

## Chapter 4

### Central-Local Fiscal Politics

Just like a human being cannot be alive without blood, the state cannot function without revenue. The extraction of fiscal resources is a precondition for the implementation of all other government programs. In this sense, the capacity to extract revenue is the infrastructural capacity of the state.

Understanding that the greater the revenue, the more possible it is to extend rule, the state tends to extract as much revenue as it can from the taxpayers. But the revenue maximizer are usually subject to various constraints which limit its capacity to produce more revenue. Under non-state-socialist systems, according to Margaret Levi, the state's "relative bargaining power," "transaction costs," and "discount rates" have determinant effects on its revenue production capacity. Those constraints are generally imposed by societal forces.<sup>1</sup> Under the authoritarian state socialist system, however, organized societal forces are virtually nonexistent. The state doesn't have to negotiate with anyone in making its revenue policy, and it thereby pay little, if any, "transaction costs" for negotiating an agreement on the policy and for implementing the policy. What restrains the extractive capacity of the state thus is merely "discount rates"---its concern over securing future revenue. Sensible policy-makers will "extract revenue up to the point at which further extraction would put future output at risk."<sup>2</sup>

Does it mean the end of fiscal politics in the state socialist system? Far from it. While fiscal politics between the state and society largely ends, fiscal politics between the central government and local governments (at provincial level and below) assumes prominence. The local government has a dual "personality" under the centralized fiscal system of the state socialism. On the one hand, it acts as a "tax collector," collecting taxes from taxpayers (mainly state and collective enterprises, not individuals) within its jurisdiction. On the other hand, it is a "taxpayer" itself, paying certain amount or certain proportion of the revenue it generates locally to the central authorities. As a "tax collector," the local government is predatory. But as a "taxpayer," it has to deal with the no less predatory central government. Fiscal politics between the central and local governments results from that the former tends to maximize its share and the latter to minimize their contributions. The central government's capacity of revenue production thus is constrained by its relative bargaining power vis-a-vis the local governments and its calculation of the costs and benefits of attempted actions.

This chapter attempts to trace the trajectory of the changing central-local relations by reconstructing the patterns of fiscal politics between Beijing and the provinces over the last 40 years. It will show how the central government's holding over financial resources has eroded, why the central state has lost its battle over the control of the crucial political resources to competing local governments, and what have been the direct and indirect economic, social, and political consequences of the loss of the central fiscal control. In the

course of presenting the historical process through which the once nearly monolithic power has deteriorated into a fragile "weak state," we hope to test two hypotheses:

1. Under the authoritarian state socialist system, the central government's extractive capacity is circumscribed mainly by the evasive tendency of the local governments.
2. The decline of this capacity contributes to the general crisis of the Chinese state socialist system.

## **Revolution**

The Chinese communist state in the early 1950s was extraordinarily powerful not only because the war and revolution had pulverized the old social formation to the degree that no social group was in a position to challenge the new regime but also because recently established state agencies were too young to sprout strong independent policy preferences of their own. In March 1950, the central authorities imposed an unified management over the national financial and economic affairs with little resistance from local governments, despite the fact that during the 12 years from the outbreak of the Sino-Japanese War in 1937 to 1949, the financial and economic affairs in the various communist-controlled areas were managed separately, with each having its own currency and taking care of its own revenue and expenditure. The emphasis was on unifying revenue. The state budget was transformed into a consolidated budget that included the budgets of central, provincial, and subprovincial governments. Except few local taxes approved by the central government, all the tax income was turned over to the central treasury. As to the expenditure, even small items needed formal approval from Beijing. At a time when the country still faced tremendous economic difficulties and enormous fiscal deficits and there were only a limited amount of funds available for extraordinary uses, planned allocation by the central government made it possible for the state to use limited funds according to what it perceived as the nation's priorities.

As the unified and centralized system developed during the First Five Year Plan (FFYP) period (1953-1957), the state's extractive capacity continued to grow. State budget revenue rose rapidly during this period, both absolutely and in proportion to GDP, constituting 22 percent of GDP in 1952 and 29 percent in 1957.<sup>3</sup> Of the rising proportion of GDP captured by the budget, the central government concentrated a large share in its own hands. Throughout the FFYP period, the central government's share accounted for 80 percent of the total revenue while the various localities (at the provincial and county levels) could have access only to the remaining 20 percent. Of the total expenditure, the central authorities accounted for 75 percent while the various localities accounted for the remaining 25 percent.<sup>4</sup>

The large share represented a distinct increase in the potential role of the state in support of socioeconomic development compared to the prerevolutionary period, when a lack of revenues had severely constrained state-sponsored modernization programs. According to Lardy, "at the end of the 19th century, the revenues of the central government

were only 1 to 2 percent of China's GDP. Under the somewhat more vigorous fiscal program of the Nationalist government after 1928, central government revenues were only about 3 percent of GDP. Even when provincial and local revenues are included, the total government revenue share of GDP was less than 5 percent." In comparison with other less developed countries, the role of the budget in resource allocation in China after 1949 was also significantly greater.<sup>5</sup> The greater extractive capacity of the state enabled central planners to accelerate the rate of capital formation and allocate investment resources to priority sectors and regions. A tangible result was the overfulfillment of the FFYP in 1957.

### **Devolution**

However, the high degree of centralization of financial resources was not without its problems. After several years of existence, local governments began to become aware of their distinct interests. No longer resigning themselves to being merely central agents, they became more interested in establishing independent fiscal base than in serving the center. On the one hand, because there was no functional link between revenues collected and expenditures at any level below the consolidated state budget, local governments' initiative in mobilizing revenues was dampened. On the other hand, because of the center's annual redetermination of revenues and expenditures for each and every locality, there was no way for local governments to play any role in comprehensive long-term local economic planning.<sup>6</sup>

Mao didn't like the concentration of political and economic authority at the center either, but for a different reason, namely, his fear of the spread of bureaucratism. For him, the way to retrench bureaucratism was to decentralize economic power. Thus decentralization became an important component of Mao's 1958 program of "Great Leap Forward," which was enthusiastically endorsed by local governments.<sup>7</sup>

The 1958 decentralization had three key aspects:

1. The great majority (over 80%) of the central enterprises were transferred to the management of the local authorities. Many of those enterprises, such as airlines, railroads, highways, post service, and the like, by their natures, cannot be effectively managed by local public authorities in any circumstance.

2. Central planning was replaced by local planning. Local governments were given permission to approve medium-sized and even large capital construction projects, to issue construction bonds, and to recruit and deploy labor force as they saw fit.

3. Local governments were delegated greater fiscal power. The provinces received a large fixed portion of a substantially broader revenue-sharing base and their expenditures were to be determined by revenues collected, rather than the other way around.

However, the decentralization of fiscal power didn't result in reduction of the degree of state penetration, which was reflected in the rising ratio of budget revenue to national income. During the FFYP period, the state budget revenue on average constituted 32.7 percent of the national income. But the percentage rose to 39.6% in 1958, 47.3% in 1959, and 53% in 1960.<sup>8</sup> However, the degree of political integration declined tremendously. Of

the rising proportion of national income captured by the budget, the central government's share fell from 80% during the FFYP period to 50% in the GLF period, while the local share jumped from 20% to 50%. The two developments suggest that once local governments get greater control over revenue, they tend to extort resources from society more rigorously, but revenue increase doesn't necessarily benefit the central planners.

