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Intergovernmental Fiscal Reform, Financial Deepening, and Regional Disparity in China: A Missing Link*

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Abstract:

It becomes apparent that the growing disparity of economic development in China is highly associated with regional variation of productivity, and that productivity is significantly impacted by financial deepening process. After identifying and estimating the share of bank lending to the non-state sector, this paper finds a significant variation in the level of financial deepening between regions. This paper then examines why financial development process turns out to be divergent between coastal and inland regions. The analysis places the issue of enlarging regional imbalance in China in relation to the weakness of the re-centralization process of intergovernmental fiscal relations in 1994.

Key words:

financial deepening process; regional disparity; fiscal reform in China

1. Introduction

China's long-term economic growth of over 9%, though remarkable, has eventually brought about an increasing regional disparity since the mid 1990s. The regional gap of income, especially the gap between coastal and inland provinces, once was narrowed after the initial years of rural reform and rural industrialization in 1980s.

Recent studies have found that the worsening imbalance between regions in China has been typically a result of a quicker acceleration of productivity, namely, total factor productivity (TFP), in the East than in other regions since the mid 1990s (Ezaki and Sun, 1999; Guo, et al.). In doing another study, we have found evidence that productivity growth is significantly and positively impacted by financial development in China.

However, the process of financial development varies greatly across Chinese

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* This paper is based on a research on China's regional growth and financial development, and is prepared during a sabbatical visit of the first author at UNU-WIDER in Helsinki, Finland from July to October, 2005. A sabbatical fellowship from WIDER to finance the visit of the first author is acknowledged. The first version of this paper was presented both at International Conference on Transition and Economic Development held in Fudan University on September 10 - 11, 2005. Comments and criticism from participants are acknowledged.

provinces. This is due to the various extents to which bank-based financial deepening is facilitated by local governments. For instance, there is variation in the efficiency of credit allocation suffering in bank sector across provinces. And some local governments still exert their influence over the decision making of banks and direct the bank loans to investment projects initiated by governments. The degree of governmental intervention in banking sector of course varies greatly across regions in China, reflecting the stylized facts of their fiscal status, endowments, financial development, and the level of economic development. In this paper we attempt to develop a conceptual framework within which the divergent pattern of financial deepening process is impacted by the evolution of intergovernmental fiscal relationships.

This paper is organized as follows: Section 2 provides a comparative description of coastal-inland disparity measured in income and productivity. In Section 3, we examine the connection between governments' fiscal spending and financial development process. Some techniques are adopted in this part to measure the real magnitude of financial deepening process across regions. In Section 4, we present a discussion of the recentralization process of intergovernmental fiscal relationships in post-reform of China. For the purpose of this paper, we focus on the evolution and weakness of this system. The impact on the local governments' fiscal status of 1994 recentralization of fiscal revenues is typically analyzed. Section 5 ends with concluding remarks.

2. Regional Economic Imbalance and Productivity Variation

The issue of regional imbalance in China has received enormous attention. [1] Kanbur and Zhang provide a GINI and GE analysis of Chinese regional disparity over the last 50 years. As Table 1 indicates, the regional imbalance has persisted since 1987, and the gap between the coastal and inland regions has further widened since 1996. [2] This enlarged regional gap of income China reminds us of the observed decline pattern of real economic growth at national aggregate level and of reduced efficiency of aggregate investment, as measured by incremental capital output ratio (ICORs). [3]

[1] A recent bundle of research papers on this issue, for example, can be found in a special issue of *Review of Development Economics*, 9.1(2005).

[2] In the literature, the coastal region in China usually includes 12 provinces and municipalities, namely, Beijing, Tianjin, HeBei, Liaoning, Shangdong, Shanghai, Jiangsu, Zhejiang, Fujian, Guangdong, Hainan and Guangxi. The inland provinces include Shanxi, Inner Mongolia, Jilin, Heilongjiang, Anhui, Jiangxi, Henan, Hubei, Hunan, Sichuan, Guizhou, Yunnan, Xizang (Tibet), Shaanxi, Gansu, Qinghai, Ningxia and Xinjiang. In this study, we include Chongqing in Sichuan Province as Chongqing was granted the status of province-treated municipality in 1997, but we exclude Xizang (Tibet) from this research due to the lack of data. Hong Kong, Mauco and Taiwan are not covered either in this study.

