THE POLITICAL ECONOMY OF CHINA

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AGENDA OF PRESENTATION

- **First** – About political economy and China.

- **Second** – The political game in China: why was the Chinese state able to promote economic growth during the reform era, yet has been unable to do so during the Mao era?

- **Third** – The power of political institution in China: why the Chinese leaders accept formal, institutional constraints on their authority?

- **Fourth** – Policy-making in China: Logrolling among interest groups.

FIRST

About political economy and China

Question: Is China Democracy, Autocracy, or maintaining a distinct form of political model?

WHY STUDY CHINA'S POLITICAL ECONOMY?

Why China?

- China is a place where no business or country can afford to neglect nowadays.
- China study can influence the study on main stream political economy.

Why political economy is important in understanding China?

- The business of all business is politics.
- In China, the biggest political issue is the economy, and the biggest economic issue is the politics.

CHINA STUDY'S IMPACT ON POLITICAL ECONOMY

- Sadly… small

- In 1986, Kenneth Lieberthal observed that the study of China in the United States had had little effect on the evolution of political science. (Reny, 2011)

- Some of the most influential books in the study of contemporary China have not been significant in the mainstream economics or politics.

- But, is increasing!
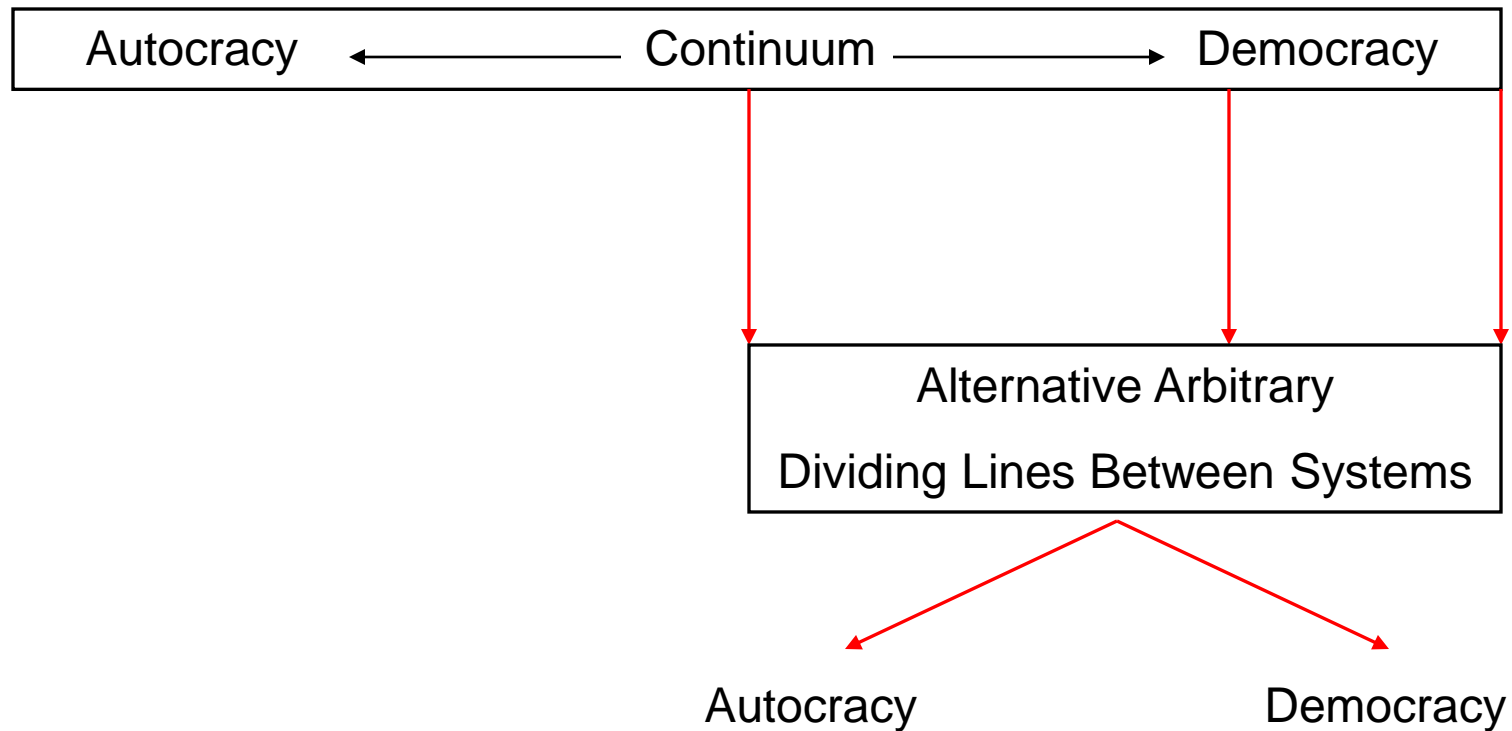
CHINA STUDY'S IMPACT ON POLITICAL ECONOMY

