Causes, Scale, and Characteristics

Conflict Between Central and Local Governments

For three millennia, China’s central government has struggled to control local leaders, and the degree of centralization has varied. At times, for example during the Zhou dynasty (1050–256 BC), fiscally and militarily independent feudal princes operated mostly beyond the control of the emperor. At other times, such as the Qin dynasty (221–206 BC), a strong emperor used hierarchical bureaucracy to centralize taxation and military power. These models of government can be seen as different solutions to two challenges faced by any government of a large, diverse country such as China.

First, how much control should the central government have over local governments? Too little and the central government may lose control; too much and the bureaucratic costs become onerous. The control of local government financing (the power to set tax rates and collect and spend tax revenue) is perhaps the most important dimension because it underlies all other autonomies.

The second challenge is how to ensure that local governments act in the interest of the country as a whole rather than in the interest of their region or even the interests of the local officials themselves. In the language of economics, this is a principal–agent problem: how can a principal (the central government in this case) control the actions of the agent (the local government)?
These challenges are not unique to China. The USA also struggles with the degree of control that the federal government should have over the states; and even in a smaller country like the UK, the degree of devolution to local governments has become a topic of active debate. The way in which China has addressed these challenges is critical to understanding the evolution of local government finance since the 1990s and the prospects for future reform.

**Centralization of Tax Revenue**

Prior to 1985, the majority of tax revenue was raised by local governments, while the majority of spending was carried out by central governments. In 1980, for example, central governments raised only about 13% of total government revenue but were responsible for 55% of expenditures. The central government relied on the transfer of funds from local governments (Fig. 11.1). During the late 1980s and early 1990s, the central government shares of revenues and expenditures were roughly equal but low. Local governments controlled approximately 70% of the total government budget.

Local government control of the majority of revenue created three major problems. First, it weakened the ability of the central government to influence local government policies since local governments were not financially dependent on the central government.

![Figure 11.1](chart.png)

**Fig. 11.1** Central government share of total government expenditure and revenue.  
*Source: Statistical Yearbook of China, National Bureau of Statistics*