In addition to taking advantages of the favorable new revenue-sharing system, local governments endeavored to increase their extrabudgetary incomes by various legal, semilegal, or illegal means. Extrabudgetary sources of revenue are those funds in public sector which are not subject to central budgetary control. In an ideal centrally planned economy, there should never be anything not subject to central control. Nevertheless, extrabudgetary funds have existed in China since the establishment of the People's Republic. During the FFYP period, funds mobilized annually outside the budgetary control mechanism were very small, never exceeding 8.5 percent of total budget revenues. The three years of 1958-1960 saw the first upsurge of extrabudgetary funds. In 1957, there was only 2.6 billion yuan of extrabudgetary funds in the nation altogether. The number was doubled to 5.6 billion in 1958, jumped again to about 10 billion in 1959, and peaked at 11.8 billion in 1960. In a short period of three years, the extrabudgetary funds registered a more than 400% increase. During the FFYP period, the extrabudgetary funds had been on average only as much as 6.5% of the budget revenue, but in 1960 the percentage reached 20.6%.<sup>9</sup>

With more money in their pickets, local governments became enthusiastic to display their initiative. One of the results was that a massive campaign to build new industrial projects swept the country. Even in economically backward Gansu provinces, 224,500 factories were built in the six months between January and June of 1958.<sup>10</sup> In 1958, a total of 26.7 billion yuan was invested in capital construction, up 97% from 1957 or equivalent to half of the total amount of 55 billion yuan invested during the entire FFYP period.<sup>11</sup> The over-extended capital construction caused an all-round imbalance between sectors, which pushed the central government to spend more money to fill gaps. The result was large deficits, 14.8 billion in all in the years between 1958 and 1961.<sup>12</sup> With neither market nor central plan to coordinate the economy, the Great Leap Forward ended up with a colossal failure.

The failure of the GLF demonstrates that general state revenue as such doesn't reflect the capacity of the state as a corporate actor. What general state revenue reflects is aggregate extractive capacity of governments at all levels. When local governments command a large share of financial resources, they tend to use those funds to pursue their own preferences. Thus, growing general state revenue may weaken rather than strengthen the ability of the state as a corporate actor to achieve the policy goals set by the central planners, whatever the goals are.

Nevertheless, the center's flexibility in redeploying resources generated by governments at all level survived the temporary ailment between 1958 and 1960. While the center's ability to manage the national economy was enfeebled by Mao's 1958 decentralization, its ultimate political authority over governments at lower levels remained

intact. The center might have become less able to exert positive sanctions (to reward desired actions), but it still kept the power to exert negative sanctions on local governments' behaviors (to prevent undesired activity).<sup>13</sup> The retained political authority enabled the center to transform the techniques of state intervention from decentralization back to centralization, at least partially.

In 1961, the central authorities decided to recentralize the system of economic management. All the rights to manage production, capital investment, materials, labor force, purchase, and financial affairs, that had been delegated to local governments, were taken back into the hands of the center. What was crucial to all recentralization measures was the recentralization of fiscal power. It was declared that subnational governments had no right to issue currency (including construction bonds). At the same time, the central government tightened up control over the management of both the budgetary and extrabudgetary funds.

In the five years of readjustment between 1961 and 1965, while budget revenue as a proportion of national income fell back to the level of 1957 (around 34%), the central government's share of the total increased from 50% to 60% (it was not able to recover to the level of the FFYP period). At the same time, the central authorities took rigorous measures to cut extrabudgetary funds. Extrabudgetary funds declined both absolutely and in proportion to budgetary funds, being as much as 20.6% of the budget revenue in 1960, 20.3% in 1962, and 16% in 1965.<sup>14</sup> The recentralization of fiscal power enabled the center to reduce the scale of capital construction, improve the internal structure of the national economy, and achieve a favorable balance between revenue and expenditure in addition to repaying all of China's foreign debts in this period. By 1965, the entire economy had taken a turn for the better. If resources had remained scattered and at local governments' disposal, it would have been impossible for the center to fulfill the task of readjustment and thus for the nation to tide over the difficult period in a matter of few years.

For Mao, however, the recentralization was merely an expedient measure for tiding over the difficult period. Once the economy recovered from the crisis of 1959-1961, he again decided to smash the Soviet-styled centrally planned system. In March 1966, Mao declared that his ideal was what he called a "republic with a nominal monarch"[xujun gonghe], in which central planners should play only a limited role of providing ideological guidelines. Criticizing that the recentralization of 1961-1965 had been overdone, he ordered that all enterprises which the central government had taken back from local governments should be returned to local governments.<sup>15</sup>

The Cultural Revolution paralyzed not only the central government but also governments at all levels. China was in anarchy from late 1966 to late 1968. While Mao enjoyed absolute personal power, the state lacked the basic ability to erect social control, much less to direct socioeconomic development. The 1967 plan never reached to the provinces, and there was no plan at all in 1968. Budget revenue fell from 55.9 billion yuan in 1966 to 41.9 billion in 1967 and 36.1 billion in 1968.

When public authorities were restored in the early 1970s, Mao initiated yet another decentralization drive. This time, he ordered that all enterprises "suitable" for local

management were to be transferred to local governments. Even such giant enterprises as Anshan Steel, Daqing Oilfield, Changchun Auto Works, Kailuan Colliery, Jilin Chemical Industries Company were considered "suitable" for local management so that they were transferred to the respective provincial governments in 1970.<sup>16</sup>

Along with transferring central enterprises to local governments, most revenue sources and expenditure categories were shifted to the provincial level in 1971. The provincial governments were allowed to keep and use all or most of remaining revenues after transferring a lump-sum to the center according to agreements set between them and the central government. The aim of the 1970-1971 decentralization was to induce the initiative of local governments. However, the center soon found that local initiative thus aroused was directed to further parochial interests of various localities without regard for macroeconomic rationality. Many problems surfaced in the wake of the decentralization of industrial management and fiscal system. With more resources at their disposal and the rights to use them, local governments ran wild in capital investment. The planned targets for investment were exceeded again and again. Without effective mechanism to coordinate economic activities, the decentralized system brought about blindfolded construction and overlapping construction. The unchecked expansion of the scale of capital construction was followed by a sharp increase in the number of people on state payroll. It had been planned to employ 3.06 million more people in state enterprises in the two years 1970 and 1971, but the actual increase was 9.83 million, three times as much as the planned figure. Because of the big jump in the number of state employees, the year 1971 saw a considerable increase in the total amount of wage payment and the scale of urban food grain consumption, which caused an acute shortage of supply on the market.<sup>17</sup>

Due to the fact that to a large extent, local governments were responsible for the over-extended capital construction, moderate central leaders made efforts in 1973 to restore central control over industrial management and budgetary funds. But this attempt was obstructed by the radical Gang of Four.<sup>18</sup> Mao on the whole sided with the Gang of Four, though sometimes on some specific issues he played a role in checking the Gang of Four's excesses. Because of Mao's insistence on letting each region, locality, or enterprise rely in so far as possible on its own resources, throughout the first half of the 1970s, local governments had greater access to revenues they extracted locally and more discretionary control over their expenditures than they had had in the 1960s. This was true despite the fact that local governments still had to revert most of revenues generated locally to higher levels under the consolidated budget. One of new sources of income for local governments was the so-called "five small local industries." In 1970, the central treasure earmarked 8 billion yuan in the following five years as a special fund to be handled by the provincial, municipal, and autonomous regional authorities for the development of these key industries. As for the newly built "five small industries" run by county governments, the county governments were allowed to keep 60% of the profits made by those enterprises. Even if those within the category of the "five small industries" suffered losses, county governments would not lose, because those enterprises would be exempted for a certain period of time from tax levies, or even better, getting financial subsidies.<sup>19</sup>