- Mancur Olson (1993). Dictatorship, Democracy, and Development. *The American Political Science Review.*

Why, then, have most populous societies throughout history normally avoided anarchy? An answer came to me by chance when reading about a Chinese warlord (see Sheridan 1966). In the 1920s, China was in large part under the control of various warlords. They were men who led some armed band with which they conquered some territory and who then appointed themselves lords of that territory. They taxed the population heavily and pocketed much of the proceeds. The warlord Feng Yu-hsiang was noted for the exceptional extent to which he used his army for suppressing bandits and for his defeat of the relatively substantial army of the *roving bandit*, White Wolf. Apparently most people in Feng's domain found him much preferable to the roving bandits.

The Selectorate Theory

- Bueno de Mesquita, Smith, Siverson and Morrow (2003). *The Logic of Political Survival*, MIT Press.

- **Research Question:** Why do some political systems seem more prone to policy failures than others?

- **Dependent Variable:** Leader's choice between providing public goods, private goods or her own pocket.

- **Claim:** It makes no sense to classify regimes as democracies or dictatorships, a better classification is according to the size of the **selectorate** and the size of the **winning coalition**.

STANDARD VS. SELECTORATE VIEW OF GOVERNANCE

Autocracy	←——— Continuum ———→	Democracy

Alternative Arbitrary

Dividing Lines Between Systems

Autocracy   Democracy

CHINA STUDY'S IMPACT ON POLITICAL ECONOMY

- Susan Shirk (1993). The Political Logic of Economic Reform in China.

  - *" top leaders of the party appoint the subordinate officials of the party and government" and, in turn, "the officials in the Central Committee choose (or at least ratify the choice of) the leaders". "Officials hold their positions at the pleasure of the party leadership, but party leaders hold their positions at the pleasure of the officials in the selectorate." -- Shirk (1993), p. 83*

  - Explain the politics in China as a game between the leader and the selectorate. The origin of the "selectorate theory".

CHINA STUDY'S IMPACT ON POLITICAL ECONOMY

- More and more mainstream political economists begin to write on China
  - Avner Greif and Guido Tabellini (2010). Cultural and Institutional Bifurcation: China and Europe Compared. *American Economic Review: Papers & Proceedings*
  - Song, Zheng, Kjetil Storesletten, and Fabrizio Zilibotti. *2011.* Growing Like China. *American Economic Review.*
  - Daron Acemoglu and James A. Robinson *(2012). Why Nations Fail.*

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China study's impact on political economy
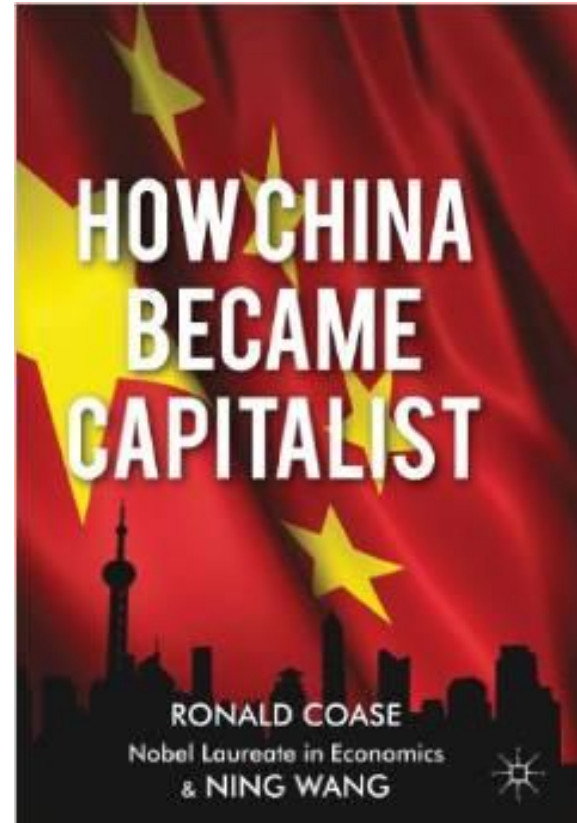
Some new trends in China

- Many claim that China is going capitalist and staying autocratic.

