Local Economic Protectionism in China's Economic Reform

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A hallmark of China's economic reforms since 1979 has been the decentralisation of the use of resources to lower levels of the administrative hierarchy. The central leaders have expected the subnational units, by making greater use of the market, to use the decentralised resources in economically productive areas. Provincial and local authorities are, however, very pragmatic. They miss no opportunity to maximise their control of resources, in order to minimise conflict in their units or localities. In a country with as unfavourable a resource-population ratio as China, local protectionism is not inconceivable, though it is neither inevitable nor desirable.

Although it is widely accepted that China's reforms have achieved notable success in moving towards a market economy, as evidenced in the remarkable reduction in the share of goods allocated through the plan and in the deregulation of price controls (World Bank, 1994: xiii–xiv), progress in the greater integration of the domestic market is less pronounced. Local protectionism or the 'feudal economy' principally takes the form of using a restrictive economic blockade by China's provincial and local governments to prevent the outflow of scarce local raw materials and the sale of non-locally produced goods within their areas. This article addresses the issue of why local economic protectionism has arisen and been sustained in the course of the economic reforms.

In the first section of the article, incidents of economic localism in the provinces are presented. The causes of the rise of local economic protectionism will be suggested in section two. It is argued that local protectionism occurs because of the fiscal squeeze experienced by subnational governments in the economic reform period and the use of 'import'-substitution industrialisation to promote 'infant' industries in inland China. Section three examines the effectiveness of the tax-assignment reform, implemented nationwide in 1994, in containing the economic problem.

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The rise of local economic protectionism

A qualitative approach is used here to assess the severity of local economic protectionism in the Chinese national economy. Such an approach refers to a review of the central government's responses to local trade practices as witnessed in the national newspapers and to the cases reported in regional publications.[1]

The problem of a 'feudal economy' has caused concern among leaders at the central and lower levels in the course of the economic reform. In the mid-1980s local protectionism in the form of 'trade wars' occurred frequently along the borders between the various administrative regions. 'Wool wars' broke out in the wool-producing areas in northwestern China — Gansu, Inner Mongolia, Ningxia, Qinghai and Xinjiang — in 1985. In 1986 a policy of 'own production, own use and own sales' was introduced in the wool-producing areas, which substantially increased the demand for raw wool. In order to meet the demand for wool from the local woollen manufacturers, the local authorities decided to restrict the outflow of wool to other localities. This involved the setting of local production quotas, with fines or budget cuts for those who failed to meet their targets. Alternatively, steel, cement and timber might not be supplied, or cadres' wages might be withheld and cadres themselves summoned for investigation (Watson et al., 1989; Ai, 1988).

The price of wool was bid up by the scramble for the raw material. Purchase prices for wool set by the Ministry of Commerce, the State Commodity Price Bureau, the Ministry of Textile Industry and the governments of the producing areas had been raised by over 50% in 1985 and by 25–44% in mid-1986.[2] By the end of July 1986, however, the price of fine wool, regardless of grades, had risen by 70% to 10.6 yuan per kilogram, 19% higher than the upper limit stipulated by the provincial government. The price of native wool had risen by 111.5% to 8.82 yuan per kilogram.[3] In 1987 the wool price in Xinjiang

1. Kumar (1994) and World Bank (1994: 210) provide quantitative studies of China's internal trade system. They conclude that there tended to be a relative decline of interprovincial trade, compared with the growth of domestic production, over the period 1985–92. The share of interprovincial trade in total retail sales fell from 63% in 1985 to 47.8% in 1990, recovered to 52.3% in 1991, but declined to 50.3% in the following year. Their findings suggest that contrary to China's commitment to the creation of a market economy, the economic reforms have failed to create a better spatially integrated economy based on regional specialisation. The World Bank research team was headed by Anjali Kumar.

2. *Liaowang* (Outlook), Beijing edition, 24 February 1986: 32; *Zhongguo shangye bao* (China Commercial News), 3 July 1986.

3. *Jingji ribao* (Economic Daily), 15 November 1986.

province was reported to rise further to 24 yuan a kilogram.[4] In the light of the drastic price hike, wool producers in Xinjiang were not allowed to deliver wool out of the region until the tea and native products companies and the industrial and commercial administrative bureaux, both at county level, had certified that they had fulfilled the procurement obligations in the first place, followed by an endorsement by the autonomous region's tea and native products, textile materials and leather companies and after paying a 20% pasture construction fee (Beijing Agricultural University Research Group, 1988: 296). In the autumn of 1988 Xinjiang even prohibited the 'export' of wool out of the autonomous region.[5]

Furthermore, in 1990 the Xinjiang authorities restricted the inflow of a total of 48 types of commodities to the region, including bicycles, tyres, colour television sets, soaps, detergents, light bulbs and electric batteries. Despite objections from the local commercial department, the Xinjiang government reportedly asked it to purchase and market all the 150,000 locally made bicycles by offering it a favourable interest rate of 0.75% on credit loans.[6]

Heilongjiang in the northeast region put forward a list of manufactured products the entry of which to the province was restricted in the spring of 1990. These included television sets, refrigerators, radio-cassette tape recorders, and bicycles, which were the commodities whose local supply exceeded demand.[7]

Hebei provincial government also stipulated that small tractors and small diesel engines had to be sold by the provincial Farm Machines Company, and that the marketing of convenience goods such as matches, soap and detergents was to be put under the monopoly of the relevant commercial departments. These measures virtually prohibited unauthorised 'imports' of manufactured goods which were locally stockpiled.[8]

It was reported in 1988 that the governments in many silk-producing areas deployed armed forces and militia on their borders to prevent silkworm cocoons from being sold to other areas offering higher prices. The provincial government of Sichuan, one of the country's major silk-producing provinces, banned the 'export' of silk, but some departments in Guangdong circumvented the ban by

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4. China News Service, 11 August 1989, in Foreign Broadcast Information Service, *Daily Report: China* (hereafter *FBIS-CHI*), 18 August 1989: 31.

