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The mainstream economics interpretation of the local state and central-local relations in Post-Mao China: a critical review

Alexandre De Podestá Gomes *

Abstract

Decentralization and the role of local governments have long been touted as key factors in the Chinese economic miracle. This paper intends to critically assess the chief theories advanced by mainstream economics in its attempt to make sense of these aspects of China's growth story. Firstly the theoretical underpinnings of fiscal federalism, new institutional economics, and market-preserving federalism approaches will be presented, as these theories offer the bedrock for most of the applied insights in which China is framed through the lenses of the central-local relations debate. Secondly, the idea of 'market-preserving federalism, Chinese-style' will be critically appraised, highlighting its shortcomings. Thirdly, the paper proceeds by bringing in the mainstream response to these problems, relying on the notion of political incentives and career concerns faced by local cadres. It will be argued that the continual adherence to some core tenets dear to the new institutional economics literature in all previous explanations prevents this broad camp of knowledge to properly grasp the complex dynamics of China's decentralization drive and the role of local governments in the process. Finally, and in closing, an alternative approach will be offered.

Keywords: Decentralization; Central-local relations; local state; federalism; political incentives; career concerns

JEL classification: D72, H70, H77, O43, P26, P30, P48

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1. Introduction

This paper aims to critically present an account of the main theoretical insights put forward by mainstream economic theorists, in order to understand and explain China's post-1978 economic reforms through the lenses of the central-local relations debate. Key theories, and their applications to the Chinese case, will be presented. Initially, the theoretical underpinnings of fiscal federalism will be exposed. It was decided to start with the fiscal federalism debate because many of the theories and insights that mainstream economists and even political scientists employ rests on the rationale of the fiscal federalism approach. Market-preserving federalism (MPF) may be perceived as a logical follow-up of fiscal federalism, once it encountered the new institutional economics (NIE) debate that flourished in the turn of the 1980s to the 1990s. The application of these theories to China was meant to explain how the country managed to trigger a successful reformist programme, while the reforms in the former Soviet Union encountered a distinct fate. Subsequently, I aim to criticize these federalist-inspired theories applied to China. To my account, they correspond to rough simplifications of China's reforms throughout the 1980s and 1990s, and are not reliable paradigms if one endeavours to investigate China's central-local relations and the 'decentralizing' efforts in the period. Following, I present mainstream theories modelling China as a large corporation organized in a multi-divisional (M-Form) fashion, in opposition to the former Soviet Union, arguably a unitary organizational form. From this debate, another body of literature has emerged, based on the political incentives determining the behaviour of local governments, given local cadres' career concerns. This could be perceived as the mainstream response to the shortcomings and flaws of the 'federalism, Chinese style' story. While accurately addressing some key issues of China's political economy (namely, the continuous power of the central government), this last strand of literature has its own flaws, and its adherence to neoclassical assumptions makes it unable to grasp the complex dynamics of China's intergovernmental relations. Finally, an alternative framework is presented, centred on Heilmann's (2008a, 2008b) notion of 'experimentation under hierarchy'. This approach proves to be adequate and useful to explain the intricateness of China's intergovernmental institutions, and allows the debate on the role of the local state in spurring economic growth during the Post-Mao Era to fit China's central-local institutional arrangements.

2. Fiscal decentralization and fiscal federalism

The theoretical underpinnings of fiscal federalism, in general, and fiscal decentralization, in particular, can be traced back to the 1950s debate on public (local) expenditure. Samuelson (1954) realized that public goods (or 'collective consumption goods', to employ his expression) cannot have their level of consumption optimally squared in a purely 'market-type' solution. These goods are non-excludable and non-rival, giving rise to the free-riding problem, and as a result the levels of collective consumption cannot be achieved optimally.

The key problem was how to efficiently provide public goods to citizens. Assuming that they have distinct preferences for public goods, the question therefore is how to reveal their preferences, and then satisfy them in the same way as competitive markets would do, and

finally tax them accordingly. Acknowledging that there are no means to force the citizenry to reveal its preferences, Tiebout (1956) searches for a mechanism or social institution that can somehow work as a proxy for that. He innovates by breaking down public expenditures vertically, inserting the local level governments in the discussion.

Tiebout (1956) focus on the citizenry decision-making of where to dwell, assuming that households possess full mobility, perfect information and that the decision is based on their particular preferences for public goods. Therefore, households will move to the localities whose local governments can best meet their preferences. As one can notice, the act and ability to move is crucial in the reasoning. The household decision to move may reveal one's actual demand for public goods.

The original problem is solved then. With a mechanism to reveal the citizenry's preferences, Samuelson's original concern disappears and public goods can now be provided optimally by local governments. Decentralization of public expenditure becomes the means for governments to emulate markets in the provision of goods. The parallel is straight-forward. To quote Tiebout (1956):

‘just as the consumer may be visualized as walking to a private market place to buy his goods, the prices of which are set, we place him in the position of walking to a community where the prices (taxes) of community services are set. Both trips take the consumer to market...Spatial mobility provides the local public-goods counterpart to the private market's shopping trip’ (p.422).

The literature on fiscal decentralization has evolved on a steady pace after these initial developments, involving not only theoretical advancements but also empirical tests. Porcelli (2009) offers a brief and neat survey on this matter. The ensuing paragraphs will focus on the more recent paradigms regarding fiscal federalism, especially based on the works of Oates (1999, 2006).

As Oates (1999) notes, fiscal federalism's crux is to determine ‘which functions and instruments are best placed in the sphere of decentralized levels of government’ (p.1120). Consequently, it is necessary, on the one hand, to have a framework for the assignment of functions to different levels of government, and on the other hand to study the appropriate fiscal instruments for carrying out these functions.

It is generally understood that the central government should be in charge of the provision of national public goods, such as national defence and macroeconomic stabilization, whereas local governments should be in charge of the supply of goods and services whose consumption is limited to their own jurisdiction, which enables them to tailor outputs to the particular preferences and circumstances of the constituencies. On the grounds of allocative efficiency reasoning, it is argued that as there are local differences in both preferences and cost differentials, the efficient level of output of a local public good is likely to vary across jurisdictions. Hence, in order to maximize overall social welfare, local outputs must vary accordingly (Oates, 1999).

A stimulating associated discussion that has become more important recently is the one regarding the so-called ‘laboratory federalism’. Literally, local governments are supposed to work as ‘laboratories’ to try to find out superior policies and programmes. If the central government undertakes nation-wide policies or experiments, in case of failure or undesirable outcomes the whole nation will have to endure with the negative consequences. However, if local governments are allowed to experiment and search for alternatives by themselves, the costs of potential failures are limited, and a wider array of policy options are available to be chosen nationally. In an environment characterized by imperfect information and learning by doing, local experimentation with a variety of policies may offer potential national gains (Oates, 1999).

A shortcoming of this idea, nevertheless, is the possibility of a free-rider problem. Local governments that innovate generate valuable information to others, but also incur risks and deal with uncertainty when experimenting and attempting to innovate. The best rational decision for a local government might be to wait and copy the policy solution of a neighbouring jurisdiction, entailing a collective action problem on a macro level.

Another drawback related to fiscal decentralization is the ‘race to the bottom’: in a setting of sharp inter-jurisdictional competition, local governments may be overly eager to lure investors and promote economic growth and job creation, employing active tax competition. As a result local governments might end up with lower levels of taxes and local revenues. The deleterious effects are not only limited to the fiscal realm, but also are translated into more lax standards and regulations for environmental quality and labour rights. In purely economic terms, the result might be suboptimal levels of outputs of public services and allocative distortions.

The whole debate on fiscal federalism and decentralization is based on a neoclassical reasoning, with static allocative efficiency as the ultimate driving objective of the theory. Oates (1999) puts it straight-forwardly: ‘From this perspective, institutions are evaluated in terms of their impact on efficiency in resources allocation and the distributions of income’ (p.1137). Indeed, the overriding concern has always been to vertically mould and manage the state’s financial activities in order to provide public goods in a fashion that somehow can resemble the canonical neoclassical competitive market, given the undeniable existence of both governments and public goods. Tiebout (1956), at the very onset of his article, does not hide his dismay: ‘Seemingly, we are faced with the problem of having a rather large proportion of our national income allocated in a ‘non-optimal’ way when compared with the private sector’ (p.416).

