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The impact of Province-Managing-County fiscal reform on primary education in China

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ABSTRACT

Using longitudinal Chinese county-level data from 2005 to 2007, we examine the causal effect of the Province-Managing-County fiscal reform on primary education spending by combining propensity score matching with the difference-in-difference method and allowing for the concurrent County Strengthening and Power Expansion reform. While the fiscal reform significantly increases per pupil expenditure on elementary education, there is little evidence showing that this fiscal reform narrows the urban-rural expenditure gap within counties. This Province-Managing-County reform, on the other hand, aggravates regional educational spending disparity in elementary schools based on the observation that the reform has caused a higher increase of per pupil educational spending in the affluent Eastern Region than the increase in Central and West China.

1. Introduction

China's unprecedented economic growth over the past few decades has been accompanied by an alarming increase in income inequality, which is now higher than that of the United States by a significant margin, and has become a major policy concern of the government (Knight, 2014; Sicular, 2013; Xie & Zhou, 2014). While personal and family characteristics are the key determinants of income inequality in developed economies, it is widely held that regional disparities and the urban-rural gap play much more important roles in China, as a result of China's pro-urban institutional framework (e.g. Xie & Zhou, 2014). To the extent that the urban-rural gap in human capital (in both quantity and quality) drives the urban-rural earnings gap (Zhang, Li, & Cue, 2015), it will be interesting to study the effect on primary education spending in counties (that are largely rural) arising from a recent fiscal decentralization reform in China which has eliminated the prefecture city government as the intermediate layer between the province and the county.

The hierarchical structure of governance in China consists of five layers of governments - from the highest to the lowest: the central, province or municipality-level, prefecture or city-level (hereafter city-level), county-level and township-level (Wang, Zheng, & Zhao, 2012; Tsang, 1996). Between the 1980s and the early 2000s, this hierarchical system featured a highly centralized fiscal managing system. Governments at the city level undertook a strict control of fiscal revenues and expenditures of the lower county-level governments, which in effect were the primary providers of public education for residents in their jurisdictions. The risk of this institutional arrangement is that city governments are inclined to withhold revenue sources allocated to counties and at the

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same time shift expense responsibilities to counties due to the priority of urban construction and development that had been pursued by most city-level governments in China (Wang et al., 2012). One of the consequences is that many county governments suffer from chronic underfunding of basic public services.

The central government, therefore, enacted a fiscal reform known as the Province-Managing-County (PMC) reform in 2004, aiming to lessen the fiscal stress of county governments. In contrast to the old system where county governments were strictly under the control of city governments, this reform enabled county governments to directly receive funding from the provincial government and report to the provincial government about expenditures. Specifically, the three stated goals of this reform are to (a) improve local economic development, (b) augment local finance capacity, and (c) equalize the supply of public services across counties. As the middle layer – city governments between local and provincial governments, is less likely than before to withhold sources allocated to counties and to shift expenditure responsibilities to county governments, the PMC is expected to promote fiscal decentralization in China (Wang et al., 2012).

The impact of the PMC reform on the public service delivery and regional disparity has been inconclusive in the existing studies. The proponents of the reform contend that by simplifying government administration and standardizing intergovernmental financial relationship the reform will increase the supply of public services by city and county governments (Wang & Li, 2008). The PMC reform is also found to have a positive effect on reducing the disparity of educational expenditure between urban and rural areas (Zong & Ding, 2013). The critics of the PMC reform, nevertheless, insist that the PMC reform will decrease local spending on education and public health as more resources could be redirected to productive expenditure at the expense of welfare expenditure (Liu, Wu, & Wu, 2012).

The reasons for the inconclusive results in the existing literature might be two-fold. On the one hand, existing research based on data from one or a couple of provinces lack national representativeness. In fact, the PMC reform was implemented in 24 provinces or equivalent administrative divisions. In addition, participating provinces may have responded differently in designing measures and institutional arrangements to redistribute responsibilities between city and county governments within the province. It is very likely that estimates may depend on the specific provinces used in the study. On the other hand, previous conventional panel data and generalized method of moment analyses do not adequately account for selection bias of the PMC reform, which is very likely to result in biased estimates of the impact of PMC reform on educational expenditure (Cai & Huang, 2010; Liu et al., 2012). In the framework of a quasi-experiment design, this article addresses both of these two methodological challenges to examine the impact of PMC reform on per pupil educational expenditure and its impact on the spending disparity between urban and rural areas. Since the Western, Central and Eastern Regions of China are quite different in socio-economic development, the effect of the PMC reform on per pupil educational expenditure gap across regions is also explored.

The remainder of the paper is organized as follows. Section 2 introduces the PMC reform. Section 3 reviews the consequences of fiscal decentralization practice across countries and sets up the research propositions to be tested in the empirical analysis. Data and empirical framework are described in Section 4. We present our results in Section 5 and the concluding remarks in the final section.

2. Background of the PMC reform

China has witnessed an institutional reform in the 1980s which placed county governments under the exclusive control of city governments. This institutional arrangement, in the transition time, broke the long-standing segregated development between cities and counties. For a long time, the cities had the chance to focus exclusively on the industrial development at the expense of the counties. At that time, this system change had greatly improved the efficiency of resources sharing across different administrative divisions as rural areas could not only provide food for the city population but also lease land needed for the urban expansion (Zhang, 2011). With the rapid growth of the Chinese economy, this City-Managing-County (CMC) system with too many layers and therefore with soaring costs has become increasingly incompatible with a more market-oriented economy. Liu and Alm (2016) highlight the administrative inefficiency and the widening gap between revenue and expenditure assignments at the county level. The CMC model also caused the over-industrialization of urban area and the underdevelopment and stagnant socio-economic growth of rural districts, which further reinforced the inequitable distribution of public services across counties.

Faced with all these challenges, the Chinese Central Government started the PMC reform in which the provincial government would directly manage counties, bypassing the layer of cities. The phases and key features of the PMC reform are summarized in Table 1. The most important change of the PMC reform in public finance is to allow the provincial government to simultaneously control city and county governments in fiscal revenue and public spending. The county governments now directly report to the provincial government with regard to public affairs including, but not limited to, the sharing of revenues and expenditures between local and central government, inter-governmental transfer, government budgets and final accounts. As such, the PMC reform is also referred to as “PMC flattening reform” (Li, Lu, & Wang, 2016). The reform was first piloted in counties of provinces located in the middle and north part of China such as Anhui, Henan, Hubei, Liaoning and Jilin as listed in Table 1. In 2006, the program was expanded to Jiangsu, Shaanxi, Sichuan, Gansu, and Qinghai in Eastern and Western China. Although the Department of Finance, in July 2009, released the Opinions on Enhancing the Province-Managing-County Reform, proposing to implement this reform across all provinces except the minority autonomous regions by 2012, it seems that the PMC reform was slowed down and even at a standstill. By the end of 2012, 1099 counties from 24 provinces, representing approximately 56% of all counties across the country, had implemented the PMC reform (Liu, 2013).

By sorting out the inter-governmental financial relationship, the PMC reform is expected to accelerate local economic growth, to improve the financial capability of local governments, and to close the gap in basic public services between urban and rural areas. However, the extent to which the PMC reform has achieved any of these policy goals remains an open question.

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