Provincial and Local Governments in China: Fiscal Institutions and Government Behavior

Roger Gordon (UCSD and CKGSB)
Wei Li (CKGSB)

Fiscal Federalism: Chinese Style

- Greater fiscal decentralization in China than in the U.S.
  - Only about one-third of government spending done by the national government in China
  - In comparison, two-thirds done by national government in the U.S.

Fiscal Federalism: Chinese Style

- Local governments commonly credited with some of the key successes and key failures of the economic reforms
  - A key success: explosive entry of TVE's
  - Key problems
    - Trade barriers
    - Poor access to education in rural areas
    - Stagnation of incomes in agriculture
    - Instability in land markets
- How do we best explain these outcomes, given the incentives faced by local officials?

Existing models of incentives faced by local officials

- Voice: Poor performance
  - generates a loss in votes
  - Reduces political “contributions”
- Exit
  - Poor performance causes individuals to leave (Tiebout model)
  - Resulting loss of tax revenue harms officials, though also save on expenditures
  - If mobility substantial, then competition should lead to efficient outcomes, as in any market sector, though undermines redistribution

Neither model that appropriate for China

- Voice: no elections
  - Demonstrations, but create little pressure
  - Side payments, though
  - Also promises of future employment
- Exit: Due to the hukou system, exit in the past was difficult, and remains costly.

Alternative models

- Two possible alternatives:
  - Voice: from national government rather than from voters
  - Exit: of economic activity rather than of people, causing loss in tax revenue
- Parallel alternatives when examining agency problems in a firm: threat of being fired (career concerns) vs. incentive contracts

Aim of this paper

- Develop more fully a model based on threat of exit of economic activity
  - Officials affected both by resulting loss in tax revenue and also resulting drop in expenditures
- Will argue that this natural adaptation of the Tiebout model to China quickly explains a variety of the stylized facts about local government behavior

Sources of local government revenue

- Tax revenue
  - Corporate and business taxes
  - Excise taxes and later a VAT
  - Agricultural taxes
  - Personal income taxes
- Extra-budgetary revenue
  - Net-of-tax profits of collective firms
  - Sale or lease of land transferred out of agriculture
  - Minus compensation paid to farmers based on value of land in agriculture
- Fees for use of public services
- Transfers from the national government

Policy choices

- Spending on public services aiding
  - Firms
  - Farmers
  - Households
- Allocation of bank loans (prior to 1994)
- Allocation of land

Taking as given

- Tax structure
- Prices for outputs in the national market
- Set of residents
- Market allocation of workers within the jurisdiction
- Available bank funds (prior to 1994) and market interest rate since then

Forecasted behavior (pre-1994)

- Forecast efficient investments in capital in collective firms
  - Local governments the residual claimant
  - Firms operated in a competitive national market

Forecasted behavior (pre-1994)

- Neglect of agriculture
  - Tax rate higher on industry, so gain from shifting activity from agriculture to industry
  - Lowering the marginal product of farmers lowers the cost of labor in industry, raising profits of collective firms
- Opposition to entry of private firms
  - Receive only tax payments, instead of the full profits received from collectives
  - Control over land can prevent most entry
  - But side-payments can induce support for these firms. (Firms wear a “red hat”.)

Forecasted behavior (pre-1994)

- Public services
  - Efficient provision of services and infrastructure to collective firms
  - Minimal services to agriculture, unless can charge high enough user fees
  - In general, no services to households unless they pay the full cost.
  - Education raises future excise tax payments by firms, but may risk future exit from the jurisdiction

What about short time horizon for officials?

- Officials can’t legally sell position, so have a short time horizon.
- Doesn’t this reduce incentives to invest in capital and infrastructure?
  - With fixed pool of local funds available for new investment, no effect on total investment, though favor investments with a quick payoff.
  - Incentive to contract with outside firms at favorable terms to undertake infrastructure investments, attracting side payments.

Major policy changes around 1994

- Major changes in tax structure
- Bank loans (in principle) now controlled by banks rather than local governments
- Privatization of smaller state-owned firms, and implicit national support for entry of new private firms
- Introduction in 1998 of the right to sell lease-holds on land
- Recently, elimination of taxes on agriculture

Forecasted provision of services (post-1994)

- Favor firms with higher tax payments per worker
  - Favor capital-intensive firms
  - Favor firms facing higher VAT rate
  - Weaker incentives, though, than before 1994
- Continue to neglect agriculture, particularly after end of agricultural taxes

Forecasted behavior (post-1994)

- Limit shift of land to industry
  - to keep land prices high
  - to keep required compensation to farmers low
- Implications of short time horizon of officials
  - Prefer sale to lease of land
  - Prefer rapid sale of land.
  - One explanation for sales now in spite of rapid increases in land prices

Forecasted behavior (post-1994)

- Still no incentives to provide services to households without sufficient user fees
- Forecast in particular reluctance to finance tuition-free education.
- In order to implement tuition-free education, national government in the end forced to cover full cost. But local governments may divert funds.

Forecasted Behavior (post 1994)

- Government responses to migration pressures
  - Migrants increase tax base but can create extra costs for public services
  - Governments have incentive to discourage entry (encourage exit) of migrants that are net recipients, but encourage entry of migrants who are net contributors to budget

Forecasts from alternative model: Voice from national government

- Promotions under control of national government
  - Means for national government to exercise influence
  - In practice, information poor, limiting direct oversight to egregious cases
  - Threat also weak for most officials, given that most future assignments close substitutes

What additional incentives result?

- The above model forecasts that promotion will focus on implications for future tax revenue of higher levels of government
  - Current tax payments to national government
  - Growth rate in tax payments
- Local officials should then favor sectors facing a high national tax rate to the extent that these promotion incentives matter

Forecasted vs. actual behavior?

- So far can only say that forecasts seem consistent with our anecdotal observations
- Han and Kong (2011) find that the tax changes in 2002-3, lowering the share of enterprises taxes going to local governments, reduced support for industry

Sources of local government tax revenue elsewhere

- Local tax revenue comes from very different sources in other countries
- Business profits taxes and even property taxes on businesses play little role
  - Competition drives down these taxes, in principle until jurisdictions break even from having more firms.

Incentives faced by local governments elsewhere

- Residential property taxes the dominant source of local government revenue.
  - Since property values quickly reflect the present value of net effects of government policy on the utility of residents, this tax provides effective incentives on local officials.
- Prominent role for user fees.
- Retail sales taxes occasionally used by U.S. cities, but at the cost of cross-border shopping.

How are local taxes in China likely to evolve, if little migration?

- Competition will undermine:
  - taxation of business income
  - VAT paid based on local production, since compete for industries paying VAT
- Pressure towards neutral incentives regarding forms of employment
  - Neutral if revenue depends on consumption, regardless of source of employment, e.g. retail sales tax or a consumption-based VAT.

Competition for migrants

- To attract residents who are net tax payers,
  - Provide better services to richer households, and poorer services to net recipients
  - Reallocate more land, in order to raise wage rates and lower residential rents
- Competition leads to increase in services until government breaks even from new residents.

Summary

- Financial incentives do seem to matter for government officials
  - Help explain striking initial success of collective firms
  - But also help explain continuing neglect of agriculture and education, leading to growing inequality.
- Rethinking the design of these incentives important to avoid potential threats to future growth