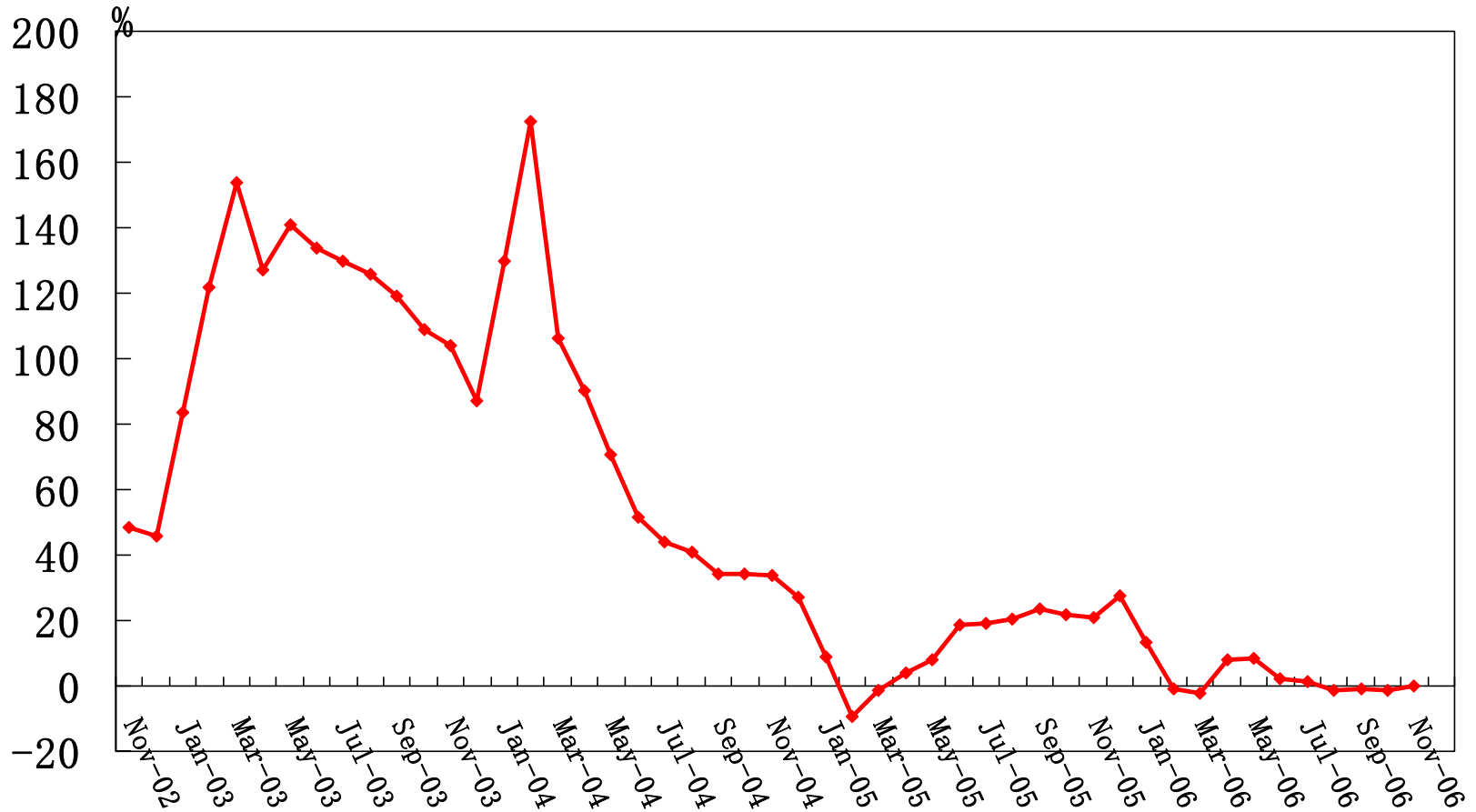
# Local governance improved

- Local governments obtain abundantly more information than the central government .
- Local investments approved by local governments have obvious stimulation and market mechanism constraints.
- Local investors assume sole responsibility for returns and losses of investments.

# Local governments self- restrained

- Local governments have enthusiasm in supporting local investment expansion, also have self- restrained response to economic fluctuations to evade risk
- Reduced investment, which is the effect of the central government's regulation for preventing overheating, but more a function of self-restrained behavior of local investments.

# Steel investment growth



# Dilemma of decentralization

Decentralization strongly stimulates the vigor of local economies

but may bring macroeconomic overheating and fluctuation

# The conflict intensifies and eases

- In 1994, the problem was resolved by cancelling decentralization and recentralization.
- In 2004, the conflict between decentralization and recentralization have occurred and intensified.
- Since 2005, the conflict easing, investment decentralization has been maintained

# Tieben Steel Plant in Jiangsu province was closed in 2004



# Shagang(沙钢) in Jiangsu province, the largest nonstate-owned steel plant, is expanding



# The tragedy of recentralization not replayed

- Local governments and local investments self-restrained behavior, relieving the conflict
- Local governments and enterprises are vigorous, while also self-restrained.
- The tragedy that excessive local expansion resulted a returning of concentrated powers has not been replayed