[3] For a study of investment, investment efficiency and economic growth, see Zhang (2003).

Table 1 Evolution of Regional Disparity in China: 1987 – 2000

Year	GINI (%)	Change of GINI (%)	GE (%)	Change of GE (%)	Coast/Inland	Change of Coast/Inland (%)
1987	27.0		12.0		0.6	
1988	28.2	4.4	13.1	9.2	0.8	33.3
1989	29.7	5.3	14.4	9.9	1.0	25.0
1990	30.1	1.3	14.9	3.5	1.0	0.0
1991	30.3	0.7	14.9	0.0	1.2	20.0
1992	31.4	3.6	16.0	7.4	1.5	25.0
1993	32.2	2.5	16.8	5.0	1.7	13.3
1994	32.6	1.2	17.2	2.4	2.0	17.6
1995	33.0	1.2	17.7	2.9	2.3	15.0
1996	33.4	1.2	18.2	2.8	2.6	13.0
1997	33.9	1.5	18.9	3.8	2.7	3.8
1998	34.4	1.5	19.6	3.7	2.9	7.4
1999	36.3	5.5	23.4	19.4	3.2	10.3
2000	37.2	2.5	24.8	6.0	3.8	18.8

Source: Calculation based on the data provided by Kanbur and Zhang (2005).

Regional disparity is here measured and reflected in the divergent growth path of GDP and /or per capita income among Chinese provinces. Studies have found that the gap in GDP growth between coastal and inland provinces, which has widened since 1996, is largely due to the fact that the productivity growth has accelerated far more quickly in the coast than in the hinterland, though additional promotion of capital input is also partially responsible (Ezaki and Sun).

This finding is further mirrored by the stylized fact that a gradual lift of regulations over labor and capital accompanying the rapid commercialization process has substantially promoted the mobility of inputs between provinces of China. Therefore, it is justified to contribute the worsening coastal-inland imbalance in the past decade mainly to the divergent pattern of productivity growth in local economies.

In the appendix of this paper, we used a standard growth accounting methodology to produce a 1987 – 2001 average of total factor productivity (TFP) for Chinese provinces, which is depicted in the map of China in Figure 1. It shows that coastal region is more productive than the rest of China in terms of total factor productivity. This result suggests that a miserable growth of productivity in middle and western regions partly accounts for their enlarged gap with the coastal area, given the mobility of inputs.

In the existing literature, most studies either look for geographic endowments or for preference of policies that favor the coastal areas to explain the regional imbalance of China in post-reform era. Undoubtedly the advantageous location of the coast deserves the merit of this account. But geographic location is a given and fixed factor, and

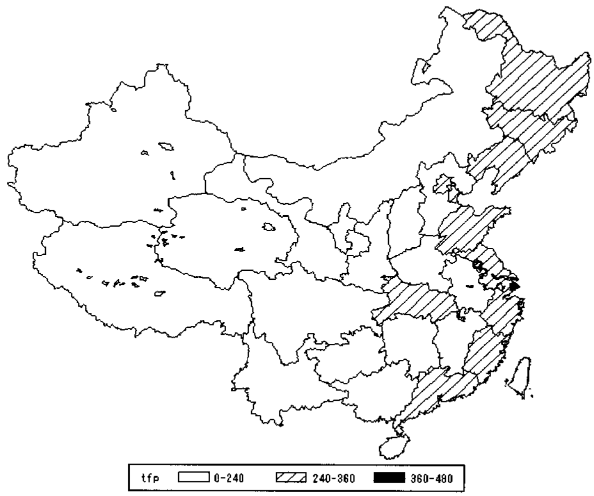

Fig. 1 Regional variation of TFP in China (averaging 1987 - 2001)

Note: Tibet and Taiwan are not included in the calculation of TFP.

though it partly contributes to the high productivity of the coast, it explains little, if not nothing, as to why the productivity difference between the coastal and the hinterland provinces has become greater continuously over the past decade. The reason behind such an observation still needs to be further explored.

For an evolving economy, quite a number of variables generate positive impact on the productivity improvement in Chinese provincial economies. Though exogenous factors such as geography, package of opening up policies made by the central government all have effects, endogenous variables play even more important roles in offsetting the disadvantageous factors such as unfavorable location and late coming of policies, and in raising productivity. These endogenous variables in a local economy that positively influence the productivity change generally include the definition and protection of local private property rights, liberalization of financial sector, improvement of investment environment which include good physical infrastructure and human capital, less intervention and more accountability of governments, and so on.