5. Ibid.

6. *Zhongguo shangye bao*, 3 July 1990. *Xin bao caijing xinwen* (Hong Kong Economic Journal), 9 July 1990.

7. *Jingji daobao* (Economic Reporter, Hong Kong), 5 March 1990: 8–9 in *FBIS-CHI*, 16 March 1990: 24.

8. Ibid.

offering high kickbacks to Sichuan suppliers and even used army trucks to haul the silk to Guangdong.[9]

The coastal regions were often the victims of the protectionist measures. Guangdong province was hard hit amid the tide of local protectionism. A 'rice war' broke out between the southern province and neighbouring Hunan in 1988. The former was short of foodgrains because of the decline in acreage under foodgrain cultivation and wanted to purchase rice from Hunan but found the official asking price too high. The Guangdong government therefore set up purchasing agencies bordering Hunan offering higher prices than the Hunan authorities directly to the Hunan rice-producers and arranging its own transportation. In May 1988 Guangdong raised the rice procurement price from 19.16 to 25 yuan per dan (Zhou, 1997: 141). The Hunan farmers found such prices irresistible and sold their rice to Guangdong.[10] Faced with the fiscal pressure to increase grain price subsidies, the Hunan provincial government responded by deploying troops along the common border to forbid the outflow of rice (Chao, 1991; Goodman, 1992). Guangdong was forced to spend a large amount of foreign exchange to import rice from Thailand.[11]

The industrial city of Shenyang in the northeast reportedly suffered a lot from local protectionism. The *Jingji cankao* (Economic Reference) reported that in the first quarter of 1990 Shenyang was due to 'import' 2,050 tons of cotton from Shandong; however, in fact, it was able to buy only 310 tons. Shandong officials argued that the cotton Shenyang wanted was listed in Shandong as an item 'outside the plan'. In the mid-1980s Shenyang had invested in northeast and north China to build aluminium and coal production bases. But when production came on stream in the late 1980s, officials in these host areas refused to honour the contracts. They were quoted as saying that they would rather go through a lawsuit or pay a fine than ship the goods according to the contracts.[12]

As the problem began to cause alarm among political as well as academic circles in China in 1990, the State Council embarked on measures to combat it. The relevant departments, including the Ministry of Commerce, were instructed to put forward suggestions to break down the trade barriers.[13]

9. *Liaowang*, overseas edition, 26 September 1988: 3.

10. One dan equals 50 kilograms. Prices of grain were often many times more in Guangdong than in neighbouring Hunan and Guangxi. See *Far Eastern Economic Review* (hereafter *FEER*), 8 December 1988: 61.

11. China News Service on 11 August 1989 in *FBIS-CHI*, 18 August 1989: 31.

12. *Jingji cankao*, 27 April 1990 in *FBIS-CHI*, 16 May 1990: 32.

13. *Ta Kung Pao* (Hong Kong), 22 June 1990 in *FBIS-CHI*, 28 June 1990: 37–38 and *Hong Kong Standard*, 10 July 1990.

It was apparent that Xinjiang's protectionist measures had caused the Ministry of Commerce in Beijing to raise an eyebrow. The Ministry openly criticised them in its mouthpiece, *Zhongguo shangye bao* (China Commercial News).[14] The Xinjiang commercial department complained that the erection of trade barriers had added to the sales slump and further depressed the stagnant local economy. The department had incurred huge losses in being forced to close its doors to outside products. Local commercial stores had been obliged to offer about 1 million yuan in compensation to outside producers for cancelling marketing contracts. The sales of the local wholesale companies promoting bicycles and metals fell by 5 million yuan and 46% respectively. The commercial department also argued that restrictions on the 'import' of commodity goods had contributed to the flourishing of 'grey' markets in the region; 60–70 colour TVs a day were said to have been transported by air to Urumqi.[15]

Local protectionism has not subsided in the 1990s and the judiciary has now tended to assume the role of principal actor. Some judges reportedly come to the aid of local enterprises in their lawsuits with enterprises in other regions. After a wholesale department in the northeastern region went into a debt crisis, its Beijing, Tianjin and Shanghai creditors were alleged to have lodged a lawsuit against it in its home town. As the suit got under way, the store transferred 95% of its assets to another company before applying for bankruptcy. The judge in charge of the case was said to be partial to and sided with the department store.[16] Evidence of localism on the part of local legal officers can also be observed from a report in a national newspaper, *Renmin fayuan bao* (People's Court Daily), which praised the attempts by a middle-level court in Zhuhai, Guangdong to resist local protectionism. According to the report, the court handled a total of 218 civil and economic cases in 1994. Although only 53% of the plaintiffs came from outside Zhuhai, 91% of the parties that won the cases were outsiders. The judges at the court received high praise from the newspaper for protecting the legitimate interests of all parties involved.[17] It was reported that the central government would be launching a crackdown on protectionism committed by regional legal officers in the second quarter of 1997.[18]

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14. See *Zhongguo shangye bao*, 3 July 1990 and *Hong Kong Standard*, 10 July 1990. Note that it is unusual for the Chinese press to criticise subnational governments openly by name.

15. Ibid.

16. *Liaowang*, 22 April 1996: 38–39; 1 July 1996: 31–32.

