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Abstract

This paper examines how fiscal incentives affect the policy choices of local governments in the context of China. Based on exogenous changes in the intergovernmental revenue-sharing scheme, we construct a simulated instrumental variable to resolve the endogeneity problem. We find evidence that local governments shifted their efforts from fostering industrial growth to "urbanizing" China, i.e., to developing the real estate and construction sectors, when their retention rate of enterprise tax revenue was reduced. The increase from the new revenue source compensated for half of the losses in revenue that resulted from the reassignment of fiscal rights. The reassignment had also the effect of retarding the industrial growth of domestically-owned firms in particular. (JEL: H77, H70, H39)

Keywords: Fiscal Federalism, Fiscal Incentives, Revenue Sharing, Local Governments, Land Conveyance, Urbanization, Simulated Instrumental Variable.

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