In this paper, we believe there has been greater variation in promoting such productivity-enhanced institutional change across Chinese provinces. In what follows, we will look at both fiscal role and behavior of Chinese provincial governments and the pattern of financial development in regional economies, because we believe the way that local governments perceive and participate in local economic development and how efficient the bank loan is allocated locally are of great importance to explain the divergent pattern of productivity changes across Chinese provinces. For a better view of this divergence, much attention will be paid to the comparison between coastal and inland regions.

3. Local Fiscal Status and Financial Development

It is very important to note that the initial fiscal status of local governments, especially since 1994 tax reform between the central and the local governments, largely determines the extent to which local governments distort the fiscal accountability and exert the influence over the bank loans, and thus distort the allocation of financial resources. In Section 4 we will turn to the analysis of the evolution of intergovernmental fiscal relationship in China and explain why provincial governments face different initial fiscal status. But here we only look at the pattern of local fiscal spending in both coastal and inland regions during the era of economic reform and rapid development. And then we attempt to specify and measure the financial development process at both provincial and regional level.

Figure 2 depicts the time pattern of local fiscal expenditure relative to GDP between coastal and inland regions. It is generally believed in the literature that fiscal spending-to-GDP ratio roughly measures the depth of government intervention in the local economic development, and that government fiscal spending usually exerts negative effect on economic growth. Since there is a proportion of fiscal expenditure on the development of sciences and technology, education and health, which should be positively related to the long-run growth, a deduction of this proportion is therefore made from the data of government fiscal spending for each Chinese province before measuring this ratio. [4] The rest of fiscal expenditure at local level covers primarily the fiscal grants on capital construction, on maintenance of state enterprises, on agricultural sector, and public administration.

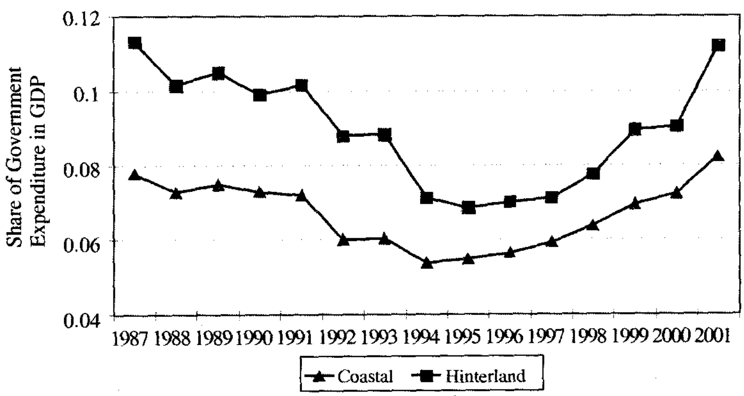

Fig. 2 Fiscal spending disparity between coastal and inland regions (1987 – 2001)

[4] However, there is a lack of data in fiscal expenditure on sciences, education, culture and health care in Sichuan Province for the period 1987 – 1993. An averaged expenditure of such items for the rest of time period is estimated here to make up this gap.

As shown in Figure 2, the fiscal burden of local governments in inland region has been much heavier than that of those in coastal provinces. It is also interesting to notice that 1994 intergovernmental fiscal reform has actually reversed the decline in the ratio of local government fiscal spending relative to GDP in 1980s. Given the fact that inland governments have had much worse fiscal status than coastal governments since 1994 intergovernmental fiscal reform, such a higher ratio of fiscal spending to local GDP in inland provinces would tell us a story of how they get financed.

The reversed pattern of this ratio came after the mid 1990s and deserves our attention. It reflects a growing consensus that is reached by the Party and the government on the necessity of rapid economic growth and an introduction of democratic selection and turnover system of Chinese local officials that guarantees the top priority of local economic development. Under this regime, local governments substantially increased the share of local spending relative to local GDP in order to create an induction for more investments from outside. As there is no unified financial system, the local governments would be interested in carrying out protectionist policies for the economic growth of their localities, as many studies have found (Young, 2000; Poncet, 2002). In hinterland provinces, such a distortion has been much more serious than coastal ones. We worry about this reversed pattern because the rising fiscal spending-to-GDP ratio in inland region is most likely to be associated with a shift of roles of governments from giving supports to grabbing local interest.