More recently, some scholars attempted to widen the horizons of the fiscal federalism approach. Oates (1999) himself noted the approach lacks a theory of fiscal decentralization and economic growth. Aiming to overcome this deficiency, scholars started to include growth and developmental concerns into the paradigm, and the fiscal federalism approach soon sided with the broad camp of new institutional economics (NIE) (see, *inter alia*, Acemoglu et al, 2004; North, 1990; and Olson, 1993. For critical views see Dosi et al, 2016; Hodgson, 2000a; Hodgson, 2000b; and Meramveliotakis and Milonakis, 2010).

A brief summary on the NIE's main tenets is provided by Dosi et al (2016): NIE privileges economic self-interest as the chief (if not the only) motivational purpose in driving individuals' behaviour; those individuals, in order to maximize their utility function, participate in market transactions and promote win-win exchanges. Markets, thus, play a pivotal role, enabling individuals to boost their utilities. Nevertheless, markets are not without their own problems, as there are transaction costs involved in using the price mechanism. North and Wallis (1994), for example, define transaction costs as 'the cost of purchasing inputs, monitoring the production process, and selling output' (p.609). Individuals, then, create institutions with the explicit objective of lowering or circumventing costs inherent in economic exchange, to delineate and enforce property rights, and ultimately to minimize transactions costs and thus enhance economic growth. Institutions, therefore, emerge due to specific problems individuals perceive, and are created specifically and simply in order to subdue them, allowing for market exchange to flourish. Thus, the classic definition of institutions is given by North (1990): 'Institutions are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction' (p.3).

Some mainstream scholars associated with the fiscal federalism approach sought to combine their research programme with the NIE paradigm (Weingast 1995, 2014), and thus the idea of 'market-preserving federalism' (MPF) was forged. The MPF sustains that government's enforcement of property rights and contracts, simultaneously allied with limited intervention in other areas, can only be achieved in a sustainable and credible manner in a federal-like, decentralized system.

3. Market-preserving federalism (MPF)

The fiscal federalism literature suggests that factor (capital and labour) mobility constrains local governments in attempting to undertake market-unfriendly policies, because resources will leave the jurisdiction. This outward movement of capital and labour punishes government-encroaching behaviour, in practice limiting their discretionary power. The question, however, is how to devise an institutional arrangement that makes these limits self-reinforcing, restricting, therefore, the ability of organized groups to influence state policies and intervene in the economy. In other words, resolving what Weingast (1995) believes is the crucial political dilemma of any economic system: 'a state strong enough to protect private markets is strong enough to confiscate the wealth of its citizens' (p.24). Building upon the idea that the essence of federalism is that it provides a sustainable system of political decentralization, Weingast (1995) is concerned to understand which sort of political institutions are able to guarantee a commitment to a limited government, i.e., a government that can secure property rights and that will not encroach into markets, providing, therefore, a political foundation for markets to develop.

For Weingast (1995), the state can usually exploit societal divisions within a country and forge alliances with one particular group, so to transgress on the individual rights of other societal groups. This pattern of behaviour can be stable, as long as the different groups within the country are not able to form a consensus on what should be the limits and scope of the state's

actions. It is, therefore, a problem of coordination between different groups, akin to a prisoner's dilemma. Market-preserving federalism (MPF) institutions arises when, due to historical reasons, this consensus is reached, entailing a curtailment of the state's legal and economic power.

MPF is a sub-set of federal systems. While the latter requires two conditions to exist - an hierarchy of governments, each with a delineated scope of authority (first condition) and an institutionalized autonomy for each governmental level (second condition) - the former requires three extra conditions: subnational governments should be the primary authority over the economy; the existence of a domestic common market, with no local protectionism; and subnational units should face hard budget constraints¹. It is important to notice that the simple delegation of power to subnational units is not sufficient, because any delegation of power can always be reversed. The crucial question is how to make this delegation of power credible and permanent.

Analysing the case of England, Weingast (1995) suggests that the Crown could exploit the societal divisions between Tories and Whigs, allying itself with the former and transgressing over the rights of the latter. However, after an attempt by James II to also disenfranchise the Tories from the polity, both societal groups united against the Crown, as the Tories became wary of the unrestricted power of the state. A consensus on what should be the limits of the state ensued, restricting, thus, the power of the English Crown. Tories and Whigs were able to agree on what were the fundamental transgressions by the state, imposing, then, limits on the national regulatory authority. This new consensus was the coordination device that established the limits the state should abide for. As a consequence, local power was strengthened, and the ability of national government to intervene in the economy curtailed. According to the author, this was the critical political component for the industrial revolution in England. The guilds could set a whole series of regulations on new economic activities, but the central government no longer could enforce these restrictions at the local level across the whole country. It was this decentralized regulatory authority which allowed for local variation in economic controls, and 'allowed local governments to ignore, avoid or repeal the regulatory restrictions on the local economy' (p.18). As a result, areas far from the well-established commercial centres had leeway to craft their own policies, and the industrial revolution occurred in the North, initially.

The same reasoning is applied for the United States, albeit in a different twist. According to the Weingast (1995), different interest groups grew wary of the power of a federal state to impose policies favoured by one or another particular region. Therefore, it was necessary to devise a system that could limit the ability of a region to impose its will on others. Different political and economic groups had local autonomy, and simultaneously were interested in a set of national rules that would prevent the federal government of being encroached by a particular interest group. This system would avoid, thus, rent-seeking behaviour crystalized in beneficial specific laws to one specific group or another. 'Federalism thus proved the solution to the dilemma of how to limit the states protectionists' activities without providing the national

¹ See Maskin (1996) for a discussion on budget constraints.

government with too much power' (p.8), Weingast (1995) concludes. More importantly, it was the result of a national consensus which made those limits credible.

Purely economic reforms alone, like liberalization of economic activities ('getting the prices right'), are not enough to achieve economic development, the argument goes. In order to thrive, markets must be accompanied by their 'political foundations', i.e., economic development requires a political arrangement that limits the scope of action of governments in a credible and self-reinforcing manner. Historically, it is argued, this task has been achieved by when political institutions resembling the idea of a MPF have surfaced.

4. Federalism, Chinese-style (FCS)

The evolution and unfolding of China's decentralization measures of the 1980s have (re)brought the topic of federalism to the surface in China (Shirk, 1993). Waldron (1990) recounts the debates over federalist ideas in the country, tracing its roots back to the period between the late Qing dynasty and the pre-1949 era, and thus attempts to draw some parallels with the current (late 1980s) debate.

In academia, the scholarship throughout the 1990s evolved by applying the idea of MPF to China (Cao et al, 1999; Jin et al, 2005; Montinola et al, 1995; Weingast, 1995). The central point these authors defend is that the Post-1978 reforms in China arguably placed several limits on the discretion of the central government, and, conversely, augmented the power of local authorities. The political system that emerged in the 1980s, with local governments enjoying a greater say in the economic and political arena, makes it difficult for a reversal of this trend, guarantying the durability of the reforms. Montinola et al (1995) concludes that 'political decentralization enhanced the powers of local governments... the decentralization of power is not merely at the discretion of the central political authorities' (p.52-53).

As a result, the argument goes, China experienced an increased inter-jurisdiction competition, experimentation, learning, and adaptation. Therefore, the country was able to reap the benefits of a higher mobility of factors, as suggested by the fiscal federalism literature, and also the benefits of a limited government, which does not encroach into economic activities as before and simultaneously is able to guarantee a certain level of security for property rights, as the NIE and MPF literatures points out. This sort of 'federalism, Chinese-style' (FCS) is distinct from the Western-style counterpart because it lacks the individual rights and political freedom of the latter (Weingast, 1995), but share a diminished role of central governments in economic affairs and a relatively stable political system that guarantees the centre will not claim its power back. Inter-jurisdiction competition assures resources being allocated more efficiently, via market mechanisms and not via administrative and bureaucratic fiat, while the new political system guarantees limits on rent-seeking² and political patronage. Economic growth, then, ensued, explaining 'China's miracle'.

² The concept of rent-seeking deals with the notion that expenditures made to capture a transfer are a form of social cost. This social cost comes to being because 'the resources used for transfer seeking have a positive

5. Critiques on ‘federalism, Chinese-style’ (FCS)

Albeit ‘federalism, Chinese-style’ (FCS) has become relatively a popular idea, used by many to explain the Chinese success, it suffers from a number of caveats. The main problem might be with the assumption of a diminished power of the central government. Weingast (1995) explicitly affirms that local governments gained ‘political freedom and political protection’ (p.27) and that the central government promoted its ‘loss of political control over local economic policy-making’ (p.22). Montinola et al (1995) states that ‘local political officials are now far less beholden to the central authorities’ (p.70) and that ‘the central government no longer retains the capacity to monitor the vast new economy’ (p.70).