Extrabudgetary funds, which were beyond the central control, expanded in the early 1970s. From 1970 to 1976, while the budget revenue increased only 17.1%, extrabudgetary funds increased 172.8%. In 1970, the amount of extrabudgetary funds amounted to only 15.2% of the budget revenue, but in 1976, the ratio increased to 35.5%.<sup>20</sup> As central financial control over regional economic activity weakened, many localities found that they did not have to take central plans seriously; some of them even went so far as to act contrary to central plans and arbitrarily discontinue coordination with other localities arranged by central planners.<sup>21</sup>

The late Mao era was characterized by totalitarianism. Almost every aspect of social life was carefully monitored by state agencies at various levels. However, the very organizational structure which gave the state its power over society also weakened it, so the repressive Chinese communist state was unable to control priority economic activities and to secure inputs for them. By the time of Mao's death in 1976, China's national economy had been very much fragmented along regional lines. The fragmentation of the economy reflected the parcelization of the state apparatus. According to Lyons, the Chinese system in the late Mao era can be characterized as one in which "substantial devolution of authority---intentional or otherwise---was not accompanied by appropriate incentive and information structures, leaving decisions taken by the various planning offices largely uncoordinated."<sup>22</sup>

Mao's decentralization not only heightened local governments' consciousness of their particular interests but also expanded their pool of resources. The self-consciousness and independent source of resources, as expected, reinforced each other, resulting in disintegrative potential within China's political structure. This legacy of the late Mao era created an inertia that Mao's successors would find difficult to overcome.

Nevertheless, the centrifugal tendency in the Maoist era was relatively weak for several reasons. First, that Mao was still alive itself set a limit to the development of localism. No one was in a position to challenge Mao's authority as a symbol of unity. Second, while Mao was advocating the decentralization of economic management, he insisted on centralized and unified political leadership. In the early 1970s, most of provincial leaders were just recently rehabilitated after having been in disgrace for several years during the early stage of the Cultural Revolution. They still had lingering fears. In the treacherous political situation of the early 1970s, they had to act carefully as if walking on thin ice to avoid any political accusation, which might destroy their careers. "Localism" was the last thing with which they wanted to be associated. The centrifugal tendency thus was less apparent at the provincial level.<sup>23</sup> At lower levels, local leaders didn't have to deal with the ferocious Gang of Four and their direct superiors at the provincial level were generally irresolute and namby-pamby. Thus they were usually more bold in taking advantages of the central leadership's call for self-reliance and independent system by interpreting it as license to build autarkic "kingdoms" and to protect them with trade barriers.<sup>24</sup>

Third, to reduce the interprovincial differences in level of development, the central government still retained control over a large share of the budget revenue even after the

fiscal decentralization. In the 1970s, the provinces collected over 80 percent of total budgetary revenue, but they were entitled to carry out about 45 percent of expenditure, higher than in the period of readjustment of the early 1960s but lower than in the Great Leap Forward period. Moreover, the revenue-sharing rates with the provinces were subject to annual adjustment, so the center retained a certain leeway to extract more from the provinces if it found it necessary. In fact, the decentralized fiscal responsibility system was modified at the end of 1971, less than one year after it had been put into practice. Localities could no longer keep all the revenue surplus they collected above the targeted amount. In 1973, the percentage of above-target revenue being kept by the localities was once again lowered. Then, the year 1976 witnessed a retreat away from fiscal decentralization to basically the same system that had existed in the early 1960s.<sup>25</sup>

### **Involution<sup>26</sup>**

Since Mao's death in 1976, the Chinese economic system has undergone significant changes. The essence of the economic reform may be summarized by one phrase "fangquan rangli",<sup>27</sup> that is, to devolve central control over resources and decision-making power to local governments on the one hand and enterprises on the other. Deng Xiaoping chose the fiscal system as the breach of his overall reform program.<sup>28</sup> Many have interpreted Deng's fiscal decentralization as a voluntary concession, which aimed at narrowing the scope of state intervention and strengthening the role of the market. This is probably right. Indeed, while Mao advocates decentralization as an alternative to both central planning and market, Deng views decentralization as a way through which China would be able to move away from a command economy and to head toward the direction of market economy. But Deng's intention to replace the planned economy with a market economy was only part of the reason why he initiated the fiscal decentralization in 1980 and further expanded local autonomy and enterprises autonomy in later years. As a matter of fact, in 1980 the reformist central leadership hardly had any option other than fiscal decentralization.

In December 1978, the Chinese Communist Party convened the Third Plenary Session of the 11th Party Central Committee. The plenum set out to solve many problems affecting the daily life of the people in city and countryside that had piled up for quite some time. It was decided, among other things, to raise the prices by a wide margin for the purchase of farm products and sideline products, to reduce or remit agricultural taxes for some poor regions, to import a large amount of grain from abroad, to arrange jobs for millions of educated youth who had been sent down to the countryside, to raise the levels of salary for state employees, to restore the bonus system, to build more houses for urban residents, and the like. All of those measures were imperative for winning popular support for the reform drive, but they entailed great burden on the budget. In 1979, China ran a deficit of 20.6 billion yuan, almost three times as large as the previous peak of 7.1 billion in 1960. The next year saw yet another big deficit of 14.2 billion. Together, the amount of deficits in the two years was as high as 34.8 billion, exceeding the total of deficits in the previous 29 years

between 1950 and 1978 (24.8 billion).<sup>29</sup> It is not hard to imagine how anxious the central planners were when facing such big numbers.

How to make up the deficit? One way was to print bank notes. The total volume of new paper money issued in the two years was 13 billion yuan more than normal increase. This, however, ran the risk of inflation. Ultimately, the government needed either to increase its revenue or to cut its expenditure, or both. Unlike under the capitalist system in which individuals and private firms are tax payers, in China, state enterprises are the main contributors to the budget revenue. Some of enterprises were run directly by the central government, but more were under the control of local governments at various levels. Although it is not recognized as factually existing in China, local governments in effect possess proprietary rights over their "own" enterprises. This is not something which is observed in the Soviet Union or in the former state socialist countries of European CMEA.<sup>30</sup> Thus, most taxes are collected, not from society, but from elements of the state itself (local governments). Because of the quasi-ownership, local governments tended to resist the center's encroachment of local source of revenues as much as they could. To increase revenue or cut expenditure, the central government hence had to negotiate with the provincial governments. Because the fiscal system had become very dispersed since Mao's decentralization of the early 1970s, the central government couldn't expect to increase revenue by recentralization without facing strong local resistance. At the moment when the reformist central leadership desperately needed the support of the provincial leaders for their reform drive, it would be no less than committing a political suicide to provoke such resistance. To choose the path of least resistance, the reformist leadership adopted the "eating-in-separate-kitchens" reform in 1980.<sup>31</sup> The scheme had two advantages: having localities to bear more financial responsibilities while at least guaranteeing central income at current levels. The center hoped that as the pie expanded its slice would become larger.