Once again it is important to keep in mind that the above-discussed pattern of fiscal spending among provincial governments would suggest a subtle interchange with the local process of financial development, because the provincial governments face different ad hoc status of fiscal revenues, which is almost separated from the expenditure assignments after the 1994 intergovernmental fiscal reform (Wong). For inland provinces where the initial fiscal status is worse, the increasing fiscal expenditure burden is most likely to result in an appeal to the local bank sector or a rising distortion of allocation of financial resources.

In the literature of development economics it is widely believed the development of financial deepening process, as a result of the removal of direct intervention of government in credit allocation in bank sector, should exhibit both positive and significant correlation with productivity and economic growth. An empirical study of China by Aziz and Duenwald, however, finds that, though positive, the financial intermediation-growth nexus is more apparent than real in China. Their explanation is that the non-state sector, which contributed most to China's remarkable growth, does not use the domestic financial system in any substantial way for getting financed. This, we guess, should be true more of inland provinces where there has been much greater proportion of inefficient state industrial sector.

Economists usually use the credit/GDP ratio as a proxy for the development of financial deepening in cross-country analysis. This practice, however, should be followed with care when studying a country in transition, because even when financial liberation is going on, there is still a relatively larger share of credit that is directed through influence by governments to many dying state owned enterprises to keep them afloat. For instance, as an exercise, if we use the ratio of total bank lending to GDP as a proxy for the degree of financial deepening, then the finance-growth nexus is not significantly positive, and even is negative. Figure 3 (A and B) presents the results of this correlation between total bank lending-to-GDP ratio and the growth of GDP, based on the provincial data covering 29 Chinese provinces for the period 1987 - 2001.

In figure 3 (A), we calculate the bank lending-to-GDP ratio for each province and we use the mean of these ratios to divide the 29 provinces into the groups whose bank lending-to-GDP-ratio are above or below the average level. Then we depict the average growth rate of GDP of these two groups of provinces for the period 1987 - 2001. It turns out that, as Figure 3A shows, the provinces with the bank lending-to-GDP ratios above the average level generally have lower growth rate of GDP than those with the bank lending-to-GDP ratios below the average level. As a contrast, in Figure 3 (B), we average the growth rates of 29 provinces and use the result to group these provinces into two categories, one with growth rates above the average level, and the other with growth rates below the average level. Then we find that the provinces with growth rates above the average level generally have lower bank lending-to-GDP ratio, and vice versa.

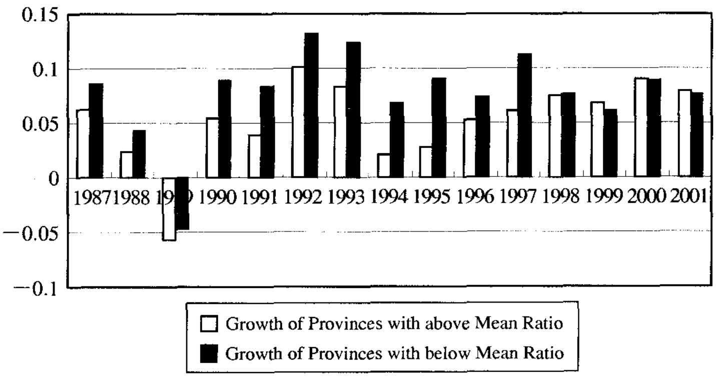

Fig. 3(A) Growth Rates Grouped by Loan/GDP Ratio above and below the Average Level (Growth Rate Is Scaled on Vertical Axis)

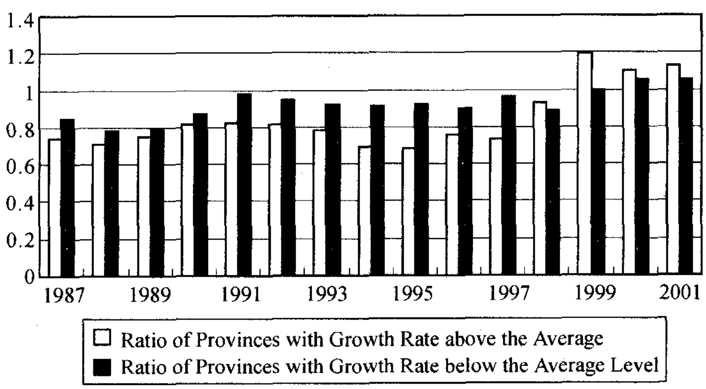

Fig. 3(B) Loan/GDP Ratios Grouped by Mean Growth Rates above or below the Average Level (Loan/GDP Ratio is Scaled on Vertial Axis)