- China's political system provides political leaders authority without contentious legislatures or challenging media.

- The public is invited to respect the authorities and stay out of politics.

- But in fact, the Chinese political process is much diverse than this picture.

THE CHINESE LEADERS HAVE BECOME LESS DOMINANT

- Mao has absolution power and authority.

- From Jiang to Xi, the top leaders are the first one among equals, which is called collective headship.

- Obtaining consensus among the elites is needed for every important decision to be taken.

- The leaders need the support of the "selectorate" to remain in power (Shirk 1993).

- There was an increase in the size and power of the selectorate after Deng's reform, which created selectorate accountability in the political system (Yuan Li and Gilli, Economics of Transition, 2013).

RECIPROCAL ACCOUNTABILITY

CCP General Secretary Politburo Standing Committee

Weak authority ↑

Strong authority ↓

Selectorate: the upper echelon of the elites in China				
Members of the Central Committee	Retired elders	military leaders	high-ranking officials of Central CCP and Government	high-ranking officials of local CCP and Government

Reference: Shirk 1993; Gilli and Li 2013

# The elite has become increasingly fragmented

- In the late 80s and early 90s, a group of influential China Study scholars developed the "Fragmented Authoritarianism" framework to study the vertically segmented political system in China. (David Lamptom 1987; Lieberthal and Oksenberg, 1988; Liebertal and Lampton, 1992)

- It argues that authority below the very peak of the Chinese political system is fragmented and disjointed. The fragmentation is structurally based and has been enhanced by reform policies.

- These vertical segments need one another's cooperation but cannot command each other. Thus, reaching consensus is very difficult, and usually depends on bargaining, guanxi (connection), and xietiao (coordination).

Reference: Lieberthal and Lampton 1992

The citizens have become more powerful

- The Chinese citizens are empowered by increasingly diffuse financial and human resources, the Internet, and other tools of instantaneous communication (Lampton, 2014).

- Maintain social stability become the top priority of the Chinese leaders (Shirk, 2007).

- Collective actions by the citizens may influence policy outcomes.

  – provincial leaders will implement policies more in favour of the citizens in response to intensified labour Disputes (Yuan Li, 2014, Economics of Transition).

Changes of the Chinese political system

Leader:
less dominant

Elites:
more fragmented

Citizens:
empowered
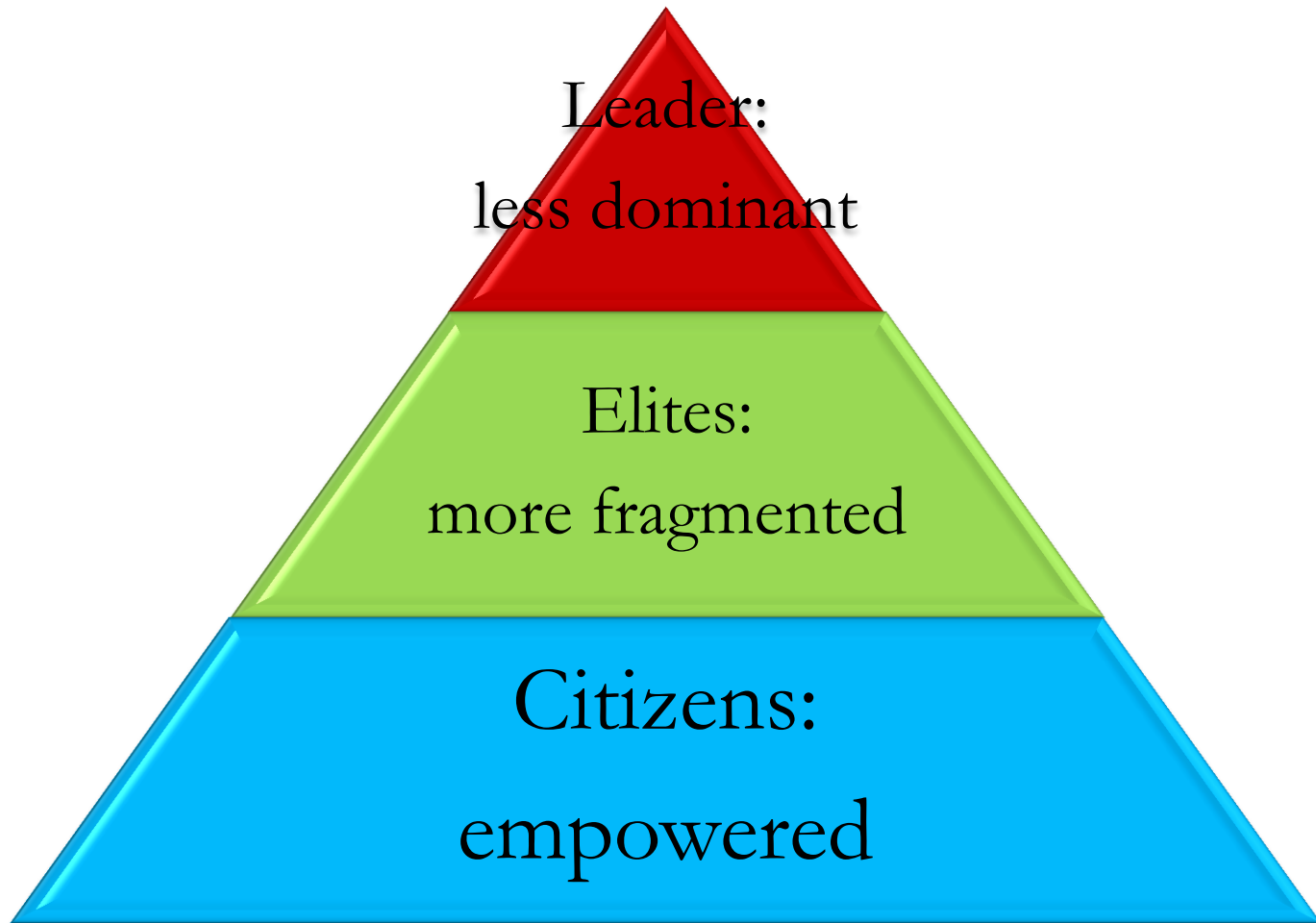
Some new trends in China