In reality, the central government has never actually lost its control over the localities and has actually developed new methods, arguably even more efficient, of monitoring local cadres. The proponents of FCS largely ignore some key features of China’s political system, in special the ones relating to the political control the centre can wield, and its ability of monitoring local cadres. In his study of the agricultural reforms during the early 1980s, Chung (2000) endeavours to understand the limits and scope of action of both the central and local governments in the Post-1978 China. Ultimately, for Chung (2000) ‘the centre remains capable of delineating the boundaries of permissible local discretion’ (p.174-75). When a policy becomes a high priority for Beijing, one should expect tight control, with little room for local manoeuvring. This should not be a surprise, given that China’s political system is, and has never left to be, a unitary system. In this sort of system ‘the central government almost always reserves the right to change the rules of the implementation game’ (p.175), Chung (2000) recalls. If his conclusions are accurate, it means that a central pillar of the MPF approach simply does not exist in China: the delegation of power to subnational units only happened because the centre wished so, and it still maintains the ability to claim it back. In other words, the *durability* and the *commitment* to decentralizing reforms cannot be taken for granted in China. Here it might be worthy to quote Chung (2000) in full: ‘the durability of the arrangements governing the allocation of authority, resources, and responsibilities has been highly contingent upon the discretion of Beijing, not the provinces. . . . the political discretion of the centre is not constrained legally or institutionally, the durability of decentralization is closely tied to the strategic choices of the centre’ (p.175).

Summing up, *administrative* (and not political) decentralization, coupled with provinces’ higher grasp of fiscal and financial resources, indeed took place in the 1980s. This double movement has allowed provinces more leeway in promoting local economic strategies and some degree of local deviations from the centre in terms of policy implementation. There is no longer the appeal of a single model for the whole country to emulate³. However, the centre will continue to have the right and capacity to impose its priorities on localities and on society in general. Local deviations surely exist, but it cannot be interpreted as outright loss of central

opportunity cost somewhere else in the economy with respect to engaging in positive-sum activities’ (Tollison, 2012: 74). The concept of rent is simply defined as excess incomes or super-profits which would not exist under perfect competition.

³ Like Dazhai for agriculture and Daqing for industrial management during the Maoist Era

power (or as a sign of a regime's collapse, as suggested by doomsayers in the early 1990s⁴). Saich (2004) encapsulates: 'when the centre has really wanted to impose its will on a significant issue it can, and the provinces have been willing to go along with this' (p.159). Even Shirk (1993), an author often quoted by those stressing the rise of local power in Reform Era China, is explicit about the nature of China's political system and the likelihood of it being characterized by any shade of federalism: 'China is a unitary and not a federal state, and the centre hands down powers and resources to local governments in a 'nonstandardized manner' and may retract them at any time' (p.182). Fiscal authority has never left to be centrally controlled. If local governments gained more fiscal autonomy, it was because it was *granted* to them, by the centre. It has never abolished its ultimate authority – powers over fiscal revenues allocation can be retrieved by the centre, with varying degrees of tranquillity. Indeed, that was what happened in 1994 with the tax reforms (Kroeber, 2016).

Hence, one may need to understand the *modus operandi* of the system which the central government employs to guarantee the compliance and control over local cadres. Political and administrative authority aspects can be even more important than the fiscal facet of the problem. Measures of a supposedly weakening of the central government, focusing on the *fiscal dimension* of central-local relations, may not be enough to capture the dynamics of China's inter-governmental relationships (Yang, 1994).

The nomenclature and the systems responsible for cadres' evaluation, thus, are of fundamental importance if one endeavours to scrutinize contemporary China. Unfortunately, these are topics neglected by the proponents of FCS. The Chinese polity is still characterized by the nomenclature system, which permits the centre to make appointments, remove and rotate cadres, in a top-down fashion (Yang, 1997). The nomenclature, in addition to the cadre responsibility system (CRS), has arguably improved the centre ability's to monitor and manage local development, and its coercive power can still be felt by local leaders, and even governors of wealthy provinces. As Chung (2000) encapsulated, the nomenclature control is 'the ultimate antinomy of provincial discretion and autonomy' (p.178).

Unlike the understanding presented by scholars who highlight a supposed loss of central power, Edin (2003) emphasizes the ability the Chinese Communist Party (CCP) and the central government have to oversight and discipline local cadres. The author argues that the central government's ability to control and monitor local agents has actually *increased* during the 1990s. The cadre responsibility system (CRS), weakened during the 1980s, was strengthened on the following decade. Very specific economic performance criteria were established, with targets set by higher governmental levels. Fundamental to the implementation of the CRS was the maintenance of the nomenclature system, attesting the continuous hierarchical nature of the party-state. Political and economic rewards - promotions and bonuses, respectively - were granted for successful local officials, bolstering the central government's control over agencies and localities. A system of local cadres' rotation was also employed, in order to foster the identification of cadres with higher governmental levels, rather than with a particular local

⁴ See Kristof (1993), Wang (1994), and in special Goldstone (1995).

community. Edin (2003) concedes that ‘localism’ was on rise in the 1980s, but it went through a decline during the 1990s, thanks to the measures employed by the CCP. Moreover, the control and monitoring appears to be greater in areas that thrive economically⁵.

Tsui and Wang (2004), building on the idea of the CRS, highlight the mechanisms the central government has devised in order to maintain its control reaching up to the grassroots level. The CRS and the target responsibility system allow the centre to oversee the appointment, evaluation, promotion and dismissal of local cadres. The system features quantitative targets, relatively easily measured⁶. Upper-levels then are able to impose rewards and penalties on local cadres. This system of targets, allied with the power to appoint and demote local cadres, allow superior levels of government to induce local cadres to behave in a way approximate with that of the central government’s preferences, thus diminishing the actual autonomy of localities⁷. Equally importantly, this system shapes the allocation of fiscal resources at the local level. It is perceived as the concrete manifestation of central control.

The continued nature of the central power can be observed in many historical events in the last decades. Throughout the 1980s, the centre would commonly ‘borrow’ funds from subnational governments, but not necessarily would pay it back (Tsui and Wang, 2004). Moreover, rules over fiscal sharing changed frequently, generating, thus, uncertainty over the amount of fiscal revenues that should be remitted to the centre (Shirk, 1993). This uncertainty certainly undermines the argument of credibility and durability of fiscal arrangements, a distinguished pillar for the proponents of the FCS approach. Furthermore, even leaders of wealthy provinces like Jiangsu and Guangdong felt the political clout of the centre: Just before the revenues-centralizing 1994 tax reform their leaders had to agree with the centre’s new policy proposal after Jiang Zemin called them to a face-to-face talk. Later, Zhu Rongji reportedly said Guangdong should be praised for being a model ‘for submission by the part to the whole’ (Yang, 1997: p.103-104)⁸. In fact, according to Huang (1995) the average tenure of provincial leaders actually declined in the 1980s, in relation to the Maoist Era, as they were often rotated or demoted. The 1994 tax reform was a major (re)centralizing effort, dictated mostly by the concerns of central bureaucrats and politicians. And even after the reform was concluded, other fiscal centralizing movements ensued, like the 2002 amendment on the revenues from the income tax⁹. Regarding the extra-budgetary revenues, often seen as a safe source of local

⁵ This last finding of Edin (2003) somehow mirrors a key result of Dickson (2003): in his study of county-level party officials and entrepreneurs, it was found that in more prosperous and privatized counties entrepreneurs are more likely to agree that their business associations represent the government’s viewpoint, and that they are less likely to believe they can influence policy-making, indicating they have actually lesser autonomy in relation to the party-state.

⁶ Local cadres were evaluated in accordance with three broadly defined major tasks: economic construction; social development and party building.

⁷ Even in the cases when it seems harder to get rid of local officials, it is so because they have strong patrons at the centre (Huang, 1995; Yang, 1997).

⁸ In fact, Ye Xuanping, former Governor of Guangdong, was removed from his position in the run up for the 1994 tax reform. The Party Secretary of Jiangsu had the same fate (Cai and Treisman, 2006).