This exercise reminds us that the simple use of total bank lending-to-GDP ratio at provincial level is not sufficient to reflect the nature and magnitude of financial deepening process in Chinese provinces. The reason is that, similar to most developing economies, Chinese financial system is bank-based and government-owned. Even after the partial liberation and complementation of financial reforms, the four big commercial banks and their regional branches are not only wholly owned by government but also frequently subject to government influences. Under this financial system, bank financing is still a common channel for the majority of inefficient state enterprises to get investment, though financial reforms alleviate the difficulty of non-state enterprises accessing to bank loans.

Given the unavailability of data, it is extremely difficult to distinguish the loans to efficient and to inefficient state-owned enterprises at aggregate level. In this regard, a much better proxy of financial deepening may be calculated not by using the overall credit, but using the part of credit that only goes to non-state-owned enterprises.

Even so, it is almost impossible to get any consistent provincial data from officially released statistics as to how much has been lent to state-owned enterprises, and the only available dataset is the time series of overall bank credit for each province. Therefore we have to carry out a regression calculation in order to construct the relative share of bank lending between state owned enterprises and non-state owned enterprises. Following Aziz and Duenwald, we estimate a fixed effect panel regression of total bank loan-to-GDP ratio on the industrial share of state owned enterprises during 1987 - 2001, also with the error terms following a first order autoregressive (AR1) process to correct for serial correlation. Table 2 reports the estimation results.

Table 2 Panel Regression for the SOE Share in Bank Loans (1978 - 2001, AR1/FE)

	coefficient	t-value
SOE output/total output	0.507	8.45
rho-ar	0.806	
R-sq	0.172	
observations	406	

With the regression results, the bank lending to non-state owned enterprises is obtained simply by deducting from overall bank lending the share explained by the coefficient of industrial share of state owned enterprises in the estimation function. Having an estimated share of non-state owned enterprises in the total bank lending for each province, we can then calculate and observe the changing pattern of financial deepening process in both coastal and inland regions during 1987 - 2001.

Figure 4 shows that coastal provinces have much higher level of financial deepening, and the regional disparity of financial deepening has been worsening in the past decade, and especially since the year of 1997. This disparity pattern of financial development is nicely consistent with the observation of growing economic imbalance between coastal and inland provinces.

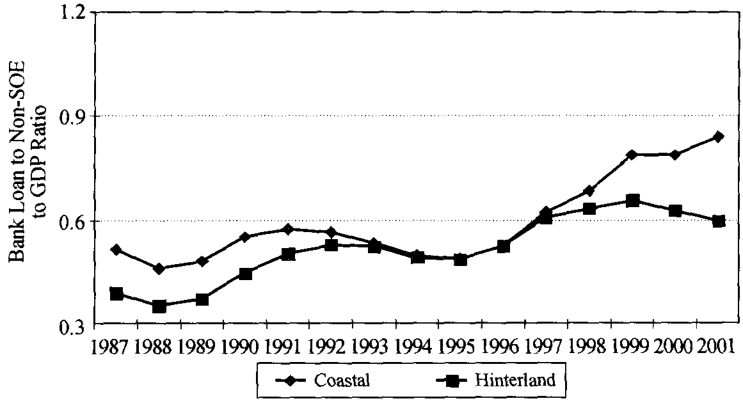

Fig. 4 The regional variation of financial deepening (1987 - 2001)

4. The Evolution of Intergovernmental Fiscal Relationship

In this section we attempt to provide an institutional background within which the financial deepening process is endogenously determined by the interaction between the generated fiscal status of local governments and the distortion of allocation of bank loans as a result of the fiscal relationship between the central and local governments.