What follows from my analysis is that the 1980 fiscal decentralization was a reflection of constraints on the reformist central leadership imposed by powerful provincial forces. In other words, the decentralization must be attributed not so much to the reformist leadership's voluntary decision to extract below capacity as to its incapacity to extract the greatest amount of revenue in the old way and its desire to increase revenue over time in a new way.<sup>32</sup>

Many authors have discussed the contents of the 1980 fiscal reform and the evolution of fiscal sharing system thereafter in detail,<sup>33</sup> we need not repeat them here. Since it is apparent that Deng's fiscal decentralization was a result of the declining capacity of the Chinese communist state to govern, in what follows, we shall focus on whether and how the fiscal decentralization has in turn affected state capacity, and, if yes, what are the political consequences of the changes in state capacity.

It is widely accepted that Deng's fiscal decentralization has significantly weakened Chinese communist state's capacity-as-fiscal-extractive-capability. As a result, the institutional environment within which local governments make their own decisions has been changed in a fundamental way.

1. Budget revenue as percent of national income has dropped by a wide margin.

Because of the major government role in the economy, the level of revenue as a share of GNP should be substantially higher in the socialist setting than in the capitalist setting.<sup>34</sup> In 1978, on the eve of the economic reform, government revenue as a ratio of GNP was 34%, which was already very low in comparison with the Soviet Union and East European countries.<sup>35</sup> After ten years of economic reform, the ratio fell to 19.8% in 1988. This ratio was lower even than that in developed capitalist countries (24.2% on average) and middle income countries (24% on average), and only slightly higher than that in the Third World countries (15.4% on average). It needs to be noted that for all country groups, data refer only to central government revenue while for China both central and provincial revenues were included.<sup>36</sup>

2. Of the budget revenue, the central government's share has dropped by a wide margin.

The central government's share of total budget revenue was above 70% in the 1950s, about 60% in the 1960s, around 55% in the 1970s, but only 50% in the 1980s. In 1988, the central share accounted only for 47.2% of the total budget revenue. Between 1980 and 1986, on average, the local revenue increased annually 8.29%, higher than the increase rate of either the total budget revenue (6.9%) or the central revenue (5.5). During the same period, the local expenditure increased annually 9.2% on average, but the central expenditure only grew at an annual rate of 3.6%.<sup>37</sup> In the Soviet Union and former socialist countries of East Europe, central revenue generally accounted for 70% of the total revenue. Even in capitalist countries, whose budgets are generally not responsible for capital formation, it is rare for the ratio of the central revenue to the total government revenue to be lower than 50%. In the United States, which is a decentralized fiscal system by world standards, the federal government's tax income accounts for 57% of the total tax revenue while state and local governments together get only 43%.<sup>38</sup> As for expenditure, on average, subnational governments in industrial countries account for about 30% of all government expenditures, compared to 15% in the Third World countries. In China, however, the subnational share of government expenditure is about 55%, well above these averages. No wonder the World Bank exclaims: "only a few countries in the world can claim as great[er] a degree of expenditure or revenue decentralization [than China]."<sup>39</sup>

3. Extrabudgetary funds have skyrocketed.

Before Deng's reform, there were two periods in which extrabudgetary funds expanded rapidly: the Great Leap Forward period and the Cultural Revolution period. In 1978, on the eve of the reform, extrabudgetary funds were as large as 31% of total budget revenue. In the ten years between 1979 and 1988, while budget revenue increased 133%, extrabudgetary funds increased five-fold. By 1988, almost as much money was circulating outside the state budget as within it. In many provinces, extrabudgetary revenues have surpassed budgetary revenues. Given their magnitude, some Chinese economists call the extrabudgetary funds "the second budget." On paper, only a small fraction of extrabudgetary funds (2%) are under the direct control of local governments, while most are to be managed by enterprises. But, in reality, local governments have no difficulty encroaching on the resources of the enterprises under their jurisdictions. As long as funds

are kept within localities, they are within the reach of local governments. Since an increase of extrabudgetary income would enhance the autonomy of local governments vis-a-vis the central government, whenever it is possible, local governments always attempt to maximize local extrabudgetary funds even though it may be detrimental to the central government.

To keep as much local resources from central extraction as possible, local governments are often very "generous" to enterprises at the central government's expense. China's tax administration and collection system enable them to do so. In most unitary countries, the central governments directly employ their own tax administration and collection staff who are responsible for levying all central taxes. But in China, the central government has no nationwide tax collection administration. Instead the central government relies on local government for the implementation of central tax policy and for the remittance of tax revenues. The World Bank believes that no country in the world can claim to have a more decentralized tax administration system than China does.<sup>40</sup> If local government had no preferences of their own, thinking and acting as central agents, this system should work fair. Under the new revenue-sharing regime, however, local governments benefit little from higher collections, so that they would prefer to see their enterprises flourish rather than subject them to taxes revenue from which they have to share with the central government.

There are opportunities for them to do so. First, local governments may set a reduced tax rate, authorize a tax holiday, or grant ad-hoc tax relief to enterprises. It was estimated that in 1988 alone, 10 billion yuan of taxes were lost in this way. Second, local governments may wink at enterprises when they evade taxes. The level of tax evasion has reached colossal dimension in the recent years. It is reported that at least 50% of state enterprises were engaged in tax evasions.<sup>41</sup> Every annual tax audit conducted by the central government in the recent years could recover as much as 10 billion yuan of unpaid taxes. Some estimated that about 2% of budget revenue was lost in fiscal fraud.<sup>42</sup> Without local governments giving tacit consent to such practices, tax evasion can hardly become so widespread and persistent.

Third, local governments may enter into contract arrangements with enterprises for payment of negotiated amounts of taxes. During the mid-1980s, local governments successfully boycotted the center's "substituting taxes for profit" reform, and forced the center to stay with problematic "contracting" system. Most of experts agreed that the "taxes for profit" would increase central revenue and simultaneously promote economic efficiency in enterprises. But it threatened the financial position of local governments by diminishing their patronage over local enterprises. On the contrary, relied on ad-hoc negotiation of profit or tax delivery responsibilities between enterprises and their supervisory bodies, the "contracting" system allows local governments to continue acting as "patriarchs" in their regions.<sup>43</sup> The success of local interest in this episode demonstrates that local powers are now sometimes able to "veto" central decision. Under the contracting system, whether targeting on tax or profit remittance quotas, such contracts tend to reduce effective tax rates and increase enterprises' chance to retain more profit.<sup>44</sup> Local governments are often lavish in negotiating contracts with their subordinate enterprises because they understand

that flexible contracts would help their appropriation of enterprise revenue for their own uses later.