- But these new trends have too often been ignored in the existing literature. If we cannot understand thoroughly how the one-party system evolves and innovates within itself under the changing circumstances in the age of globalization and Internet, we may make serious mistakes about predictions on China's development.

SECOND

Why was the Chinese state able to promote economic growth during the reform era, yet has been unable to do so during the Mao era?

WHY WAS THE CHINESE STATE ABLE TO PROMOTE ECONOMIC GROWTH DURING THE REFORM ERA, YET HAS BEEN UNABLE TO DO SO DURING THE MAO ERA?

- Dependent Variable: Leader's choice between implementing congruent policy (pursue general interest) or noncongruent policy (pursue self interest at the cost of general interest).

- Claim: A significant increase in the size of the selectorate since Deng Xiaoping came to power had rendered reciprocal accountability effective as a disciplinary device on the leader's behavior.

PLAYERS IN THE CHINESE POLITICAL GAME

- There are three key players in the Chinese political game
  - Leader
  - Elite
  - Citizens

- Chinese leaders face two fundamental challenges.
  - The political elites who might organize a coup
  - The citizens who might initiate a revolt
  - As the balance of power among the three players shifted in different periods, we observe different kinds of policy outcomes.

THE MODEL (1)

- The basic game is a two-period political-agency model with incomplete information played between the incumbent leader and the selectorate. The country population is normalized to 1. Let $\phi \in [0,1]$ to be the size of the selectorate. The rest of the people who do not have the power to choose leaders are the citizens and their size is $1 - \phi$.

- There are two types of the incumbent leader, congruent or non-congruent, $T \in \{C, N\}$, with probability π of being congruent, and the selectorate revise expectations about the leader's type according to first-period outcomes.

THE MODEL (2)

- In each period t=1,2, the incumbent leader (L) is privately informed of the true state of the world $\theta_t \in \{0,1\}$ and has to make a discrete 'general interest' policy choice denoted by $e_t \in \{0,1\}$.

- The general interest requires the leader to match the true state of the world, but this would also mean foregoing her private benefits.

- The public payoff from the general interest policy is Δ if $e_t = \theta_t$, is 0 if $e_t \neq \theta_t$.

- However the non-congruent leader gets a private benefit r_t from picking $e_t \neq \theta_t$, where r_t is drawn from a distribution whose cumulative distribution function is $G(r_t)$ with $E(r_t) = r$, and $r_t > \Delta$.