China's intergovernmental fiscal relationship (IFR) between the central and local governments has increasingly become an issue of interest in the literature. [5] It is therefore not difficult to go through the literature and review the main issues and especially the weakness of this IFR. For the purpose of this paper, however, we will focus on the changed fiscal constraints faced by local governments as a result of decentralization in 1980s and re-centralization of fiscal revenues after mid 1990s, how the change of IFR implicitly alters the behavior of local governments, and how local governments respond.

China's intergovernmental fiscal relationship (IFR) between the central and local governments has evolved into two distinct stages over the past two decades: decentralization in 1980s and recentralization since the mid 1990s. The intergovernmental fiscal relationship was initially revised by an introduction of fiscal decentralization process in the early of 1980s, followed by the so called "tax for profit" reforms in 1983 and the following reform of industrial taxation systems. These reform programs were designed to promote the local economic development by creating financial incentive and delegating the decision making power of the local

[5] For example, Bahl (1999) develops a comprehensive analysis of intergovernmental fiscal relationships in China; Wong (2000) presents an assessment of China's central-local relations; Dabla-Norris (2005) also discusses these issues as well as the weakness of 1994 intergovernmental fiscal reform in China.

governments.

For example, the tax sharing system, or so called "eating from separate kitchens", which was introduced in 1988, was expected to increase the fiscal revenues to local governments, while guaranteeing the stability of revenue growth in the central government. Under agreed arrangement, after submitting to the central government a fixed amount of revenue and increasing this submission at an agreed rate each year, the local governments keep all the residuals, and finance their local expenditure out of this residual. It was said to be the first breakage between the revenue sharing and expenditure assignments at the tier of local governments (Wong).

The other things, however, were not going well, because soon after such a fiscal reform, there was a sudden outbreak of hyperinflation and an occurrence of massive financial deterioration of large and medium-sized state owned enterprises (SOEs), which definitely put the central government not in a position to guarantee its own revenue growth, and to manipulate the equality-oriented programs financially to narrow the regional income gap. In fact, this decentralized nature of fiscal system had led to a continuous declining central-to-overall fiscal revenues ratio and declining central budget-to-GDP ratio. By the year of 1993, these two ratios had dropped from 40% and 25% in 1980s down to 20% and 3%, respectively. Rich provinces such as Guangdong and Shanghai had declining share of fiscal submission to the central fiscal revenues, which resulted in a reduction of central subsidies to poor provinces. [6] In this regard, the ability of central government to acquire fiscal revenues and to make regional redistribution of fiscal revenues had been increasingly contained.

It was clear that the purpose of the tax reform of 1994 was to restore and guarantee the higher percentage of central fiscal revenue in the total and to build up an intergovernmental fiscal relationship that can achieve the regional equalization. For such an end, the reforms in 1994 attempted to arrest the fiscal decline and raise the above-mentioned two revenue ratios, simplify the tax system, eliminate distortions, modify revenue assignments to different level of governments, and change the bargaining-based transfer into rule-based transfer (Dabla-Norris). The measures introduced in 1994 and after include: (1) adjustments of rates for local collections and tax bases; (2) a change of share percentage between the central and local governments; (3) a reassignment of taxes between central and local governments to have separate "central fixed income," "local fixed income" and shared revenue from the VAT (value added tax); and (4) establishment of general purpose equalization transfers.

The first three reform programs indeed quickly reversed the declining share of total revenue transferred to the central government, and eventually raised this share slightly above 50%. In this sense, this round of recentralizing the local fiscal revenues made a success. It must be noted, however, that the last objective of 1994 tax reform mentioned above has not reached the result of expectation. The central government tried hard to increase the equalization transfers to local governments, but had to

[6] Wang and Hu (1999) provide an in-depth discussion of this issue in their book, *The Political Economy of Uneven Development: The Case of China.*

eventually make compromise to most rich local governments in exchange for their support for the package of tax reforms. As a result, the transfer system had to be finally and largely based on *revenue returned*, which provided each province with 30% of the increase in VAT receipts over the 1993 base, and *fixed subsidies*, which ensured that each province has total revenues no lower than subsidies in 1993, prior to the tax reform. The general purpose transfer including equalization transfer, though was put in place, did not make much sense.