⁹ Starting in 2002, they became shared taxes, instead of local. Personal income taxes proceeds were assigned mostly to the central government (60%), and the remaining 40% for subnational governments. Regarding corporate income taxes on SOEs, the ownership principle gave way to a shared percentage between local and

governments' revenues, actually throughout the 1980/1990s an attentive observer would have noticed a central government always willing to, and often being able to, meddle into local revenues affairs. There have been innumerable attempts to rein over extra-budgetary revenues, abolish some surcharges (the final abolition of the agricultural taxes¹⁰ on January 1st, 2006, is a case in point), and the continuous attempt to better integrate them to a formal budgetary system (Tsui and Wang, 2004). In tandem with the fiscal system, the Chinese administrative-political system also suffered more centralizing reforms throughout the 1990s (Mertha, 2005): many key bureaucratic units, especially commercial and regulatory agencies, were partly 'centralized'. This process took place at the grassroots level, i.e., township and counties bureaucracies were recentralized up to the provincial level. Instead of being controlled by superiors located at its own local governments ('kuai-kuai', or horizontal lines of control), bureaucratic units became directly controlled by their administrative superior ('tiao-tiao', or vertical lines of control). The aims of these reforms were to combat local protectionism and to promote a standardization of norms across the country. As one could anticipate, these centralizing reforms were carried out thanks to the nomenclature system. Mertha (2005) labels the process a 'soft centralization'. While counties and townships lost direct control over bureaucracies, provinces were the great beneficiaries, not the centre itself. The reforms attested the reach of the central government in putting forward its preferable policies, but at the same time the ambiguities¹¹ of an administrative system encompassing five tiers of government.

Moreover, other requirements of a MPF system did not, and still do not, hold in China. The requirement of a unified common market, with no local protectionism clearly did not apply to China until 1994. Academic research (Kumar, 1994; Young, 2000) and anecdotal evidence signaled to the erection of internal trade barriers and local protectionism throughout the period¹². The 1994 tax reforms, the 'soft centralization' reforms as exposed by Mertha (2005), the reforms on China's monetary system and later on its ascension to the World Trade Organization (WTO) certainly mitigated substantially these issues. Nevertheless, it seems fair to believe that a degree of local protectionism still exists when it comes to the banking system, as many local leaders still can wield certain influence on loans granted by local banks and local branches of the 'big five' banks¹³. Moreover, factor mobility is certainly not without impediments, even nowadays. Notwithstanding substantial flexibilization in the past decades, the hukou system – often dubbed China's 'invisible wall' - is still able to restrict labour mobility across the country to some extent.

central governments: as for 2008, Man (2011) reports that the central government accrued 64% of the revenues, and the remaining 36% was designated to local governments.

¹⁰ See Lu (1997) for a discussion on the so-called 'peasant burden' in Post-Mao China

¹¹ For Mertha (2005), the empowering of provinces was an unintended consequence. The key point, however, is that when the central government decided to curtail the discretionary power of lower level units, it had the means to do so.

¹² Holz (2009), in a response to Young (2000), concludes that there is no evidence for interprovincial *increasing* barriers to trade. Rather, the evidence shows that barriers to trade were decreasing over time. Holz (2009) concedes that interprovincial barriers to trade existed, though. His point is that they were actually being mitigated throughout the 1980s and early 1990s, in relation to the Maoist Era.

¹³ These are: the Bank of China, Agricultural Bank of China, Industrial and Commercial Bank of China, Bank of Communications Banks and China Construction Bank.

Finally, the requirement that local governments face hard budget constraints seems far from being the reality in China, even nowadays. Access to bank loans due to political connections instead of creditworthiness was common practice in China during the 1990s (Yi and Guo, 2015). While the situation certainly improved after 1994, local governments are still able to tap from extra-budgetary revenues, still rely on (and compete for) subsidies from the central or upper governmental levels (especially poorer counties) (Tsui, 2005) and have devised many mechanisms to circumvent the formal prohibition of local borrowing. The recent rise of local government financial vehicles (LGFVs) or local financing platforms (LFPs) (Tsui, 2011) is the most touted example, but not the only one. Budget constraints, yet almost surely harder than during the Maoist Era, cannot be described as ‘soft’.

Lastly, the FCS literature usually suffers from neglecting the Maoist legacies inherited by the Dengist leadership. Mao’s Era experienced some episodes of greater economic autonomy for local governments, especially at the county-level (Donnithorne, 1972; Riskin, 1987), and also promoted an overarching programme of rural industrialization (Bramall, 2009). For Donnithorne (1972), the Chinese economy by the late Maoist Era could be characterized by its ‘cellular’ nature, given the relative autonomy and the establishment of local industries in many counties. Oi (1992) rightfully emphasizes that the explosive growth experienced in rural China’s throughout the 1980s ‘has reinforced rather than broken down the cellular nature of rural society’ (p.124). Wong (1991) also agrees that the rural industrialization of the 1980s actually ‘exacerbated’ (p.712) this cellular pattern originated under Mao. The key point is the continuity in relation to the local state as a crucial scale of governance, with the necessary autonomy to mobilize economic resources and craft developmental strategies. As Huang (1995) reminds, to assume that the economic power of sub-national units is a new phenomenon is a false premise¹⁴. Indeed, one of Mao’s paramount concerns was arguably the dream to create a socialist system distinguished from the Soviet-style one, i.e., less bureaucratically centralized and a system in which local leaders had more autonomy on policy making, with the population establishing closer liaison with local cadres (Gray, 2006).

6. *De facto* federalism

In tandem with the FCS approach, Zheng (2006) holds that albeit China does not have a *de jure* federalist system (understood as a constitutional division of power between different levels of government), its central-local relations could be framed as a *de facto* federalism. For Zheng (2006), there is an actual centre-province hierarchy; an intergovernmental decentralization which is hard to be fully reversed; and provinces have the primary responsibility over the economy and in a minor extent also over politics within their jurisdiction. Likewise, the rationale is anchored in an argued ‘rise of provincial power’ (p.122). This particular institutional arrangement that has emerged in China propelled the country towards a system of checks and balances in its central-local relations dynamics, even in spite of the lack of a *de jure* formalization.

¹⁴ As others commentators (Cai and Treisman, 2006) have noticed: ‘Provincial governors are important players in the games of Beijing politics, as they have almost always been. But the notion they can be relied on to coordinate to limit central interventions is not supported by much evidence’ (p.16).

Zheng (2006), however, has a more nuanced view on the system. He recognizes that as the priority of the leadership is to promote economic growth (rather than neatly dividing the power between centre and provinces, and among provinces), the leadership has to constantly mediate and adjust the relations among distinct levels of governance, depending on the actual circumstances. An institutionalization of the *de facto* federalism into a *de jure* federalism could possibly endow the Chinese polity with some undesirable degree of political rigidity: ‘In contrast, *de facto* federalism has its advantage of flexibility... In other words, the centre needs, for the time being, not a clear-cut division between the centre and the provinces, but ambiguity between them’. (p.124, emphasis added).

While still working under a generic ‘federalist’ rationale, Zheng (2006)’s understanding is not encaged by the necessity of a well-defined, institutionalized and unambiguous division of power among different spheres of government. The role of credible commitments and durability of a certain institutional arrangement, a cornerstone of the MPF approach, is not so important here. Rather, there is an explicit recognition of positive attributes of institutional ambiguity and flexibility. That is precisely what renders the centre the ability to juggle with different interest in its vertical structure. Nevertheless, this institutional arrangement is seen as appropriate for this specific phase of Chinese development. Zheng (2006) clearly works within a ‘transitional approach’, meaning that some institutions, while not the optimal ones, are suitable for a ‘transitional economy’, and can be conducive for economic development at this stage in spite of its sub-optimality. It could be framed as a ‘second-best’ approach – the best institutional setting possible for the transitional phase China currently rests at. In the long-run, notwithstanding, an institutionalization of *de facto* federalism should lay the institutional foundations for China’s *de jure* federalism¹⁵.

7. Modelling central political control

Other mainstream scholars, virtually in a response to the FCS approach, tended to focus on the key role the central government has exercised throughout the whole reformist era. Cai and Treisman (2006) explain China’s successful economic trail based not on ‘decentralization’ (fiscal, administrative or political), but actually on factional competition at the centre. In the late 1970s and 1980s, reformists at the central level, making full use of their patron-client relations down to the grassroots level, kick-started the reformist drive and therefore obfuscated the rival conservative factions. Changes in the factional balance of power, rather than changes in ‘decentralization’ (however defined) explain the chronological pattern of reforms in China. Local leaders by no means can be overlooked, and do have a say in grand politics, but mostly because they can exploit their vertical connections, forging alliances with their patrons at the centre or higher levels of government. In other words, the political dispute for power, at the centre, is reflected in each of the layers of the multi-tier system of the Chinese polity. Local

¹⁵ The distinction of *de jure* and *de facto* federalism, as presented by Zheng (2006) has been recently criticized by Breslin (2012): ‘China as being *de facto* federalist sounds like a contradiction in terms; federalism is a legal (*de jure*) concept, not an informal one. But this apparent contradiction is actually an apt summary of the gap between the way China is meant to be administered and governed, and how it actually is in reality’(p.45).

leaders are important insofar they are politically connected to their patrons at the centre, giving and receiving support to and from them.