#### 4. Ad-hoc charges run wild.

As Huang Yasheng puts, "[t]he crucial link between [local] bureaucratic largesse and their pecuniary interest is what is known in Chinese as *tanpai*---the imposition of various fees on enterprises in addition to formal tax obligations."<sup>45</sup> An outgrowth of Deng's decentralization, *tanpai* is a sign that local governments have become strong enough to make rival claims over resources extracted from society in defiance of the center's regulatory authority. To enterprises, these ad-hoc charges are exorbitant levies. But the new revenues generated in various forms of *tanpai* are all arrogated by local governments. Whenever local authorities need funds on a temporary basis, they impose *tanpai*. Originally, *tanpai* was put on by rural cadres after the decollectivization because accumulation funds of teams, brigades, and communes were no longer available to them. In the early 1980s, the central government issued numerous injunctions to forbid *tanpai* in the countryside. Before long, however, *tanpai* made its way into cities. By the late 1980s, there were literally tens of thousands of forms of *tanpai*. For instance, Chongqin Municipal Public Security Bureau alone imposed over 1,000 varieties of fees.<sup>46</sup> No forms of *tanpai* have statutory basis, but they are all authorized by local governments or their agencies. It is estimated that local authorities now extract at least 20 billion yuan a year in various forms of *tanpai*.<sup>47</sup> It probably contributes more to local government revenues than many formal taxes. Due to its quick proliferation and growing magnitude, the central government finds it almost impossible to supervise *tanpai*. In April 1988, the State Council issued a directive which prohibited local governments from imposing *tanpai* on enterprises. An economist found in May 1989, however, that the Sichuan Provincial Government had imposed five new forms of *tanpai* since June 1988.<sup>48</sup> In October 1990, the CCP Central Committee and the State Council jointly issued another directive, indicating that *tanpai* is still a headache for the center and for enterprises.<sup>49</sup> It is unlikely that the center will succeed in its battle against illegal *tanpai*, because local governments, which the center expects to lead the fight against *tanpai*, wouldn't act against their own interests.

#### 5. Local control over banking institutions.

Initially, the central decision makers expected that granting some authority to commercial banks in their credit decisions would improve microeconomic efficiency and strengthening macroeconomic control. They haven't gotten either, however. Instead, allocating bank loans is still very much based on political rather than economic grounds. The only difference is that now political interventions have intensified at provincial level and below, while the central government has lost much of its grip over macroeconomic control over credit.<sup>50</sup> The reason for the heavy local hands on bank loans is simple. On the one hand, in the past few years, the interest rate of loans was often lower than the inflation rate, and therefore bank loans were virtually free. Demand for loans was understandably high. On the other hand, because bank managers are in effect under the direct control of local governments, they have to place their immediate superiors' wishes above anyone else's. An investigation shows that most of problematic loan decisions were

made under the pressures from local governments.<sup>51</sup> The pressures of local governments have contributed to the uncontrollable investment drive in the last few years. In 1984, bank loan for fixed capital investment amounted to only 29 billion yuan but in 1987 it rose to 127 billion, representing an average annual increase of 59% in the four years.

The above discussion of the effects of Deng's decentralization leads to two conclusions. First, the decentralization doesn't reduce public authorities' extractive capacity in general; it only reduces the central state's extractive capacity. If funds generated outside the budget are added to the budgetary funds, we would find that the ratio between resources kept in public sector and national income has actually steadily increased since 1980 [see graph 1]. A Chinese economist estimated that in 1987 the sum total of budgetary and extrabudgetary revenues and *tanpai* totalled 460 billion yuan, accounting for 50.3% of the national income of that year. In comparison with other countries, the ratio was very high. But, of 460 billion the central government could control only 26%, or 120 billion.<sup>52</sup>

Second, as local governments were amassing more resources under their direct control, their intervention in economic life has become more frequent and the range of their intervention has become wider.

In sum, the decentralization doesn't result in the demolition of command economy. What it brings about is fragmentation of the national political economy, which, while effectively weakening the position of central planners, reproduces command economies on smaller scale.

Fragmented command economy is the worst kind of command economy. It doesn't have the advantages of market economy, while losing the advantages of centralized command economy. The central planners not only lose control over a significant proportion of state resources, but precisely because of the expanding role of local governments, they also become increasingly unable to solve macroeconomic problems.

How do local governments use resources under their control? First of all, they tend to spend more money on themselves. After 1979, administrative expenditure has grown rapidly. Before 1979, administrative expenditure usually accounted for 4% to 6% of total budget expenditure. For most of the 1970s, it was kept below 5%. After 1979, the expenditure on public administration as a percentage of total budget started a steady increase. In 1988, it reached an unprecedented 9%. The increase rate of the administrative expenditure was higher than that of total budget expenditure, national income, gross output value of industry and agriculture, or all budget expenditure items but one (scientific research and education). And the local share of the increase was higher than the central share.<sup>53</sup>

In addition to money from budgetary funds, local governments spent a growing proportion of their extrabudgetary funds on public administration. Administrative expenditure outside formal budget registered an increase of 16.7% in 1984, 42.8% in 1985, 25.5% in 1986, and 32.2% in 1987.<sup>54</sup> A large amount of money was spent on luxurious items such as cars, air conditioners, refrigerators, modern office equipment, nice office building, and the like. The extravagant local administrative expenditure certainly runs counter to the interests of local population as well as the interests of the central

government. It demonstrates that local governments now are able to pursue their own preferences even when their preferences are divergent from central government's preferences and local societal preferences.

When local governments' preferences are convergent with local societal preferences, it is easier for local governments to translate their preferences into policy actions. The decade of the 1980s saw that luxury hotels, state of art amusement parks, skyey TV towers, modern overpasses, giant stadiums and many other types of large non-productive projects sprang up like mushrooms throughout China. Since local residents have no objection to the improvement of the appearance of their towns, local governments can claim that they represent local interests by spending money on such projects. But local bosses intend to kill two birds with one stone. The other aim for investing in such projects is to build up their personal public images. No wonder that many projects are called "monument projects of so-and-so."

Of course, local governments wouldn't invest all of their money into non-productive items. To expand their basis of future revenues, local governments tend to invest as much money into productive projects as they can generate. In selecting projects for investments, local governments usually act very "rationally." They would not invest in infrastructure constructions such as energy, raw material, highway, railroad, education, and the like, because such projects generally need large amount of investment, take long time to finish, run high risk, and worse than all from local governments' view of point, benefit other localities. Local governments' favorites are high-profit processing projects which can employ more local laborers and yield quick returns. Thus, the decade of the 1980s also saw that small cigaret factories, small breweries, small textile mills, and small home electronic appliance plants sprang up throughout China.

Having lost control over local governments' purses, Central planners find it increasingly difficult to control aggregate demand for investment and consumption. In the past, expansion drive were usually initiated by ambitious central planners. Now the driving forces for capital expansion are local officials. The problem is that while there is a self-constrained mechanism for the center, there is no constraint at local levels. Central planners may start a "great leap forward," but they cannot afford to ignore imbalance in the national economy for long. However, local governments don't have to worry about macroeconomic instability when they launch expansions.<sup>55</sup> Every local government thinks that its investments are smart, rational, and absolutely imperative for local socioeconomic development. If there are problems with the national economy, it is other local governments or the central government to blame. Since no one plans to restrain its own investment fever, the result is an uncontrollably overheated economy. Since 1982, the central government has made counterless efforts to cut fixed asset investments, but fixed investment increased 28.6% in 1982, 14.5% in 1983, 33.4% in 1984, 38.7% in 1985.<sup>56</sup> In 1986, it again increased by a big margin. In January 1987, the center convened a national conference of the provincial governor, at which the governors were told that no more new projects were to be permitted. But in the first two months of that year, 1,105 projects broke ground, among which 88.8% were financed by local authorities. In March, the central

government issues a strongly worded directive demanding that all new projects be stopped. And in July, Yao Yilin repeated the warning. In the end, however, fixed investment went up 20.7% that year.<sup>57</sup>

The center failed because it simply did not possess adequate tools to directly control local investment. By the end of the 1980s, only less than 10% of fixed asset investment was financed by budgetary funds, and the rest of it by bank loans, extrabudgetary funds, *tanpai*, and foreign investment. Under this circumstance, state planning becomes a chimera. The direction and magnitude of local investments have to a large extent been out of the center's reach. What it could do thus was merely to hold down its own spending, while watching the localities continue the expansion of their investment.<sup>58</sup>