17. *Renmin fayuan bao*, 24 March 1995.

18. *South China Morning Post* (Hong Kong), 17 February 1997.

Causes of protectionism

In this section the reasons why the local political authorities have developed a liking for local protectionism will be considered. Since local economic protectionism was said to be most serious in the western region, particularly in Xinjiang, the focus will be on the governments of Xinjiang and other provinces of the interior which opted for promoting trade barriers.

Chinese officials and academics in Beijing have been inclined to attribute the decentralisation of the use of financial and physical resources to lower-level authorities and the sluggish market resulting from the economic retrenchment policy effective in the autumn of 1988 to the emergence of the 'feudal economy'.[19] However, this article is sceptical about these claims. It argues that these two factors have only provided incentives for the subnational governments to practise economic localism. The emergence of local economic protectionism is nevertheless not inevitable. Given the fact that local protectionism has been less severe in the better-off coastal provinces which have been given more leeway than inland provinces in running their economies, there is no logical reason to hold that local protectionism is necessarily the result of decentralised economic decision-making and business depression. To understand the frequent outbreaks of economic localism, deeper structural reasons have to be considered.

Table 1
Provincial distribution of per capita GDP, 1980, 1985, 1990, 1995 (% of national average)

Province/Region	*1980*	*1985*	*1990*	*1995*
East (Mean)	127.5	127.9	130.0	140.6
Beijing	354.2	331.8	306.6	234.6
Tianjin	311.7	269.8	232.8	205.5
Hebei	95.7	88.4	89.8	93.1
Liaoning	172.2	164.2	161.1	143.6

19. Yuan Mu, the then director of the State Council's Research Office and concurrently the spokesperson of the State Council, attributed the market slump, which appeared in the second half of 1989, to local protectionism in the domestic economy. See *Ta Kung Pao* (Hong Kong), 22 June 1990 in *FBIS-CHI*, 28 June 1990: 37–38 and Wang Jinjia, 'On local autonomy and the "feudal economy",' *Jingji ribao*, 11 November 1989 in *FBIS-CHI*, 30 November 1989: 36–8 and the interview Zhang Zuoyuan, director of the Institute of Finance and Commerce, Chinese Academy of Social Sciences, gave to *Xin bao caijin xinwen* (Hong Kong) on 22 October 1992. Shen and Dai (1990) blame the fiscal decentralisation measures, the lack of separation of government administration and enterprise management, the distorted price system and unequal competition between the regions for creating dysfunctional incentives that encouraged the occurrence of the 'feudal economy.'

Shanghai	613.6	474.2	368.6	366.2
Jiangsu	122.2	129.6	128.7	153.5
Zhejiang	105.2	126.4	132.9	171.7
Fujian	77.0	86.9	100.1	109.5
Shandong	91.0	101.4	103.9	120.9
Guangdong	106.0	120.9	153.5	164.9
Guangxi	62.0	57.8	61.0	74.4
Hainan	70.3	89.5	94.8	105.8
Central (Mean)	87.1	86.8	83.6	77.7
Shanxi	98.1	99.5	91.3	74.7
Inner Mongolia	78.3	88.5	87.7	76.7
Jilin	100.6	107.8	105.0	91.7
Heilongjiang	153.6	124.3	123.0	114.5
Anhui	63.7	75.3	70.7	70.1
Jiangxi	76.7	74.0	72.9	62.4
Henan	70.9	72.1	68.5	69.4
Hubei	96.0	99.3	96.3	87.2
Hunan	81.9	76.9	75.9	72.3
West (Mean)	70.8	70.5	71.3	62.0
Sichuan	70.9	70.9	70.1	65.7
Guizhou	48.9	51.6	51.6	37.8
Yunnan	59.9	59.7	70.2	63.6
Tibet	n.a.	110.1	72.9	49.1
Shaanxi	75.9	74.7	74.7	59.9
Gansu	86.9	74.7	68.7	47.8
Qinghai	106.4	100.3	98.0	72.3
Ningxia	91.0	86.0	86.0	69.6
Xinjiang	92.5	100.5	109.0	105.7

Note: n.a. = not available.

Sources: 1980 and 1985: *Guangxi tongji nianjian* (Statistical Yearbook of Guangxi), 1995: 21, 27 (for Guangxi); Hseuh et al. 1993: 365 and *Hainan tongji nianjian* (Statistical Yearbook of Hainan), 1995: 17, 31 (for Hainan); *Jilin tongji nianjian* (Statistical Yearbook of Jilin), 1995: 56, 74 (for Jilin); *Quanguo gesheng zhizhiqu zhixiashi lishi tongji ziliao huibian* (1949–89) (A Compilation of Historical Statistical Materials on Provinces, Autonomous Regions and Centrally-administered Municipalities, 1949–89), various pages (for others). 1990: *Zhongguo tongji nianjian* (Statistical Yearbook of China), 1991: 81; 1994: 35. 1995: Ibid., 1996: 43, 70.

This article argues that two structural reasons are particularly relevant to the explanation of the outbreak of local protectionism. The first is the fiscal decline caused by the national trend of the decreasing role of budgetary revenues in the national economy and by the central-provincial fiscal contracting systems (up to 1993), which were characterised by a decentralisation of expenditure responsibilities and by a regional bias. Whereas the first factor has affected the central and all local governments, the second hit the less developed provinces in inland China hardest.[20] The second structural reason is the use of 'import'-substitution industrialisation to promote 'infant' light processing industries in order to stop the regional leakage of value from the west to the east.