7.1 Multi-divisional organizational form (M-Form)

Given the nature of China's political system and its chains of control, some scholars (Maskin et al, 2000; Qian and Xu, 1993; Qian et al, 2006) perceive the country through the lenses of organizational theories, framing China as a large corporation. They focus on China's distinctive organizational hierarchy inherited from the Maoist period, sustaining that the country resembles a multi-divisional (M-Form) organizational form. Contrariwise to the former Soviet Union, China's organizational structure prior to the reforms could be understood as a multi-layer and multi-regional form, with each geographic region at each layer regarded as an 'operating unit'. Each of these units is semi-autonomous and relatively self-sufficient. In other words, lower levels of government have little bargaining power with their superiors, but have substantial autonomy in developing their own regions. An economy organized in this multi-divisional form has the advantage of requiring lower coordination and communication efforts, as local governments are responsible for the coordination and execution of the majority of the economic tasks independently from the central level. Likewise, the M-form organization is superior in mobilizing initiatives from the grass-roots level; it is more flexible and allows to local experiments to flourish without jeopardizing the whole economy, and effects of external shocks tend to be contained within the localities. The more uncertain an experiment is, the higher the benefits of a M-Form organization. The U-Form, conversely, has the great advantage of better exploiting economies of scale and specialization, and is superior when an experimentation is more likely to yield positive outcomes (Qian and Xu, 1993; Qian et al, 2006).

An M-form economy is able to benefit from a 'gradualist' approach in economic reform, as always there is the option of 'early removal' (in case of reform failure). In a context of high uncertainty (a reform 'blueprint' is not totally reliable beforehand) the advantages of the 'gradualist approach' can be fully exploited (Qian et al, 1999). The combination of these features, under the context of marketization, was the gradual weakening of bureaucratic controls and strengthening of market activities, without the collapse of the previous organizational structure. China's peculiar organizational structure inherited from the Maoist Era allowed the 'growing out of the plan' (Naughton, 1995) strategy to be successfully implemented, with the introduction of non-state elements in its economic structure without disrupting the whole system, posing a striking contrast to the 'big bang' reforms in the former Soviet Union.

Maskin et al (2000) highlight the different structures of incentives both the U-Form and M-Form produce. They defend that different organizational forms yield distinct information patterns for the organization, which in turn give rise to different structure of incentives. Their empirical study on China's state-owned enterprises (SOEs) has found that the M-Form organization produces smaller conditional variances on economic data, hence yielding better information on relative performance of local officials (akin the middle managers of corporations). Therefore, M-Form facilitates the yardstick type of competition among local

leaders - they can be more reliably assessed, and then promoted or punished by the central government. This finding echoes the idea that it makes more sense, economically, to set competition among regions than among ministries, because it is more straight-forward to compare regions or independent departments that produce roughly the same array of goods. Ministries or a functionally divided department, on the other hand, specialize in different products/tasks. The high complementarity among ministries makes it more difficult to set a yardstick competition.

7.2. Political incentives and Career concerns (PI/CC)

Some scholars chiefly credit the success of the Chinese reforms on China's unitary system and on the ability of the centre to control, via the nomenclature system, lower level cadres. As seen above, the CRS has enabled central authorities to devise a system of rewards and punishments for local officials, based mainly on their performance on spurring local economic growth. It is argued, thus, that a system of political incentives, grounded on the career concerns of local officials, has been devised, and became conducive to the high-speed growth record of the country (Blanchard and Shleifer, 2000; Li and Zhou, 2005).

According to Blanchard and Shleifer (2000), fiscal decentralization was beneficial to China only because it was combined with political centralization and future prospects of economic growth. Political centralization enabled the CCP to reward or punish local officials according to the central's government policy objectives. As Blanchard and Shleifer (2000) sum up: 'The competitive benefits of 'market-preserving federalism' emphasized by China scholars depend very much on political centralization' (p.10). Building on the M-Form hypothesis, the Chinese economy, it is argued, can be perceived as a large corporation in which provincial leaders behave similarly to middle managers, and thus their career prospects is linked to their economic track record. The particular organizational form of China allows central leaders to supervise the performance of local officials, as showed by Maskin et al (2000).

At the core of the Political incentives/Career concerns (PI/CC) approach is the reliance on the new institutional economics (NIE) paradigm, whose main tenets have been exposed previously. In particular, the framework of the 'helping hand' vs 'grabbing hand', as put forward in Shleifer and Frye (1997) seems to be the basis of much of the PI/CC approach applied to China. To put it briefly, the framework sustains that a 'helping hand' exists when corruption is centralized or organized by the government, whereas a 'grabbing hand' emerges when corruption is disorganized or the state is unable to centralize it, leading to the spread of mafias and protection rackets. The 'invisible hand', in tandem with the main NIE principles, is considered the best option and assumes rule of law and proper property rights protection, with the state behaving as a sort of 'night-watchman'. This approach developed in Shleifer and Frye (1997) builds on the earlier work by Shleifer and Vishny (1993) on corruption. For the authors, the government is able to supply goods (licenses, permissions etc) in three different manners: the first case is when the state acts as an individual monopolist supplier. Here all the state agencies are organized and maximize the bribery charges in a collective way, reminding the collusion of oligopolistic competition. The second case is when each state agency acts independently, trying

to maximize their bribery individually, in total disregard with the other state agencies. This case is similar to the competition by different monopolists. The first case results in a lower unitary bribe price and higher output (government licenses, permissions etc). The second case renders a higher unitary bribe price and smaller output (the government goods are complementary, so as the state agencies behave individually, a higher individual profit of one agency may lower the demand for the second state agency). The most efficient manner to provide governmental goods is the third one, by competitive and decentralized provision, akin as a perfectly competitive market.

Although they do not recognize or acknowledge, it seems to me that the analyses of both Shleifer and Frye (1997) and Shleifer and Vinshy (1993) parallels the one developed by Olson (1993) - a key NIE author - regarding political systems: Anarchy or Warlordism (Roving bandits); Autocracies or authoritarian systems (Stationary bandit) and Democracies. The stationary bandit, holding monopoly over violence and over the state power, represents a great improvement in relation to the roving bandits stage. The stationary bandit aims to maximize its theft (taxes) inter-temporarily, so he must also provide public goods that will enhance the potential output of the economy and hence enlarge its taxable base, so he can accrue more and higher taxes revenues in the future. The autocrat, thus, often has a long-term horizon on the economy. Finally, democratic coalitions (encompassing majorities) are able to maximize their tax revenues at a lower tax rate level, because they are also direct beneficiaries of market development, accruing income from private entrepreneurship (which is more likely to flourish with lower taxes). Table 1 below attempts to summarize this part of the mainstream literature:

Table 1: Summary: Political systems, corruption and legal/regulatory environment (selected mainstream studies)

Olson (1993) Political Systems/Governance	Shleifer and Vinshy (1993) Corruption – based on market structures	Shleifer and Frye (1997) Legal and Regulatory environment
<u>Democracy</u> Independent Judiciary; Competition for power, no individual group is able to overrule others	<u>Perfect Competition</u> Competition between providers of government goods drives the bribe price to zero (Price = Marginal cost)	<u>Invisible Hand</u> Rule of Law; Property rights protection and enforcement
<u>Stationary Bandit (authoritarian governments)</u> Monopoly of violence, long-term planning, maximizes its tax revenues and provides public goods	<u>Single Monopolist</u> Collusion of state agencies to maximize the total value of bribes (Price > Marginal cost) (Mark-up)	<u>Helping Hand</u> Organized and relatively limited corruption by the state
<u>Roving Bandits (Warlordism)</u> Violence and theft are widespread, promoted by various groups ('anarchy', failed states)	<u>Independent Monopolist</u> Each maximizing bribes independently (highest total per unit bribe)	<u>Grabbing Hand</u> Disorganized corruption; Mafias, protection rackets...

