



The incentive role of creating “cities” in China

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ABSTRACT

China operated an urbanization policy by which counties could be given city status between 1983 and 1997. The policy had substantial impacts on the new administrative entities, including more discretionary power and fiscal independence. Such “county-to-city upgrading” provided the central government with an instrument to reward localities. Using a large dataset covering all counties during 1993–1997, I show that upgrading is not an automatic procedure that endorses the high urbanization levels in existing counties. Although official guidelines for upgrading counties to cities were published, these requirements were largely ignored in practice. Instead, economic growth rate was the key factor in determining which counties obtained city status. This paper interprets the creation of county-level cities through upgrading as part of the incentive structure of Chinese local officials. The importance of both fiscal and political incentives facing the local government in promoting economic growth is highlighted.

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1. Introduction

In developing countries, local governments play a key role in economic growth. For example, in China, the local government not only provides public goods and services to its residents but is also deeply involved in economic activities. In most regions, building infrastructures, offering inexpensive land and preferential tax policies are the main jobs of the local officials, whose goal is to attract investments. Although not allowed to directly engage in borrowing, local governments have established companies to borrow from banks and invest in urban infrastructures. The effort of the local government and its attitudes toward the market can easily become the binding constraint for regional development.

Thus, a major concern of the central government in developing countries is to give local governments the right incentive to spur market development and economic growth (World Bank, 2008).¹ Under a hierarchical political system in which local officials do not face election pressure from citizens, the central government must rely on its administrative authority to create effective incentive mechanisms (Zhuravskaya, 2007). For example, fiscal decentralization and the promotion of local officials are two important institutions that provide market incentives to local governments in China (Huang, 2002; Jin, Qian, & Weingast, 2005; Li & Zhou, 2005; Xu, in press).

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¹ The Growth Report (page 4) by the World Bank states that “the administration must also attract and retain talented people, by offering better pay, promotions, and recognition to officials.”

The current paper examines a specific incentive mechanism that is related to urbanization policies in developing countries. In China, awarding “city” status to existing counties is the dominant way to create new urban administrative units in the reform era. The so-called county-to-city upgrading is not only an endorsement of high urbanization levels in existing counties but also provides local governments many political and fiscal benefits, thus providing the center with an instrument to reward localities. Furthermore, economic growth rate, which was not written in the formal requirements, plays an important role in determining which counties can be upgraded to cities. Thus, county-to-city upgrading forms part of the incentive structure of Chinese local officials in promoting economic growth.

Using data for all counties in China during 1993–1997, I show that the official minimum requirements for county-to-city upgrading are not enforced in practice. Instead, economic performance is the key to obtaining city status. I provide evidence on the relationship between a county’s economic growth rate and its probability of obtaining city status after controlling for urbanization levels and other requirements, such as industrial output and fiscal strength. This reflects a principal–agent relationship between the center and the local governments in which the center uses incentives to induce high growth rate and the localities compete to obtain rewards, including city status.

The current paper draws extensively on the growing literature on the relationship between urbanization and economic development. In China, urbanization is featured with the emergence of a large number of new cities, which stands in contrast to the typical urban growth process of other countries, for which the main channel is the expansion of existing cities (Anderson & Ge, 2005). Studies on China’s urbanization and city creation are not rare (e.g., Au & Henderson, 2006a,b; Chung, 1999; Deng, Huang, Rozelle, & Uchida, 2008), but the political economic driving forces have largely been ignored.² The present paper makes the first attempt to interpret city creation as an incentive mechanism to promote economic growth.

This paper also highlights the coexistence of fiscal decentralization and political centralization in China. This unique institutional setting is attracting growing interest (Blanchard & Shleifer, 2001; Zhang, 2006; Zhuravskaya, 2007). While the competition and commitment role of fiscal decentralization has been discussed extensively (e.g., Jin et al., 2005; Qian & Weingast, 1997), some recent studies argue that the centralized power structure is also crucial in creating yardstick competition among local officials and constraining the practice of local protectionism (Bai, Tao, & Tong, 2008; Bo, 2002; Li & Zhou, 2005). In this paper, upgrading is the result of centralized decision-making and, at the same time, gives local officials more discretion over revenue collection. The current work provides a chance to learn political centralization and fiscal decentralization in the same setting.

The remainder of the paper is organized as follows. Section 2 introduces the background of county-to-city upgrading. Section 3 describes the data and presents evidence on the non-enforcement of formal upgrading requirements. Section 4 presents empirical evidence on the incentive role of awarding city status. Section 5 concludes.

2. County-to-city upgrading in China

There are two main sub-provincial administrative levels in China, prefecture and county. County-level jurisdictions have approximately three thousand individuals and include counties, county-level cities and urban districts.³ At the end of 2008, there were approximately 1700 counties and 368 county-level cities. In the present paper, “upgrading” refers to the reclassification from a county into a county-level city. During upgrading, the entire county is labeled a “city.” Thus, a city includes not only the relatively urbanized section, but also large expanses of rural areas. The administrative units created through upgrading are different from the typical understanding of the term “city” (Chan, 1997). The creation of cities through upgrading stands in contrast to the experience of most countries, where “city” and “county” fall into different administrative categories. Cities typically only govern a small area where urban population is concentrated. Rather than reclassifying an entire county, a new city is normally created inside a county. Furthermore, the decision is often made through a vote. For example, in the U.S., a new city could be created by adopting a home rule charter (Hennessey, 2008), while in Brazil, new municipalities are established through local voting (Naritomi, Soares, & Assuncao, 2007).

At the beginning of China’s economic reform in the early 1980s, restricting the size of large cities and promoting small cities and towns was adopted as the major strategy for achieving urbanization (Saich, 2008). Because setting up a new city government incurs great administrative costs, upgrading existing counties into cities became the major form of city creation in China (Liu & Wang, 2000), constituting more than 90% of county-level cities established after 1982. By 1997, nearly 15% of counties had obtained city status. The total number of cities grew quickly from less than 250 in 1982 to more than 650 in 1997 (See Fig. 1).

The official rule for regulating county-to-city upgrading first appeared in 1983, when cities had shown the advantage in attracting investment and the demand for city status increased in the coastal provinces. Under some rough requirements proposed by the Ministry of Personnel and Ministry of Civil Affairs, nearly 100 counties obtained city status during 1983–1986. The number of cities continued to rise, and the central government raised the minimum requirements for city status in 1986 and 1993. The 1993 requirements set different standards for counties with different population densities. The three major requirements include the industrialization level, urbanization level, and fiscal strength (see Table 1). Growth rate is not formally written into the documents as a requirement. It is apparent from Table 1 that the standards vary by population density. The entry barriers for counties with lower population density were set lower than those with higher population density. This seems to imply that, according to the central government, setting up cities does not follow the typical notion of urban agglomeration.

² For a general discussion on the political economy of city formation, see Henderson and Becker (2000).

³ Autonomous counties in the minority area are counted as counties. For a detailed description of the Chinese administrative system, see Chung (1999).

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