Shortage of fiscal resources

Up to 1993 the fiscal system gave rise to a mismatch between revenue assignments and expenditure responsibilities in the provinces. Less developed provinces were particularly hard hit by the adverse effects of the fiscal system. In order to expand the tax base to boost revenue, local governments encouraged the development of industries, particularly those yielding huge tax revenue. How did the mismatch evolve?

On the expenditure side, the central government began to decentralise expenditure responsibilities steadily in the early stage of the economic reforms. The central share of aggregate government expenditures dropped from an average of 51% in the period 1978–80 to slightly more than 30% in 1991–3 (see Table 2; Ma, 1995). The downward shift of expenditure responsibilities has been because of (i) the new stress on functions traditionally administered at

Table 2
Central share of collected revenue and expenditure 1978–95 (%)

Period	*Revenue*	*Expenditure*
1978–80	20.11	51.04
1981–85	34.89	49.79
1986–90	33.42	34.36
1991–93	26.18	30.36
1991–95	53.78	30.37

Note: The definitions of revenue and expenditure are not standard. Subsidies for covering enterprise losses are treated as negative revenues rather than expenditures.

Source: *Zhongguo tongji nianjian* (Statistical Yearbook of China), 1996: 23.

20. Although this article does not deal with regional inequalities directly, data on interprovincial disparities are shown in Table 1. From the table, it can be seen that a group of 'newly industrialising' provinces along the seaboard, notably Jiangsu, Zhejiang, Fujian and Guangdong, developed very fast between 1980 and 1995 while many provinces in central and western regions have experienced stagnant economic growth over the same period. For more discussion about China's regional development policy in the 1980s and 1990s and its impacts, see Lee (1997b), Yang (1990) and World Bank (1997).

subnational levels, such as social expenditures on culture, education, science and health (CESH), government administration, price subsidies, and subsidies for loss-making state-owned enterprises; (ii) wage rises and increases in administrative outlays, which have been principally shouldered by provincial and local governments; and (iii) sharp rises in locally managed, but centrally set, price subsidies (World Bank, 1993a: xi).

As regards Xinjiang, outlays on social expenditures have become the major items of the subnational government's budgetary expenditures, and have skyrocketed in the course of the economic reforms, rising by more than 10 percentage points during 1986–94. Among the items, CESH and administrative expenditures increased most rapidly, from 23% to more than 32% of total budgetary expenditures in the case of CESH and by 91% for government expenditure (see Table 3).[21] One of the causes of the drastic rise in administrative costs was the fact that the central government handed down plans to increase personnel in the supervision, auditing, industrial-commercial administration and taxation departments by nearly 20,000 without providing any extra funds (Huang, 1990: 410).

Table 3
Xinjiang's social expenditures (million yuan)

Year	CESH	Government administration	Price subsidies	SOE subsidies	Total budgetary expenditures
1986	749.11	399.28	326.29	289.12	3252.01
	(23.04)	(12.28)	(10.03)	(8.89)	
1988	982.24	558.34	570.48	334.37	4225.35
	(23.25)	(13.21)	(13.50)	(7.91)	
1991	1360.17	904.17	681.35	367.22	5620.71
	(24.20)	(12.09)	(12.12)	(6.53)	
1994	2396.03	1722.05	400.62	236.65	7346.27
	(32.62)	(23.44)	(5.45)	(3.22)	

Note: SOE = state-owned enterprise. Figures in parenthesis are the percentage of the total budgetary expenditures.

Sources: *Xinjiang caizheng nianjian* (Fiscal Yearbook of Xinjiang), 1986: 311–13; 1987–88: 521–26; 1991: 438–443; *Zhongguo caizheng nianjian* (Fiscal Yearbook of China), 1995: 394.

21. CESH expenditures of the country as a whole also increased because of expanded college enrolment, vocational training, and the introduction of nine-year compulsory education (World Bank, 1990: 12).

While subnational governments accounted for an increasing share of all government expenditures, they encountered a revenue shortage, caused first by the fall in the state industry contributions to the state budget. As a result of the flourishing of non-state enterprises like rural enterprises in the profitable light industries, the profitability and contributions of state-owned enterprises to the budget diminished, eroding the tax base of all levels of government, central and subnational (Naughton, 1992; Wong, 1991). This resulted in a drastic decline in the share of budgetary revenue in GNP, which fell from 34.4% in 1978 to 14.1% in 1993 (see Table 4; Chai, 1996). But it is noteworthy that the share in Xinjiang was lower than that in the booming coastal province of Guangdong during the reform era (see Table 5).

Table 4
Total government revenues as a % of GNP, 1978–95

Year	*Total government revenues (a) (bn yuan)*	*GNP in current prices (b) (bn yuan)*	*(a)/(b) (%)*
1978	123.3	358.8	34.4
1979	126.3	399.8	31.6
1980	131.6	447.0	29.4
1981	138.6	477.3	29.0
1982	141.2	519.3	27.2
1983	159.4	580.9	27.4
1984	183.5	696.2	26.4
1985	228.3	855.6	26.7
1986	244.6	969.2	25.2
1987	256.9	1130.1	22.7
1988	280.3	1406.8	19.9
1989	326.4	1599.3	20.4
1990	355.0	1857.8	19.1
1991	367.2	2171.3	16.9
1992	392.8	2667.2	14.7
1993	481.0	3409.6	14.1
1994	578.9	4653.3	12.4
1995	676.3	5727.7	11.8

Note: The definition of revenues is standard. Both price subsidies and subsidies for enterprise losses are added back to budgetary revenues.