Source: Own elaboration

This branch of NIE literature ended up classifying China as typical ‘helping hand’ country, featuring organized corruption driven by an authoritarian regime with a long-term view on development. Russia, on the other hand, has fallen prey to the ‘grabbing hand’ problem of disorganized corruption and mafias (‘krysha’, or ‘roofs’). In other words, the initial NIEs explanation for the Chinese miracle, focusing on governmental decentralization (FCS literature), was replaced by an explanation focusing on a centralized state whose behaviour entails positive aggregate benefits, thanks to its ability to control local officials and to curb ‘disorganized’ corruption. Following this conclusion, a growing body of literature emerged, trying to ‘apply’ the ‘helping-hand’ paradigm to China. Li and Zhou (2005), for instance, in an econometric study, found that the probability of provincial cadres’ promotion increases with their economic performance. Accordingly, the likelihood of their demise increases with poorer economic record.

In particular, the notion of yardstick competition, applied to the mechanisms of control the CCP wields on local officials, has also flourished in tandem (Che et al, 2014; Persson and Zhuravskaya, 2015; Suzuki, 2012). The main argument is that the central government is able to reward and punish local officials according to their economic performance. The role of selecting superior (local) outcomes is not anymore assumed to be performed by the market mechanism (as in the FCS literature). Instead, this selection is done by the central government, somehow acting as a surrogate of the market mechanism. Local officials performing badly in terms of GDP growth will be punished, and are much less likely to get a promotion within the CCP hierarchy than local officials presiding over high GDP growth local economies.

7.3. Critiques on the Political incentives/Career concerns (PI/CC) literature

In spite of the potential merits of this body of literature, some shortcomings and drawbacks can be identified. Regarding its assumptions, the literature builds on the broad NIE paradigm, and therefore one may find a blind reliance on the idea of economic self-interest as the leading or only motivational purpose driving individuals’ behaviour. The state bureaucracy, by extension, is perceived and modelled in a similar fashion. Considerations involving the functioning of the state bureaucracy – arguably better understood by political scientists and by other realms of academic inquiry – simply collapse to the individual utility-maximization principle. The state itself seems to be perceived merely as a collection of self-interested agents, in other words, it is dispossessed of an own coherent logic and not perceived as a category *per se*.

Regardless of problematic assumptions, one can invoke a Friedman (1953) type of positivism, claiming that what matters for any theory is its capacity to predict results and outcomes. In the case of China, however, it seems that the PI/CC literature has a rather limited explanatory power. Take Li and Zhou (2005) for instance, a widely quoted empirical test. They found out that provincial leaders presiding over faster GDP growth provinces are statistically more likely to be promoted to the central level rather than provincial leaders presiding over slower GDP growth provinces. Nevertheless, due to its fiscal decentralization reforms, most of the developmental tasks in China lie on the purview of *sub-provincial* leaders. According to Wong

(2009), in 2004 provinces accrued only 11.2% of China's total budgetary revenues, against 16.6% of municipalities and 12% for counties. For Martinez-Vazquez and Qiao (2011) local governments at the county level and below are the ones mainly shouldering the provision of most public goods, such as health and education (excluding higher level institutions), welfare and the promotion of local development. More specifically, GDP-growth strategies are more likely to be influenced by township, county and prefecture-level officials, not simply by the provincial ones.

It is important to stress that according to the study by Maskin et al (2000) the informational advantages derived from the M-Form only have a bearing for *middle level* managers, i.e., Provinces. Maskin et al (2000) state it clearly that at the top and bottom level the incentives' structure are the same, on both U-Form and M-Form organizations. Accordingly, it has already been found that grass-roots officials often advance in the Party-State hierarchy by alternative methods other than promoting economic growth: For Hillman (2010), in a county-level study, it is the ability of crafting informal coalitions across multiple local-level state agencies that mostly explains the likelihood of cadres' appointments; different factions compete with each other for the control over resources, and placing a member in a key bureaucratic position is instrumental for a faction purposes. Equally important, factions normally are based not on ideological cleavages, but on native place associations (the township level, in this case). For Smith (2015), apart from informal cadre networks and personal connections, local officials must restore to kinship ties and to financial power (sometimes even the outright purchase of positions) to get a promotion. Smith (2015) reports that many cadres realize that 'ability and effort were not enough to get ahead' (p.608), and that there is a growing consensus that many of the county-level leading cadres 'attained their positions not through merit (as media coverage of competitive examinations for government posts would suggest), but through a combination of bribery and networking' (p.604)¹⁶.

Moreover, and fundamentally, Zhou (2010) argues that most of the officials at the county level or below expect to spend their entire careers within this level of governance. In tandem, Kostka and Yu (2015), in a recent empirical study with municipal¹⁷ party secretaries, find out that upward mobility, i.e., county-level cadres being promoted to the municipal level, is a rare event. Cadres mostly move between municipal and provincial levels, but it seems there is a structural barrier between the county and the municipal level. The majority of the municipal-level cadres were previously working at the provincial level, and in only a handful of exceptional cases cadres managed to climb-up the ladder *from* the county-level. Kostka and Yu (2015) indicate that county-level cadres have limited opportunities to nourish strong ties and networks with upper-levels officials, and that provincial leaders (the ones responsible for appointments at the municipal level) usually select cadres with whom they have closer contact and stronger political connections. As one can realize, the importance of vertical patronage ties

¹⁶ As Smith (2015) concludes: 'local government works somewhat like a pyramid scheme. The sooner one enters the elite ranks, the greater the earnings of one's family over the course of a career, the greater one's prospects for further promotion, and the greater the opportunity to bring in other family members and friends. But *those lacking the funds and connections* to join the scheme faced a career laced with disenchantment and cynicism, should they choose to remain in government service' (p. 611, emphasis added)

¹⁷ It includes both county-level and prefecture-level cities.

plays a pivotal role in the prospects of promotions¹⁸. The ‘helping hand’ story applied to China would predict that grass-roots officials, when working diligently in promoting local GDP growth, would eventually get to the top. That is not what it seems to happen. These caveats are connected with the common neglect of NIE on alternative motives other than the blind pursuit for individual maximization in explaining the behaviour of cadres (and individuals in general).

Furthermore, the rationale behind this NIE literature applied to China is the belief that certain institutional arrangements (i.e., a particular institutional relationship between the central government and local governments, and between local governments and the market) will spur economic growth. Incidentally, this literature does not work explicitly with any growth theory. In other words, economic growth is supposed to be explained purely on institutional basis, neglecting any proper discussion on the mechanisms behind economic growth. This omission notwithstanding, I would argue that they actually work - implicitly and/or covertly – with the Solow-Swan paradigm: it is assumed that economic growth depends ultimately on the efficient allocation of the factors of production (capital and labour), a task that can only be accomplished by the markets (under perfect competition). There is no acknowledgement on the pervasiveness of imperfect competition and no discussion on concepts such as knowledge creation and diffusion, learning and technical change, or how productivity gains are promoted and sustained¹⁹.

Relatedly, the FCS and PI/CC literatures have a poor capacity to explain local variations in economic performance in China. The system of political incentives devised by the CCP and the central government applies to every single locality, and the fiscal arrangements between local governments and the central government holds in a nation-wide fashion as well. The literature seems to assume that successful reforms (as in China) means that every single locality will be able to promote sustainable economic growth. That resembles a ‘fallacy of composition’ argument in they assume every single locality will be able to devise winning strategies, regardless of aggregate limitations. Once again, a proper understanding on growth theories, and in particular on concepts such as increasing returns to scale, agglomeration economies and path dependencies, long incorporated by the mainstream (Krugman, 1998; Romer, 1994) are missing.

More recently, some scholars (Liu et al 2012; Tsui and Wang, 2008) started to pay proper attention to the issue of local variation, and focus on the previous level of

¹⁸ Age and education restrictions, and the limited number of positions at the municipal level also play a role in explaining the difficulties county-level cadres face in assuring a promotion.

¹⁹ I would go as far as to argue that Olson (1993) is implying the law of diminishing returns on his discussion on democracy. It comes as a surprise to many that for Olson, in spite of all the economic advantages democracy arguably has, in the long-run the growth rate of stable democratic regimes tends to decrease. That happens, according to the scholar, because different groups of interest start lobbying the state for redistributive transfers, a phenomenon that can only take place (or at least take place more vigorously) in stable democracies. The overall rationale seem to be that the initial gains of a democratic regime (political stability and the promotion of peaceful successions and lower tax rates) tend to be dissipated as the time passes by, so the marginal gains of a democratic regime slowly erode. In other words, apparently Olson (1993) is applying the law of diminishing returns to institutions. Just as a higher stock of capital decreases its profitability in the long-run, driving economic growth down (Solow model), the same process would occur with democracy.

industrialization/economic development of a given region in China. Regions featuring relatively high levels of industries prior to the economic reforms and the establishment of the cadre responsibility system (CRS) were able to promote further industrialization, accrue higher tax revenues and finally spur economic growth. Poor regions, mainly agricultural ones, were not able to promote industrialization, or at least not as successfully as other regions. With a continued reliance on agriculture, their tax base could not be enlarged, and thus the tax revenues of these regions could not grow much (inducing, thus, the creation of arbitrary charges). Compounding this duality there is the CRS and the targets from above: the targets imposed by the centre are uniform and standardized, i.e., they apply to every single local government regardless of their (fiscal) capacity to meet the targets. While the general gist of this last strand of literature is correct, for it highlights the key role of previous industrialization in explaining variations in local state behaviour and growth performance, it lacks solid foundations on growth theoretical notions such as agglomeration economies, cumulative causation and path-dependence.