The central control over the level of consumption is as loose as its control over investment. In the past, it was as easy for the central government to control the level of consumption as issuing an annual aggregate wage plan to lower level governments, which was in turn to be disaggregated into planned wage quotas for each and every individual enterprises. After the reform, the central government still sets the ceiling of the total wage bill, but it can no longer control the level of consumption, because local authorities have more say about bonuses, which now constitute a very large portion of people's income. In the 12 years between 1978 and 1989, while the total wage bill increased by 460%, bonuses registered a 4,525% increase.<sup>59</sup>

As investment and consumption were constantly expanding, aggregate demand persistently exceeded supply in much of the 1980s. The cumulative result was inflation. In the first three decades after the revolution, prices scarcely rose. From 1951 to 1978, the average inflation rate was 0.7%. In the first years of the economic reform, inflation remained mild, rising annually 2.6% on average from 1979 to 1984. After 1984, the situation got worse every year. In 1988, inflation rate rose to 18.5%, and in the first half of 1989, it reached 25.5%. The urban cost of living increased even faster. As inflation rate rose to levels that had been quantitatively unknown, it threw the whole nation into panic, which contributed to the emergence of the 1989 protest movement.<sup>60</sup>

The enormous expansion of local autonomy also resulted in growing regional inequality. During Mao's era, Lardy finds, the central authorities were able to reduce the large initial interregional differences in level of development by redistributing resources from richer to poorer provinces.<sup>61</sup> Today, the center still tries to use differential revenue-sharing rate with the individual provinces as a main mechanism for redistribution.<sup>62</sup> But this old method cannot be effective any more. A World Bank study finds that the development gap in China is bigger than ever since the founding of the People's Republic in 1949. Many of rich provinces make a lower level of revenue collection effort, e.g. Jiangsu, Zhejiang, Shandong, and Liaoning all make below average effort and Shanghai is just about average. It is poor provinces that make a greater collection effort than their richer counterparts. Of the ten provinces with the highest levels of per capita output, six had below average revenue growth during the reform period. In contrast, of the ten provinces with the lowest level of per capita output, nine had above average growth in revenue collection. Why did the richer provinces tend to make less effort to collect revenue?

Because under the provincial contracting system of "eating in separate kitchens," rich provinces have to remit a certain proportion of the shared taxes to the central government, while poor provinces can retain all revenue they collected. By authorizing tax exemptions and preferential tax treatment to their enterprises and thereby lowering the total taxable base, rich provinces can keep more resources "at home," thus available for *tanpai*. Fiscal expenditure differentials have increased in the 1980s as a result of the provincial contracting system. Between 1983 and 1986, for instance, Shanghai's budgetary expenditure tripled, Guangdong's increased 138%, and Zhejiang's 132%; but Tibet's 61%, Qinghai's 65%, Shanxi's 71%, and Ningxia's 73%. Another symptom of the growing inability of the central government to redistribute among the provinces is the declining role the transfer system. Take Ningxia, one of China's poorest provinces, as an example. During the Second Five Year Plan period (1958-1962), the fiscal subsidy from Beijing increased on average 71% annually, and during the Fourth Five Year Plan period (1971-1975) it still grew over 20% a year. But the increase rate of the central subsidy declined to 14.29% during the Sixth Five Year Plan period (1981-1985), 11.8% in 1986, and 8.4% in 1987.<sup>63</sup>

The budgetary incomes account only for part of fiscal resources the provinces control. As pointed out above, extrabudgetary funds have exceeded budgetary incomes in many provinces. In comparing increase rates of the provinces' extrabudgetary incomes, we find that the rates tend to be higher in rich provinces than in poor provinces. Between 1982 and 1985, the average annual increase rate was 111% in Shandong, 86.5% in Liaoning, 68% in Zhejiang, 57% in Jiangsu; but only 33.9% in Ningxia, and 41.3% in Gansu. In 1985, the total extrabudgetary income of seven poor provinces (Guizhou, Yunan, Tibet, Shanxi, Gansu, Qinghai, and Ningxia) was less than Liaoning's alone.<sup>64</sup>

Even under the capitalist system, the central authorities have to master sufficient fiscal resources to sever three general policy objectives: the provision for social goods (allocation function), adjustment of the distribution of income and wealth (the distribution function), and maintenance of macroeconomic stability (the stabilization function).<sup>65</sup> However, Deng's decentralization has weakened China's central government's extractive capacity to the degree that it lacks adequate resources to perform those basic functions. First, there exists a substantial backlog of infrastructure needs which is believed to be a major bottleneck to growth. The central government sought to allocate more resources to bottleneck sectors such as energy, transportation, and basic raw materials, but local governments' investments in the processing industries have always increased at higher rate. As a result, the sectorial imbalance only deteriorated.

Second, inequality within and between regions has become greater. Traditionally, the communist state didn't use fiscal policy to adjust the distribution of income and wealth. What was considered fair or just was generally set in the primary distribution by wage policy. Thus, when the economic reform generates inequality within regions, China doesn't have an efficient mechanism to adjust increasingly unequal primary distribution. And the central government has no sufficient funds for building new safety nets to replace old ones. The transfer system was and still is a main mechanism to adjust inequality between regions.

However, as the central government is losing control over fiscal resources to the provinces, there is simply not much to be transferred. Third, aggregate demand has greatly exceeded the available output in the recent years. In such situation, to stabilize the economy, the central government needs to adopt restrictive measures to reduce demand. However, due to Deng's fiscal decentralization, the center was no longer able to control local governments' expenditures. Although China's increase rate of output value was impressive during the 1980s, the country suffered high inflation, low efficiency, and volatile economic fluctuations.

A modern state has to perform the functions of allocation, [re]distribution, and stabilization. Otherwise, the state would lose its legitimacy to rule. But in China, the central government's ability to extract resources now is very limited, falling far short of the necessary level for performing the three basic state functions. Unable to cut expenditure to match revenue declines, the central government did what it could: it got into debt. China had gotten into debt before. But it doesn't mean that everytime it ran deficit it was in fiscal crisis. Between 1950 and 1978, there were 12 deficit years in China, among which four occurred during the decentralized Great Leap Forward period and another four during the chaotic Cultural Revolution period. Except those occurring during the Great Leap Forward period, the magnitude of deficits was generally small, and the government was able to eliminate them every time when it became serious about the red on its balance sheet. Since 1979, however, the budget has been characterized by continuously rising deficits. In the 12 years between 1979 and 1990, there was not even a single year in which the government escaped large deficit. Beijing has made efforts in every possible way to increase revenue in order to keep pace with soaring demand for expenditure, but it simply couldn't make that happen. What the center had been able to do in the 1950s, 1960s, and 1970s, seems to be almost impossible to be repeated in the course of Deng's fiscal decentralization. After 1985, despite intensified central efforts to curtail expenditures and increase revenue, government budget deficit began to balloon dangerously and hit a record 50.4 billion yuan in 1990.<sup>66</sup> The center seems unable to recapture control even at high prices. While the center accumulated large deficits in the 1980s, local governments sat on surpluses.<sup>67</sup> Before 1982, the center was still able to force surplus provinces to make extra contributions to the central budget in addition to what they were supposed to remit to Beijing. But it had to stop that practice after 1983 due to strong resistance from those provinces.<sup>68</sup>