Sources: World Bank, 1994: 195, 197 (for 1978–93); *Zhongguo caizheng nianjian* (Fiscal Yearbook of China), 1995: 343–4; 1996: 463–4 (for 1994–5)

Table 5
The share of budgetary revenues in GDP in Xinjiang and Guangdong 1978–95 (%)

Year	*Xinjiang*	*Guangdong*
1978	18.31	21.36
1979	11.94	16.55
1980	7.61	14.69
1981	2.79	13.88
1982	6.73	12.23
1983	7.13	11.83
1984	8.02	10.22
1985	7.56	11.84
1986	7.91	12.52
1987	7.77	11.50
1988	8.01	9.79
1989	8.97	10.43
1990	7.95	8.90
1991	7.88	9.96
1992	6.49	9.71
1993	6.94	10.75
1994	4.26	7.04
1995	4.58	7.10

Note: Owing to lack of data on subsidies for the operating losses of state-owned enterprises and on price subsidies at the provincial level before 1991, this table uses the prevailing Chinese definition of revenues in the year.

Sources: Xinjiang: *Xinjiang tongji nianjian* (Statistical Yearbook of Xinjiang), 1989: 535; 1990: 556; 1991: 496; 1995: 147; 1996: 23, 175; *Fenjin de sishi nian – Xinjiang fence, 1949–1989* (The Forty Years of Development – Xinjiang edition, 1949–89): 286; Guangdong: *Guangdong tongji nianjian* (Statistical Yearbook of Guangdong), 1996: 69, 385.

Secondly, in the 1980s the central government recentralised the collection of a number of taxes and fees. In 1983 the industrial and commercial taxes generated from the cigarette and liquor industries were to go to the central government. Other measures for increasing central revenues included the establishment of the Energy and Transport Key Construction Fund and the Budget Adjustment Fund, and the recentralisation of key enterprises in the automobile, power, non-ferrous metals and coal industries.[22] This resulted in an increased share of central revenues in total government revenues between 1978 and 1993 (see Table 2) and in a decline in the relative sizes of the revenues shared by the central and provincial governments (Wong et al., 1995: 87–8).

The final factor, which was crucial to the poorer provinces, was the diminishing role of central-provincial transfers in equalising budgetary revenues across provinces. The system of central-provincial fiscal transfers governed only one of several sets of fiscal flows between central and provincial governments. The fiscal contracts negotiated between the two levels of government covered the remittance of shared revenues (not all revenues because central revenues were excluded) and the quota transfers from the central government only. As explained below, as a result of the reduction in income handed over to the central government from the better-off provinces, the size of quota transfers to the impoverished provinces fell both absolutely and relatively.

The central-provincial sharing formula was clearly set to favour selected, more developed coastal provinces. For instance, the available information indicates that Guangdong province in the south remitted 1 billion yuan a year to the central coffers in the period 1980–2, and 976 million yuan in 1983. The annual amount fell to 778 million yuan between 1985 and 1987 (Oksenberg and Tong, 1991: Table 4; Wong, 1997: 50; World Bank, 1990: 89). Although the remittance was to increase to 1.41 bn yuan in 1988 and then to increase by 9% in subsequent years (up to 1993), the scheme left an increased share of fiscal resources in the hands of the southern province which registered an average annual growth rate of 24% in GDP in the period 1988–93 (Agarwala, 1992: 68).[23] Fujian province in southeastern China had received subsidies from the central treasury since 1980 (Oksenberg and Tong, 1991: Table 4; Wong, 1997: 50).

Shanghai was another case in point. Shanghai transmitted 90% of its 17 bn yuan collected revenue to the central government in 1979, and 88.8% in 1980 (Donnithorne, 1981: 6). Between 1985 and 1987, the municipality was able to

22. The Energy and Transport Key Fund was established in 1982 and was financed from a 10% (15% since 1984) levy on the sum of after-tax profits of enterprises (Kambara, 1996; Wong et al., 1995: 58).

23. Although the actual remittances by Guangdong were larger in some years than the contracted amount, it was the result of one-to-one central-provincial negotiations and bargaining. The perception of the unfair nature of central-provincial fiscal relations in favour of the prosperous coastal provinces on the part of the impoverished inland provinces has remained intact. In 1987 Guangdong remitted a total of 2.64 bn yuan to the centre, of which only 778m. yuan was the contracted remittances (Wong et al., 1995: 99; see also Agarwala, 1992: 5).

retain 23.54 to 26% of the total revenue collected (World Bank, 1990: 89).[24] In 1988–93 it was due to hand over 10.5 bn yuan a year to the centre and retained any excess (Agarwala, 1992: 68). The fact that the contract was fixed in nominal terms served indirectly to erode the fiscal position of deficit provinces by pushing down the remittance rate of surplus provinces. According to Wong and his colleagues (1995: 95), the rate fell from 34% in 1986 to 22% in 1991.[25]