As pointed out by many other authors, since the major source of revenues returned and shared taxes is VAT, and since VAT is paid primarily by manufacturing and service industries, it is not difficult to understand such a central transfer system, which is based on revenue returned, has been a system that helps differentiate the fiscal ability of local governments and that favors the rich and coastal provinces. Furthermore, the introduction of tax sharing scheme and the fiscal reform only touches upon the revenue collection aspect of intergovernmental fiscal relationship. It fails to clarify and assign the expenditure responsibilities between the central and local governments. And the expenditure assignments remain unchanged in the sense that local governments act as the spending agents of central government. In fact, 1994 tax reform brought in a breakage at local level of governments between revenue and expenditure, and this breakage has substantially increased the spending burden on poor and hinterland provinces (Wong).

In sum, 1994 tax reform increased the local expenditure as percentage of overall budget spending. In 2002, as local governments accounted for about 45% of total fiscal budget in China, they were responsible for about 70% of total budget spending. Given the provincial revenue difference, the 1994 tax reform has gradually enlarged the expenditure differentiation among the provinces. In Table 3, it can be seen that the economic and fiscal variations between the rich and poor provinces have been enlarged after 1994 tax reform.

Table 3 Comparative Fiscal Status in Rich and Poor Provinces

Percentage share	1990	1998
5 Richest Provinces		
GDP	22.80	25.10
Population	12.70	12.20
Tax revenue	26.00	23.00
Governments sending	19.80	18.50
5 Poorest Provinces		
GDP	12.70	11.70
Population	18.90	18.70
Tax revenue	12.30	9.80
Governments spending	14.00	8.60

Note: 5 Richest Provinces: Shanghai, Beijing, Tianjin, Guangdong and Zhejiang;
5 Poorest Provinces: Guizhou, Gansu, Shannxi, Jiangxi and Henan.
Source: Wong (2005).

Given the evolution of intergovernmental fiscal relationship between the central and local governments, it is much easier to understand how such an evolution of IFR has changed the fiscal constraints facing local governments, and why the initial fiscal status of provincial governments remains, and how this divergent financial status of local governments affects the extent to which local governments distort the allocation of bank loans to sustain their economic development.

In the literature on transitional economies, economists who argue that fiscal decentralization promotes the marketization and enhances productivity interpret the competitive bid among local governments for more investments and for reallocation of outsourcing activities of FDIs as a Nash Equilibrium result of fiscal decentralization (Qian and Weingast; Cao, Qian and Weingast). They believe the shift of authority from the central to local governments evolves into an equivalent result of fiscal federalism which contains the problem of soft budget constraints (Qian and Roland). This line of interpretation helps explain the positive nexus between the fiscal decentralization and economic growth, but does not explain the increasing regional variation between the coastal and inland provinces given the nature of the intergovernmental fiscal relationship of such. [7]

As we have discussed above, since the evolution of intergovernmental fiscal relationship in the post reform China has led to de facto recognition of differentiated fiscal situations facing local governments, then such a differentiated fiscal status must further affect its interrelationship with local financial development. The common observation is that the governments in unfavorable fiscal status, mostly in inland provinces, would seek alternative ways to make up the local expenditure gap when facing both declining fiscal revenues collection and increasing spending assignments The commonly observed practices include: (1) an expansion of extra- and off-budgetary revenues; (2) indirect borrowing from local state owned banks by setting up affiliated entities of commercial companies; (3) an exertion of official influence on the credit allocation of local banking sector and encouragement of subsidizing local SOEs through bank lending.

Generally, the local extra-and off-budgetary revenues are mostly used to finance the provision of local public goods, and the governments' intervention in bank lending and the borrowing from the banks are related to the distortional behavior of local governments in the promotion of economic development and subsidizing the local SOEs. As we pointed out earlier in this paper, it is very important to remember that, since the middle of 1990s, a performance based selection system of local officials has been introduced with the vertical appointing and monitoring political authority to guarantee the economic development and social stability (Zhou, Li and Chen 83 - 96). Under both political and fiscal constraints, local governments work very hard to have a better provision of local public goods and to improve infrastructure in order to foster the rapid economic growth, while continuing to subsidize the inefficient SOEs

[7] A recent study of fiscal decentralization and economic growth in China finds that there is both a regional and time variation in the relation between fiscal decentralization and economic growth in China (Zhang and Gong, 2005). The authors evidence that the relation between the two was negative before 1994, but positive after 1994 tax sharing reform.