8. ‘Experimentation under hierarchy’ and the local state

In a nutshell, the understanding of the FCS proponents seems to be plagued with two inter-related ideas: the first, as exposed, of a rise of local governments’ power and autonomy. Secondly, the mirror of this rise was an erosion of the central government power. The Political Incentives and Career concerns (PI/CC) literature, while correctly acknowledging the continuous role and power of the central government, has a too narrow focus on the mechanisms behind a tournament-like yardstick competition that supposedly takes place among sub-national leaders, controlled by the centre.

Building on a critical and historical perspective, Heilmann (2008a, 2008b) defends that China’s intergovernmental relations and policy process should not be framed on dichotomies such as central vs. local, or based on constitutional ideas such as federalism. The author puts forwards the concept of ‘Experimentation under hierarchy’: the combination of decentralized experimentation with *ad hoc* central interference. Localities are granted leeway to find innovations in terms of policy instruments; policy objectives, however, remain as a prerogative of the central leadership. This conceptualization, Heilmann (2008a) argues: ‘gives room to local officials to develop models on their own, while ultimate control over confirming, revising, terminating and spreading models experiments rests with top-level decision-makers’ (p.2).

The result is the selective integration of local experiences into national policy-making. That is an explicit attempt to harmonize, into a well-defined analytical framework, the enduring hierarchical nature of the Chinese party-state and the unchallenged power of the central government with the large variations in terms of policies and socioeconomic outcomes across China’s plethora of local governments.

When analysing the roots of China’s ‘Experimentation under hierarchy’ model, Heilmann (2008a) rightfully comes back to the CCP’s distinctive historical experience with governance matters, stretching back as far as to the Yan’an period (1937-1945). It may be argued that after the Yan’an period the CCP solidified a set of principles characterized by decentralized rule,

considerable operational flexibility allowed to local leaders, preference for officials who can provide leadership in a range of areas (politics, administration, military affairs) instead of only a particular, and developing and maintaining close ties with the local population (Blecher, 2003; Dorris, 1976; Lieberthal, 2004). Chung (2000) defines the ‘Yan’an tradition’ as various bottom-up initiatives and anti-bureaucratism movements. This distinctive ‘Yan’an tradition’ can be contrasted with a more centralized, functionally specialized, hierarchical, commanded-oriented approach of the Soviet Union. Heilmann (2008a) recuperates this tradition, advocating that the CCP lacked a truly national bureaucratic apparatus, which in turn undermined its capacity of implementing centralized policies. This historically-determined institutional setting entailed a decentralized, experiment-based approach to governance. The Post-1978 leadership managed to reanimate the ideas versing around local initiative and policy experimentation, which had been diminished to ‘model emulation campaigns’ for most of the Maoist period (Chung, 2000). The post-Mao environment of market-reforms and local entrepreneurship ended up fusing virtuously with the Maoist ideas of local initiative and decentralization.

A marked contrast with models of federalism applied to China can therefore be made: in China, central authorities still have to *grant* local experiments a green light somehow, usually making usage of patron-client ties. The hierarchical nature of the Chinese party-state cannot be ‘theorized away’, for the central government still holds the prerogative of appointments. Federal models applied to China imply that administrative and fiscal decentralization and inter-jurisdictional competition have replaced the country’s unique hierarchical governance. In this sense, they miss the crucial role played by the central government in the political dynamic of experimentation²⁰. Federalism is a constitutional concept, originated in Western liberal democracies, working with the idea of a vertically stable checks and balances between different levels of government. To apply these concepts in China means to neglect the nature of the Chinese political system. As Heilmann (2008b) concludes, ‘the entire policy process must be conceptualized as an oscillating multilevel interaction rather than as a dichotomized process of centralization vs. decentralization’ (p.12). Local experimentation is always controlled by the centre²¹, and the diffusion process is coordinated by the state. As the author (Heilmann, 2008b) encapsulates: ‘bottom-up experimentation goes nowhere without higher-level patrons’ (p.9). This is a very different story from the FCS approach, in which successful policy innovations are diffused and spread *via market mechanisms*, i.e., competition among jurisdictions. Successful policies, the argument goes, are learned and imitated by other jurisdictions, given the market pressure. Jurisdictions insisting in market-unfriendly policies would be doomed to lag behind in China’s unstoppable move towards the market (Montinola et al, 1995).

²⁰ This was a point already raised by Cai and Treisman (2006). For them, it was actually political centralization that boosted the spread of growth-enhancing institutional reforms. Grass-roots initiatives like the household responsibility system only became effective and spread nationwide because China was a politically centralized country, in which the central government played a fundamental role in monitoring, regulating, and steering the pace of reforms.

²¹ Shirk (1994) has an even more sceptical stance on China’s so alluded ‘experimentalism’. In her opinion the so-called experiments were never allowed to fail, as they would usually receive special treatment and favourable conditions. Experiments in China, rather than being designed to test the results of a policy change, actually fill the objective of building political and bureaucratic support for central officials.

Moreover, one must bring politics back into this debate, instead of treating the central government as merely the arbiter of a tournament-like competition played by local leaders. The successfulness of policy experimentation and diffusion are due to the pivotal role played by the central government, which, in a highly politicized fashion (contingent to the changes of policy objectives), encourages and protect some local experiments (but not necessarily all), to later spread it throughout the country. This view stands in sharp contrast with the PI/CC literature, for whom it is implied that successful policies at the local level will be manifested in better indicators (namely, GDP growth) and this will render the local official in case a promotion within the party's hierarchy (ultimately leading to the diffusion of the policy). For Heilmann (2008a, 2008b) this process is always politicized, from the grass-roots level up to the centre. There is no automatic, tournament-like yardstick competition being played, but a process of selection permeated by distinct patron-clients networks. This is not to say that local growth performance is unimportant, but it must be perceived within a broader political economy context, one which cannot be reduced to simple individual utility-maximizing calculations. Indeed, Heilmann's 'experimentation under hierarchy' incorporates earlier insights on the central government behaviour, ranging from *ad hoc* management and interference on localities, 'selectivism' and what Shirk (1993, 1994) dubs 'particularistic contracting'. Chinese reforms were forged piece by piece, negotiated for individual (set of) units. There were no uniform or standardized rules applied horizontally. This 'selectivism' was only possible because central officials could exploit pre-existent and create new patron-client ties. Granting economic privilege to particular localities (usually in the form of administrative decentralization) entailed the spread of the 'particularistic contracting' pattern across the whole country, shaping and reshaping political connections in the process. Simultaneously, the richness of local variations on policy implementation and local autonomy (often manifested in the existence of 'regional models')²² can easily be explained and understood within Heilmann's framework, encompassing China's intergovernmental relations, the party structure, local experimentation and national unity.

Not only the successes, but also the failures and limits of the Chinese institutional architecture patterned by the CCP during the Post-Mao Era can be understood through this framework. For Heilmann (2008b), the successful Chinese reforms and institutional innovations were underpinned by the collusion of local political and economic elites²³. Essentially, the reforms allowed new channels of accumulation to emerge, benefiting first and foremost local elites. This is not to say that the overall population and even the poorest ones did not become better-off. The point here is that the reformist programme of institutional innovations were driven by the interests of a national leadership and its local counterparts; as the reforms engendered higher growth and income generation, other segments of the population – who did not have a strong say when the reforms were being implemented – were towed along and witnessed a rise

²² This conceptualization of the Chinese reforms dovetails the approach developed by critical geographers, like Lim (2014), for whom Chinese reforms must be understood as always being geographically differentiated, producing a series of economic-spatial tensions. See also Zhang & Peck (2014).