During 1980–9 only 11 provinces recorded a fiscal surplus, of which 9 were coastal provinces (Zhou, 1997: 114). Xinjiang's fiscal conditions were also jeopardised by an ad hoc central-provincial fiscal restructuring in 1987. In the face of a worsening budgetary plight, the central government 'borrowed' from all provincial governments in 1987. Regardless of broad differences in fiscal capabilities, all provincial governments had to 'lend' an amount equivalent to 10% of their annual normal expenditures to Beijing. Xinjiang officials grumbled at the central government for its decision not to repay its debts to the region — amounting to 255m. yuan — (Statistical Bureau of Xinjiang Uygur Autonomous Region, 1991; Public Finance Department of Xinjiang Uygur Autonomous Region, 1993: 15). In the same year the central government announced that it would cancel the 10% annual increment in its fiscal subsidy to Xinjiang, effective from 1988.[26] During 1988–90 the annual fiscal subsidy was fixed at 1,529m. yuan. The actual amount of central subsidies paid in 1987, however, was raised by only half the supposed 10% annual increment over that in 1986— the increase in the quota subsidies was only 80m. yuan (Public Finance Department of Xinjiang Uygur Autonomous Region, 1993: 15). This in effect reduced fiscal subsidies in real terms. These two policy changes combined to lead to a reduction in the revenue base of the Xinjiang government; it was estimated that from 1987 to 1990 Xinjiang's revenue was reduced by 2.1 bn yuan, thereby aggravating the problem of revenue inadequacy (Statistical Bureau of Xinjiang Uygur Autonomous Region, 1991). The Xinjiang government had to search for new revenue sources.

24. The absolute amount of its remittance to the central government fell from 13.8 bn yuan in 1985 to 12.4 bn yuan in 1987 (Wong, 1997: 50).

25. If provincial budgetary expenditures are divided by budgetary revenues to obtain the amount of geographic transfer of revenues, 100% refers to the situation when revenues balance out expenditure; figures above 100% mean that the shortfalls of local budgets are financed by a revenue transfer from the central government. Since the start of the reforms, while the west has remained dependent on revenue transfer, some coastal provinces have reduced their contribution to the state and some, like Guangdong and Shandong, have even become dependent on redistribution from the state (Tang, 1991: 78).

26. During 1980–87, eight least developed autonomous regions had received a subsidy equal to their calculated deficit and this amount was to be increased by 10% a year (World Bank, 1990: 88).

Xinjiang officials therefore believed that, with diminishing remittances to the central coffers, the coastal provinces could rapidly increase their government expenditures (Statistical Bureau of Xinjiang Uygur Autonomous Region, 1991). In contrast, the economic expansion of Xinjiang was inhibited by its being dependent on receiving a shrinking subsidy from the centre for its economic survival. With the central government playing an increasingly diminishing role of redistributing wealth across regions, Xinjiang officials aspired to become self-sufficient in meeting their fiscal expenditure responsibilities.[27]

'Import' substitution as an economic development strategy

Local protectionism could be viewed as a policy measure on the part of the interior provinces to improve the lot of their masses by developing their own processing industries. All provinces where industrial output per inhabitant is greater than the national average are situated along the coastline. Most of the inland provinces, including Xinjiang, have less than two-thirds of the national average (Leeming, 1993: 120).

Table 6
Ratio of market to state plan prices of selected raw materials (%)

Raw materials	*1985*	*1988*	*1991*
Coal	293	243	170
Crude oil	545	-	284
Steel rod (20 mm)	138	291	-
Aluminium	210	236	108

Source: World Bank, 1994:35.

Because of price controls, the prices of raw materials and primary products like coal, crude oil, electricity and steel have for a long time been low for Chinese enterprises but the prices of manufactured products have been high (see Table 6 for the discrepancy between market and state plan prices for selected major industrial raw materials). Price controls serve to redistribute income from the sellers of the major price-controlled goods to the buyers. Taking coal as an example, nearly 36% of sales in 1992 was undertaken by the state allocation

27. As a result of the fiscal reforms, there exists a trend towards fiscal autonomy on the part of each provincial unit (Ma, 1995).

network at lower fixed prices, resulting in hidden price subsidies of about 8 bn yuan. The major beneficiaries are predominantly the more industrialised coastal provinces (World Bank, 1993b: 12). Resource-poor processing areas in the east have reaped windfall profits from high-priced processed goods, while resource-rich farming and mining areas in inland China have suffered because of low profits from low-priced farm and mining products. Regions with a larger proportion of the low-priced extractive sector have therefore suffered from trade with regions with a larger proportion of the high-priced manufacturing sector (Tang, 1991: 32–8, 73–5). Whereas the profit margins of the major industrial sectors declined in general in the course of the economic reforms, variations in the sectoral profitability were maintained. The huge productivity gap between primary and secondary industry has been virtually unchanged by the economic reforms.[28] Some raw material industries suffered loss or registered very low profit rates.[29] A recent World Bank study finds that 5 (out of 40) industrial sectors (coal, petroleum extraction, public water supply, coking, and leather products) registered below-average rates of profitability (defined as [profit + taxes]/capital). In 1989, 45% (55% in 1992) of industrial losses were in the industrial sectors of coal, coking and gas, and petroleum extraction (World Bank, 1993b: 10). Understandably, inland provincial leaders have a general belief in the magic of light industrialisation. Between the late 1980s and the early 1990s, this entailed an attempt to replace light manufactured commodities that were being 'imported' with domestic sources of production and supply. Local industrial plants were encouraged to set up behind the wall of trade protection. The rationale put forward for the establishment of 'import'-substituting manufacturing operations was that the provincial officials in the interior raised doubts as to how gains from free domestic trade were to be distributed.

As far as Xinjiang's pattern of industrialisation is concerned, its heavy industry has been dominated by the relatively less profitable extractive sector and its light industry has been overwhelmingly dependent on raw materials from agriculture. In 1989 the extractive sector produced 40% of the heavy industrial output of the region (the highest among all provinces), and 82% of the raw materials for light industry came from farm and side-line products — the second highest among the provinces (Hseuh, 1994: 24–5). Xinjiang's industrial

28. The ratio of annual value-added per worker in primary industry to that in secondary industry rose from 0.104 in 1978 to the peak of 0.166 in 1984, but fell to 0.128 in 1990 (Chai, 1996).