Donnithorne once likened the Chinese central government to a medieval king who was not able to live off his own and who had to rely on funds extracted by feudatories.<sup>69</sup> But now the "vassals" begin to feel and act like independent lords of their soil and begin to detach themselves in spirit from the vassalage. They are so powerful and assertive that they can resist the fulfillment of their fiscal obligations. Here we have what Schumpeter calls "the crisis of a fiscal system:" "obvious, ineluctable, continuous failure due to unalterable social changes."<sup>70</sup>

A weak state tends to be a corrupted state. The better the quality of rulers' information about the actual wealth, income, and property produced and the more resources in the rulers' hands to be allocated, the more effective their control over the behaviors of

government bureaucrats would be. Conversely, the more alternatives there are for local bureaucrats to gain access to resources, the more likely they are to become corrupted under an undemocratically system. In the PRC, there has never been an institutional mechanism to check bureaucrats from below. After Mao's death, the mechanism to check them from above---political campaign---was set aside. Deng's decentralization thus greatly increases opportunities for those in positions to control resource allocation to profiteer by abusing their power. The result is widespread corruption.

A weak state cannot be a fair state. With limited extractive capacity, a weak state would have little to be redistributed, thus unable to adjust the distribution of income and wealth to assure conformance with what society considers "fair" and "just." Interregional as well as intraregional disparities have been exacerbated as a result of the reform.<sup>71</sup> The increasing variance and inequality spawn dangers of social polarization and political disaffection. Tremendous resentment has been building among "losers" of Deng's policy of "letting some people get rich first" against "winners." A 1987 survey of residents in 33 cities found that 88.7% of people thought that social inequalities were "great or very great." It is interesting to note that in 1980 when Solidarity first emerged, a public opinion poll in Poland found 85% of people thought that social inequalities in Poland were "great or very great." The percentage was even lower than what was found in China in the late 1980s.<sup>72</sup>

Macroeconomic instability, skyrocketing inflation, widespread corruption and growing economic inequality have severely shaken people's confidence in the communist state's ability to manage the economy, control its own bureaucratic elites, and ensure social justice, which cast serious doubt on the regime's legitimacy. Were one to single out one factor conditioning Chinese people's support for the communist regime, it would be an expectation of protection from inequality and uncertainty by a strong welfare state. Deng Xiaoping gambled on being able to compensate Chinese people with greater prosperity in exchange for erosion of equality and certainty. In any event, the gamble failed. The state has become so weak that it can no longer "engender and maintain the belief among its citizens that the existing political institutions are the most appropriate ones for the society."<sup>73</sup>

The weakened state has also proved unable to arrest centrifugal tendencies among local governments. local governments' financial muscles can be easily converted into political muscles. Throughout the 1980s, local political elites were busy building up political machines that control local economic monopolies and engage in sometimes fierce competition with the center and with one another over scarce raw materials, goods, and funds. Having a stake in maintaining and expanding their control over resources, local governments spare no efforts to protect local industries. The local authorities in peripheral regions well endowed with natural resources tend to keep the raw materials for local processing industries. They sometimes employed police force and militia to patrol their borders in order to block local suppliers' attempt to "smuggle" raw materials out. There have been numerous media reports on "silkworm war," "wool war," "tobacco war," "tea war," "cotton war," "coal war," and "wars" on other raw materials in recent years. To retaliate, core regions depending on import of raw materials tend to block technology

transfer to resource-endowed regions. And all local governments have incentive to prevent the inflow of finished products from other localities in order to protect the sale of local products.<sup>74</sup> Local protectionism resulted in the "balkanization" of China's economic system. A number of Chinese economists and political scientists have used the term "feudalist structure" to characterize the situation in the late 1980s. They believe that China has been split into 30 dukedoms (provinces) with some 2,000 rival principalities (counties).<sup>75</sup> Although "vassals" have not been bold enough to openly challenge the ultimate political authority of Beijing, the emergence of local power centers produces deep cracks in the regime.

The mounting socioeconomic problems and political challenges tend to create deep divisions among central decision makers. "Reformers," led by former Party Secretary General Hu Yaobang and Zhao Ziyang, with the support of Deng Xiaoping, believed that the only way out of the current crises is to wage faster and more comprehensive market-oriented reform, while "conservatives," represented by Premier Li Peng, with Chen Yun's support, favored a slower pace and more reliance on central planning. There was yet another dimension of internal division within the political leadership: "hardliners," such as Deng Xiaoping, were willing to protect their authoritarian rule by whatever means necessary, including the use of brutal force, whereas "softliners," such as Hu and Zhao, prepared to tolerate new political actors and introduce certain freedoms. Internal conflicts within the political leadership are a necessary precondition for regime transition. It is not likely that socioeconomic crises themselves bring about such a transition. Comparative studies of regime transition in other contexts have established that "there is no transition whose beginning is not the consequence, direct or indirect, of important division within the authoritarian regime itself."<sup>76</sup> It is so because the internal divisions increase the fragility of the regime and thereby decrease the cost of transition.

## **Conclusion**

As should be evident from the above discussion, there has been a paradox in the Chinese experience of the 1980s: the thickening of local stateness occurred concomitantly with the thinning of central stateness.<sup>77</sup> In other words, the deepening of state penetration in local society was not accompanied by the strengthening of political integration. In many ways, this phenomenon resembles the process of state involution characteristic of the Republican period before 1949. In studying state finances of the Republican period, Duara reveals a similar situation: while the bureaucratic power of the central government was becoming parcelized, the fiscal foundations of local governments were actually strengthened in the process. The weakening of central control thus went hand in hand with the unprecedented expansion of state penetration in society. Duara believes that there were direct causal links between state involution in the Republican China and the communist revolution.<sup>78</sup>

The involutory expansion of the state seems to have been a recurrent phenomenon in Chinese history. In the late Ming dynasty, for instance, Ray Huang finds that "though the

imperial government was in theory omnipotent, in practice it was often unable to act." Characterized by its monolithic structure, the Ming fiscal system was designed to impose a unified administration over all the financial resources of the empire. The main concern of the dynasty's founders was to prevent the regions from over-developing any financial potential of their own, and thus from challenging the central government. But fiscal practice diverged increasingly from the original design. Toward the end of the dynasty, tax collectors became more and more intrusive. However, it was not a sign of strength, but of a lack of it. "The arbitrary and excessive demands of the tax collectors...in part reflected this loss of control, and in part represented attempts by officialdom to compensate for its own organizational weakness."<sup>79</sup>

The Qing dynasty started with an effective centralized fiscal system.<sup>80</sup> But, from the late 18th century on, the central government became increasingly unable to extract sufficient resources for sustaining its rule. In the 150 or so years from 1750 until the early 1900s, it suffered an enormous decline (by almost two thirds) in the real values of the revenues collected from direct taxes. The growth rate of indirect taxes did begin to accelerate in the latter part of the 19th century, but much of the increase was siphoned by local governments.<sup>81</sup> In retrospect, one has good reason to speculate that there were also direct or indirect causal links between the degeneration of "state-capacity-as-fiscal-extractive-capability" of the two dynasties and their fall.