²³ This understanding dovetails alternative theoretical approaches on institutions, especially the French regulation school. Amable's (2003) definition of institutions as a 'compromise resulting from the social conflict originating in the heterogeneity of interests among agents' (pg.10) is particular suitable.

in their real incomes. A basic consequence of this pattern of institutional innovation is the inadequate provision of social public goods, like basic health and environmental protection. As Heilmann (2008b) encapsulates: ‘experimental programs that do not immediately benefit the interest of local elites have a very slim chance of success’ (p.20) and do not ‘reach the national policy agenda’ (p.21). This is a direct consequence of the fact that these reforms will not have the local elites as the *main and immediate* beneficiaries, and the segments of society which will be mostly interested in that do not have the means to voice their demands and shape institutional setting directly²⁴.

This collusion of local economic and political elites suggested by Heilmann (2008a, 2008b) finds a parallel in the famed county-level study by Dickson (2003). For the scholar, *local* entrepreneurs and party officials, especially in the most prosperous areas, believe they have shared interests. As Dickson (2003) states, ‘the perceived harmony of interests between the state and business associations *rises* with economic development’ (p.78, original emphasis). This view here exposed, assuming a coalition among local level elites in order to deliver successful and growth-enhancing reforms, works as suitable lenses for analysing the debate on the local state and its role on economic growth in post-Mao China. It has been often argued that local governments in China have a strong control over the local economy and bureaucrats have intimate connections with local enterprises. This particular symbiosis between bureaucrats and entrepreneurs, at the local level, has been put forward as an explanation for China’s rapid growth performance.

Oi (1992), for instance, coins the term ‘local state corporatism’, referring to a new institutional development in which local governments assumed many characteristics of a business corporation. The concept entails the idea of a symbiotic relationship between state and market at the local level, with local officials playing a pivotal role in this process. In her subsequent work (Oi, 1995), she advances and employs the notion of a ‘local developmental state’, explicitly inspired by the theory of the developmental state (see Johnson, 1982; Wade, 1992; and Woo-Cumings, 1999), originally devised to understand the growth miracle of Japan (and also South Korea and Taiwan). For Oi (1995) local party bosses were at the helm of the rural economic growth. They responded promptly to the reform package, coordinating enterprises within their territory as if they were managing a diversified business corporation. They were the ones able to weld a strong local officialdom, public enterprise, and a thriving market economy together. The fiscal reforms package powered them with incentives to behave in this manner, also because their careers and salaries became directly tied to the performance and growth of their rural enterprises²⁵. Moreover, throughout the 1980s aspects such as the approval of capital construction projects, joint-ventures (JVs), planning and material supply were also decentralized, conferring local officials greater power in assuming the day-to-day control of the local economy (Shirk, 1993).

²⁴ As Blecher and Shue (2001) exemplify, in a reputed study about the developmental role of the local state in China (which will be discussed shortly): ‘the resources mobilized... were effectively diverted from other possible infra-structure projects – projects that might have aided farmers or consumers rather than entrepreneurs’ (p.391)

²⁵ In Jean Oi’s framework, ‘local governments’ refers to counties, townships and villages.

According to Blecher and Shue (2001), in a case study on Xinji city, local officials also behaved in fashion similar to the local developmental state paradigm. They ‘picked the winners’, planned and developed industrial and commercial parks, mobilized financial resources (thanks to their control on local banks), were in charge of the bureaucratic and administrative co-ordination, and exercised control over the booming private sector through the organization of state-led business groups, regulations and licences. Local cadres, Blecher and Shue (2001) state, ‘worked to create better conditions for the development of a new bourgeoisie, with which they co-operate closely...’ (p.389).

Liu (2008) applies the idea of local developmental state to a higher hierarchical level, the province. For the scholar, Shandong province acted in a developmental fashion, for its promotion of industrial policies by targeting large enterprises to become ‘provincial champions’ (p.481), offering them priority supply of water and energy, discounted rates for land usage, preferential tax rates and low-interest loans. Also, provincial officials supervise the selected enterprises and set plans and targets for them, facilitate mergers, and support the upgrading of technological capabilities of local groups.

In her study of Tianjin municipality, Duckett (2000) realizes that local officials started to set up their own businesses, ranging from small restaurants to large department stores. This was a response to the central pressure to downsize and restructure local bureaucracies, amid a context of marketization: by establishing new businesses, local officials created new sources of income, profits would be spent primarily within the original department and to pay bonuses to officials. The author dubs this phenomenon the ‘local entrepreneurial state’, as individual departments were investing directly, in risk-taking activities, to generate income, in a less coordinated fashion than the local developmental states²⁶.

All these examples reviewed above indicate the symbiotic relationship between political and economic elites in local China, and the pivotal role the state played in the country’s development track record. To be sure, many scholars have already convincingly argued that the Chinese state and its SOEs in general have played an active and fundamental role in the Chinese miracle story (see, *inter alia*, Felipe et al, 2013; Lazonick, 2004; Lo and Li, 2011; Lo and Wu, 2014; Poon, 2009). What it is highlighted here is the intertwined nature of state and markets at the local level, with local bureaucrats performing the pivotal role of setting innovative institutional arrangements responsible for generating new sources of income for local elites.

²⁶ Perhaps the best typology of local states in China is given by Baum and Shevchenko (1999). Local entrepreneurial states are characterized by bureaucrats or state bureaus going into business independently or entering into partnerships for profits; in the local developmental state bureaucrats intervene indirectly in the economy, helping to plan, finance and co-ordinate local projects, investing in infra-structure, creating an environment conducive to growth but do not engage in business for profit. Note still that for the authors Oi’s (1992) local corporatist state is simply a variant of her local developmental state (Oi, 1995).

This resonates with Heilmann's ideas exposed previously, and certainly undermines most of the NIE assumptions over economic growth. For the NIE-inspired literature the state mostly plays negative roles, often described as 'theft'. Individual bureaucrats, in particular, are assumed to behave in a utility-maximizing fashion, normally by accepting bribes in exchange of favours (like subsidies, licenses, preferential loans etc). State and state bureaucrats enable rent-seeking behaviour to occur, generating inefficiencies and thus halting economic growth. This evaluation might arise from the fact that most NIE-inspired approaches understand economic rents as always a negative phenomenon. Following Khan (1996, 2000), one can argue that NIE assumes the only possible rents are monopoly rents, which functions as restricting market entry, thus inhibiting private business to flourish. Nonetheless, it is possible to argue that some types of rents, namely 'Schumpeterian' and 'learning' rents also exist, and play a rather positive role in economic development. These are the rents related to innovation and technological catching-up. Because the process of late industrialization and technical change necessarily involves the acquisition of 'knowledge' in general, which by definition involves externalities and increasing returns to scale, rents are a *sine qua non* condition for innovation and catching-up to proceed.

Indeed, for Heilmann (2008b: 22) the behaviour of local elites cannot be conflated with simple 'predatory' rent-seeking²⁷. While the process of local growth in China has been permeated by the creation of rents²⁸, this process encouraged the rise of new profit-seeking entrepreneurship which promoted highly productive investments. Official corruption and sky-rocketing levels of economic growth co-existed habitually. China's 'experimentation under hierarchy' allowed a local elites-sponsored experimentation process to work as a catalyst for local investments, putting local states at the fore of the debate on economic growth.

9. Concluding remarks

Competing theories aiming at making sense of China's central-local relations were presented, and it was suggested that the local state in China is characterized by an intertwining nature of state and markets, with local bureaucrats performing the pivotal role of bringing to life growth-enhancing institutional arrangements. It was advocated that theories reliant on the core tenets of the new institutional economics and fiscal federalism normally fail to properly investigate the behavioural particularities of local states in China, as well as the multiple variables relevant in their relations with the central government. That occurs because states' behaviour cannot be reduced to the simple individual behaviour of a representative cadre driven by the maximization of his utility function. Instead, one needs to grasp the historically assess the

²⁷ Clearly inspired by the NIE literature, Pei (2006) debated the issue of the rise of local power through the corruption perspective: the author labels the phenomenon 'decentralized predatory state', in which 'local strongmen choose to appropriate to themselves the power of higher public authorities and monopolized the extraction of revenues' (p.134). Under the context of political authoritarianism, local bosses amass the state's fiscal power and are free to abuse their authority within their local jurisdiction.

²⁸ Duckett (2000), for instance, highlights the exploitation of legal loopholes by bureaucrats, the privileged access to goods and knowledge they enjoyed, and the informal links their enterprises maintained with the original state bureau.

development of China's central-local relations, and to acknowledge the politicized composition of interests and goals existent across the different layers of governance in China.

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