29. In the late 1980s, the production cost of a metric ton of petroleum in Xinjiang was more than 320 yuan, but the state purchase price of petroleum was only 152 yuan per ton. In Xinjiang the rate of profitability on investment in the Yili woollen mill was 66.3% while that of the Urumqi petrochemical plant was only 18.5%. See Xu, 1990.

structures serve to compel the regional officials to contain the outflow of raw materials in order to promote regional light industry. In addition, the province is geographically isolated from the coastal regions where consumer demand has been considerable, and the prospects for expanding its 'exports' of light industrial products to eastern China seem rather remote. The regional consumer market in the northwest — estimated to be worth more than 15 bn yuan (Tong, 1988) — remains the sole market for Xinjiang producers to capture.

The competitiveness of Xinjiang products has been rather poor, partly because of the underdevelopment of its light industry and partly because of the economic success of the outward-looking coastal provinces.[30] Before the launching of the economic reforms and the open-door policy, as pointed out by a Xinjiang researcher, only a few consumer products made in the coastal provinces entered Xinjiang; however, since the second half of the 1980s, a large amount of clothing, furniture, electric appliances and foreign cigarettes were 'imported' from the coastal regions (Yu, 1989).[31] Coastal development strategy functioned to increase the production capacities of producers in the shoreline provinces. If the inland provinces were to 'open' their markets to the other rich provinces, increasingly more consumer goods would flow to the rest of the country, and producers and their employees in the hinterland provinces would clearly suffer as they lost business to the lower-cost coastal suppliers. Given the unlikelihood of the central government abrogating its commitment to the coastal economic development strategy, some Xinjiang researchers believed that if local production of consumer goods was not promoted and protected, the economy of Xinjiang would not be able to take off (Yu, 1989; Cui, 1988). Xinjiang has not been content with being a production base of primary products based on its comparative advantages, but has wanted to be self-sufficient in consumer goods production. In the view of Xinjiang leaders and academics, free domestic trade would work against the rapid expansion of Xinjiang industrial production.

To sum up, in order to shore up the financial health of local enterprises and to capture revenue from their profits and taxes, the viable strategy for Xinjiang as well as other less developed provinces to pursue has been seen as to stimulate the growth of more profitable, less technically sophisticated light processing industries and to protect the fledgling 'infant' industries so that they can capture the northwestern regional market.[32] Nearly all provinces have therefore been motivated to develop light but profitable processing industries, resulting

30. Xinjiang industry has been dominated by the production of capital and intermediate goods, such as petroleum prospecting, petroleum-processing and salt-extracting. See Cui, 1990.

31. Another study (Tong, 1988) pointed out that in 1985 more than 70% of the consumer goods needed by Xinjiang's inhabitants were 'imported' from outside.

32. For a discussion of the situation in Shaanxi in northwest China, see Lee (1997a).

in a convergence of regional industrial structures.[33] A World Bank (1994: 13–14) study reveals that 8 principal industrial groups (coal mining, tobacco, textiles, chemicals, building materials, machinery, and electronics and telecommunications) are located in all provinces, with little variation across provinces in terms of gross industrial output and average number of employees per enterprise. The loss of regional comparative advantages also encouraged the closure of the domestic market to outside suppliers during periods of economic slump and the blockade of the outflow of scarce raw materials earmarked for local processing.

Tax-assignment reform: a cure-all for local protectionism?

In the light of the central government failure to exercise macroeconomic control over the economy, the Third Plenum of the CCP's 14th Central Committee in November 1993 called for reform of the public finance and taxation system. Following the Third Plenum, the tax-assignment system (*fenshui zhi*), the centrepiece of the public finance and tax reform, was announced to take effect from 1 January 1994.[34] As the outbreak of regional trade wars is widely attributed, at least in part, to the fiscal reforms of the 1980s, it is suggested that the tax-assignment system can provide a real long-term solution to the problem of local protectionism (He, 1994; Zhang, 1995; Zhou, 1997: 118). The rationale behind this argument is that, under the tax-assignment system, the business tax on the wholesale and retail sectors and the product tax were to be merged with the value-added tax, one of the shared taxes. Given that the shared taxes are to be collected by the central government, local tax revenues were to be delinked from the financial health of local enterprises.[35] Kumar (1994: 125) also notes that:

> The fiscal reforms introduced at the beginning of 1994, designed to gradually 'recentralise' a part of government revenues, together with the substantial progress in price decontrol, and the

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33. 'Similarity coefficients' of regional industrial structures, originally proposed by UNIDO, are calculated to quantify the convergent trend. Using the whole country's industrial structure of gross output value as a benchmark, provincial industrial structures are compared. It is found that more provinces (21) had a similarity coefficient above 0.9 in 1989 than in 1981 (18). For details, see Ma and Li (1994: Table 3). For data on changes in the profitability of 10 major industrial sectors from 1982 to 1990 and their variations see ibid.: Table 2.

34. *Beijing Review*, 22–8 November 1993: 12–31, especially 20; 13–19 December 1993: 4; *Renmin ribao* (People's Daily), 14 December 1993. For more discussion of the practice of the tax-assignment system, see Chung (1994–5), Naughton (1997), Wong (1995, 1997).

35. Only three taxes are to be shared: the value-added tax, the resource tax, and the stock market trading tax (Ma, 1995).

> decision adopted at the Third Plenary session of the [Chinese Communist Party] to promote 'balanced' regional development, may help erode incentives to constrain regional trade.