The involutory expansion of the Chinese communist state have certainly aggravated the underlying social crisis that led to Tiananmen. The Chinese protest movement of 1989 marked the beginning of the end of the Chinese state socialism. We assert that the system is moribund not so much because we believe that all undemocratic regimes are doomed to destruction as because we believe that the system's capacity to govern has been weakened to the point beyond repair. In fact, the killing of hundreds of unarmed civilians in central Beijing itself reveals how fragile the system is. If the state were strong, it would have been able either to mitigate grievances before they became the source of instability or to meet political challenges without resorting to military solution. But by the late 1980s, the Chinese communist state had become so weak that it was unable to extract adequate amount of resources for unified state actions, to guide the national economy, to regulate the distribution of economic resources, to garner the loyalty, support, and obedience of the population, and even to direct the behaviors of state bureaucrats. As a result, when a serious political crisis occurred, there was little alternative other than mobilizing the army. Even the military is not reliable, though. Some elements within the People's Liberation Army resisted the military mobilization in the spring of 1989, which was overcome only through the active involvement of Deng Xiaoping and other elder leaders. Once Deng and other aged hardliners pass away, the military could become a force for change.<sup>82</sup> By then, either being forced to initiate transition from within or being overthrown in a revolution, Chinese political system would change for good or ill, but definitely in a fundamental way.

## 1 Endnotes

1. Margaret Levi, Of Rule and Revenue (Berkeley: University of California Press, 1988), pp. 2-3.
- <sup>1</sup> 2. Ibid, pp. 32-33.
- <sup>1</sup> 3. Carl Riskin, China's Political Economy: The Quest for Development Since 1949 (Oxford: Oxford University Press, 1988), pp. 71-72.
- <sup>1</sup> 4. Liu Suinian and Wu Qungan, China's Socialist Economy: An Outline History (1949-1984) (Beijing: Beijing Review, 1986), pp. 174-175.
- <sup>1</sup> 5. Nicholas R. Lardy, Economic Growth and Distribution in China (Cambridge: Cambridge University Press, 1978), pp. 40-41.
- <sup>1</sup> 6. Ibid, pp. 88-89.
- <sup>1</sup> 7. Riskin, China's Political Economy, chapter 9.
- <sup>1</sup> 8. Liu Suinian, Wu Qungan, Zhonghua renmin gongheguo jingjishi jianming jiaocheng (Beijing: Gaodeng jiaoyu chubianshe, 1988), p. 184.
- <sup>1</sup> 9. Guojia tongjiju, Zhongguo tongji nianjian 1990 (Beijing: Zhongguo tongji chubianshe, 1990), p. 243.
- <sup>1</sup> 10. Liu and Wu, China's Socialist Economy, p. 231.
- <sup>1</sup> 11. Ibid, p. 239.
- <sup>1</sup> 12. Here I use a definition closer to that found in the other countries, which subtracts domestic and foreign borrowing from the Chinese measure of revenue and foreign and domestic loan repayments from the Chinese definition of expenditure. See World Bank, China: Revenue Mobilization and Tax Policy, pp. 9-10.
- <sup>1</sup> 13. Don Van Atta, "The USSR as A 'Weak State:' Agrarian Origins of Resistance to Perestroika." World Politics, vol. XLII, no. 1 (October 1989), p. 149.
- <sup>1</sup> 14. Zhao Dexing, Zhonghua renmin gongheguo jingjishi: 1949-1966 (Zhengzhou: Henan renmin chubianshe, 1989), pp. 680-694.
- <sup>1</sup> 15. Zhao Dexing, Zhonghua renmin gongheguo jingjishi: 1967-1984 (Zhengzhou: Henan renmin chubianshe, 1989), pp. 42-43.

- <sup>1</sup> 16. Liu and Wu, *China's Socialist Economy*, p. 364.
- <sup>1</sup> 17. *Ibid*, p. 374.
- <sup>1</sup> 18. *Ibid*, pp. 380-381.
- <sup>1</sup> 19. Zuo Chuntai and Song Xinzhong, *Zhongguo shehui zhuyi caizheng jianshi* (Beijing: Zhongguo caizheng jingji chubianshe, 1988), p. 376.
- <sup>1</sup> 20. *Zhongguo tongji nianjian 1990*, p. 243.
- <sup>1</sup> 21. Zhao Dexing, *Zhonghua renmin gongheguo jingjishi: 1967-1984*, pp. 60-62.
- <sup>1</sup> 22. Thomas P. Lyons, *Economic Integration and Planning in Maoist China* (New York: Columbia University Press, 1987), pp. 239-240.
- <sup>1</sup> 23. Lardy, *Economic Growth and Distribution in China*.
- <sup>1</sup> 24. Riskin, *China's Political Economy*, pp. 213-218.
- <sup>1</sup> 25. *Caizhengbu zonghe tongjisi, Zhonghua renmin gongheguo caizheng shiliao* (Beijing: Zhongguo caizheng jingji chubianshe, 1982), vol. 1, pp. 14-19.
- <sup>1</sup> 26. For an excellent discussion of the concept of "state involution," see Prasenjit Duara, "State Involution: A Study of Local Finances in North China, 1911-1935," *Comparative Study of Society and History*, (1987), pp. 132-161.
- <sup>1</sup> 27. Li Xianglu, "Weishemo shuo fenquan rangli gaige fangzhen shi zhongque de," *Zhishi fenzi*, (Fall 1990).
- <sup>1</sup> 28. Zuo Chuntai and Song Xinzhong, *Zhongguo shehui zhuyi caizheng jianshi*, p. 453.
- <sup>1</sup> 29. *Ibid*, pp. 431-452.
- <sup>1</sup> 30. David Granick, *Chinese State Enterprises: A Regional Property Rights Analysis* (Chicago: The University of Chicago Press, 1990).
- <sup>1</sup> 31. Susan L. Shirk, "Playing to the Provinces: Deng Xiaoping's Political Strategy of Economic Reform." Paper presented at the Annual meeting of the APSA 1990.

<sup>1</sup> 32. In fact, the 1980 fiscal decentralization was supposed to be accompanied by the return of several thousand large enterprises to direct central government subordination, but due to strong local opposition, the second part of the reform has never been implemented. It also needs to be noted that right before his second purge in 1976, Deng Xiaoping made a decision to recentralize financial resources, which was reversed after his fall. See Allen S. Whiting, "Domestic Politics and Foreign Trade in the PRC, 1971-1976," (Ann Arbor: Michigan Papers in Chinese Studies, no. 39, 1979).

<sup>1</sup> 33. Michel Oksenberg and James Tong, "The Evolution of Central-Provincial Fiscal Relations in China, 1953-1983: The Formal System," unpublished paper, February 1987; Shirk, "Playing to the Provinces."

<sup>1</sup> 34. Richard A. Musgrave, *Fiscal Systems* (New Haven: Yale University Press, 1969), p. 33.

<sup>1</sup> 35. In the mid-1960s, the ratio was 76.9 in Czechoslovakia, 62.6% in Bulgaria, 54.8% in Poland, and 50.6% in the USSR. *Ibid*, p. 42.

<sup>1</sup> 36. World Bank, *China: Revenue Mobilization and Tax Policy* (Washington, D.C.: The World Bank, 1990), p. 6.

<sup>1</sup> 37. Chan Xinhong, "Caizheng fenpei buheli shi zaocheng caizheng bulixiang de zhuyao yuanyin," *Caimao jingji*, no. 4 (1987).

<sup>1</sup> 38. World Bank, *China: Revenue Mobilization and Tax Policy*, p. 80.

<sup>1</sup> 39. *Ibid*, pp. 76-80.

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