Nevertheless, it is argued here that because of the existence of a central-local tax rebate in the tax-assignment system, reform of the tax-assignment system is unlikely to eliminate the regional blockading of the market. Under the tax-assignment system, the central government recentralises the collection of the rapidly expanding value-added tax. It establishes a national tax bureau to collect both the central fixed taxes and the shared taxes, and the value-added tax, one of the three shared taxes, is to be divided between the central and provincial governments at a ratio of 75:25. To win support for the fiscal reform from the provinces, the central government gave a promise to all provincial governments that they would retain no less revenue than they did in 1993. Part of the shared revenues collected by the central government were to be returned to the provinces. The year 1993 was set as the 'base year' on which to calculate the rebate, known as the 'base amount'. From 1994 onwards, the amount of the rebate was linked with the growth of the consumption tax (a central tax) and value-added tax, and pegged at a rate of 1:0.3 on the basis of the provincial growth rate of the two taxes. In other words, if the provincial revenue arising from the two taxes increases by 1%, the rebate from the central government will go up by 0.3% on top of the 'base amount' (Huang, 1996). Originally the amount of the rebate was to be determined by a coefficient of 1:0.3 on the basis of the *national* growth of the value-added and consumption taxes. The formula was later changed into one linking the rebate with the growth of a *province's* two taxes (Ma, 1995: footnote 34; *Zhongguo caizheng nianjian*, 1995: 62). There are, therefore, built-in incentives for regional governments to collect as much tax revenue as possible by boosting local sales volume. Also, it is suggested that the rebate system structurally favours the better-off provinces because they have originally obtained higher levels of sales and consumption amounts. In other words, the tax-assignment reform still carries a regional bias (Huang, 1996).

Moreover, the reform deals only with the central-provincial distribution of budgetary revenue. Research studies (e.g. Fan, 1995) suggest that all levels of government in China have found that budgetary revenue is no longer able to meet their expenditure responsibilities. They have to rely on extra-budgetary and off-budget revenues, which, in turn, are linked to a significant extent with the financial health of local enterprises, to finance the provision of public goods.

In addition, some of the mechanisms stimulating local economic protectionism are still in place under the new fiscal system. First, the division of tax bases is still done on the basis of ownership. As under the pre-1994 fiscal systems, the central government continues to receive income tax from the centrally owned enterprises and the subnational governments from their own enterprises. This inevitably accentuates incentives to interregional protection. Secondly, the central government still has discretion in assigning expenditure responsibilities to regions when it is faced with fiscal difficulties. It has not recentralised expenditure responsibilities from lower-level governments under the tax-assignment system. The share of central expenditures in national budgetary expenditures remained intact in 1994–5 (see Table 2). It is observed that expenditure responsibilities between various levels of government had not been clearly defined in the early phase of the reform (Lall and Hofman, 1995; Roe, 1995). Thirdly, provincial governments need healthy fiscal strength to lobby the central government to allocate more central projects to their own jurisdictions. Owing to the fact that the various fiscal systems lay stress on creating incentives for the subnational governments to collect taxes, the latter are likely to protect the financial well-being of their enterprises.

As seen from the fact that local protectionism did not subside in 1994, there are reasons to believe that the tax-assignment reform of 1994 is not so effective as was originally expected in containing local economic protectionism.

Concluding remarks and policy implications

This article shows that, despite the fight against local economic protection by the central government, the practice continues well into the 1990s. It then argues that the root cause of revenue-strapped local governments engaging in protectionist policies with respect to interregional trade has been the fact that less well-off inland political leaders are eager to promote local economic growth. The economic context within which they have been compelled to resort to local protectionism includes the fiscal squeeze and the use of self-protective measures of 'import'-substitution industrialisation to stem the interregional value transfer from the western regions of low-priced raw materials to the eastern regions of high-priced manufactured goods.

Stimulated by the exhortations of the national political leaders to 'get rich first', the inland provinces have wanted for a long time to foster economic self-reliance and overcome the state of economic dependence in which they find themselves. The establishment and thus the protection of light industries has been seen as the quickest way to generate high profits and revenues and thus the potential for future growth for producers and governments in the interior regions.

In the view of the central leaders, particularly those in the 1980s, the eventual 'trickle-down' of prosperity to the less developed areas of the interior would only be a question of time, but the inland leaders could not wait patiently for the spill-over suggested by the coastal-led development strategy. In the view of the inland provinces, the coastal-led strategy has produced outcomes that do not accord with their notions of justice; it has rewarded luck: the luck of being born or of living in the coastal areas. Moreover, the inequalities thus generated tend to be cumulative over time, with the well-off provinces having the political and economic power to maintain or even enhance their privileges. The inland officials were quite suspicious of the appropriateness of adherence to central policies. In the light of a lopsided regional development and an increasingly fiscally weak central government (in the sense of having decreasingly less leeway in redistributing resources geographically), it is not surprising to find that decisions made by local government officials in the hinterland focus on their own immediate concerns, such as profitability and capital accumulation, and not on whether and how development is occurring elsewhere. Consequently, it is not fair for the subnational leaders alone to be blamed for the undesirable consequences of local protectionism.

There is a scepticism among the hinterland officials that cannot be dismissed out of hand. Even if trade liberalisation boosts *national* output, how can they be sure that the gains from that trade are fairly distributed? To proceed towards the formation of a regionally integrated internal market to realise the benefits of scale economies in a decentralising economy, a fiscal reform that expands the scope of the budget and at the same time establishes a match of revenue and expenditure assignments in subnational governments is required. On the other hand, thorough price reform is also needed to improve the profitability of primary industries and to discourage excessively quick pay-off investments in light processing industries.

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