THE MODEL (3)

- To gain the loyalty of the selectorate, the leader pays a patronage to the selectorate by using direct payment or high-level government appointments.

- The leader distributes all the patronage to the selectorate and nothing to the citizens.

- Therefore each member of the selectorate gets $\left(\frac{X}{\phi}\right)$, and each citizen gets 0.

The model (4)

- At the end of each period, the representative member of the selectorate observes his utility in that period and on the basis of this information decides whether to support the leader or not.

- If the selectorate support the leader, then the leader still holds office in the subsequent period, otherwise the leader is ousted from power, as a leader with no support base cannot survive.

- When the incumbent autocrat is ousted from power, a new ruler will replace her and form a new selectorate of size ϕ.

THE SELECTORATE THEORY: LOYALTY NORM
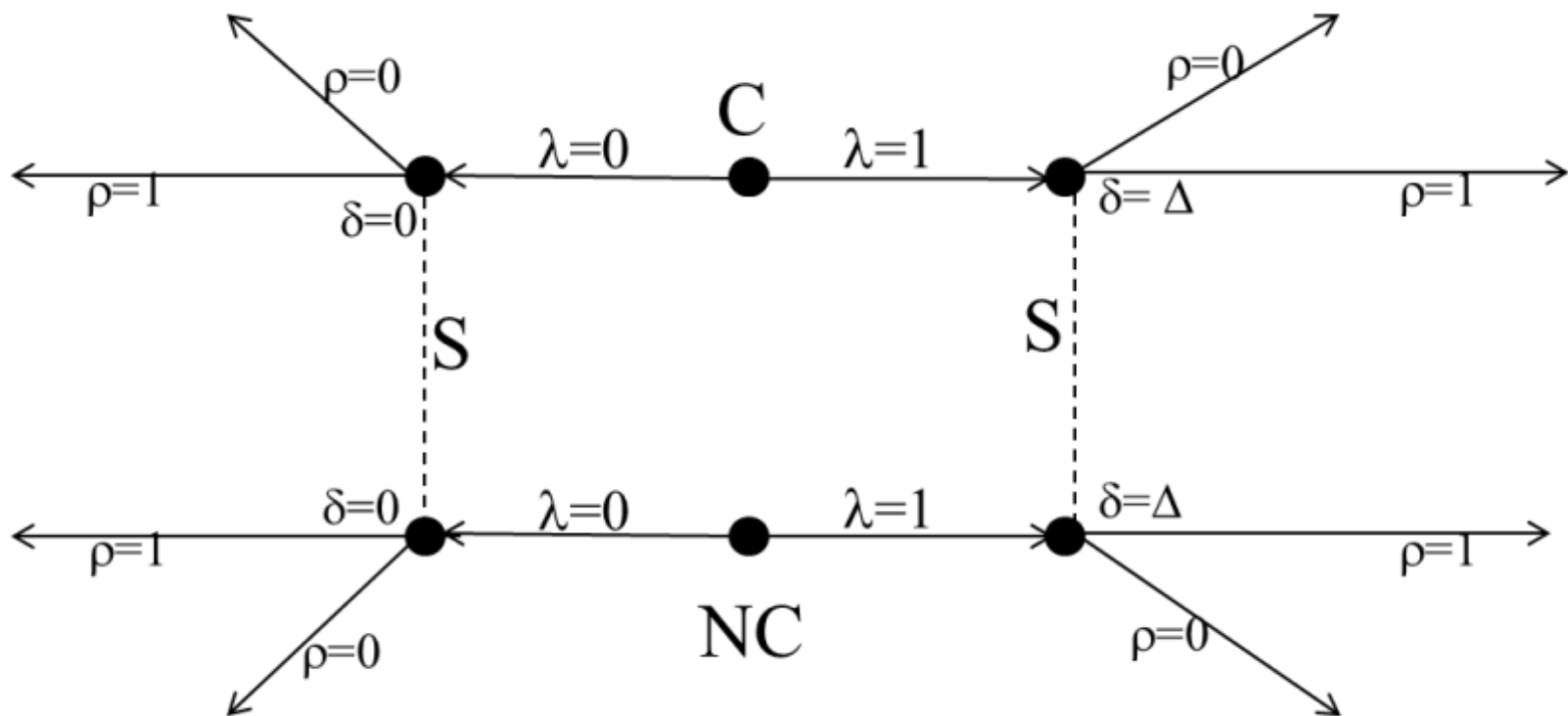
Selectorate: ϕ
Citizens: $1 - \phi$
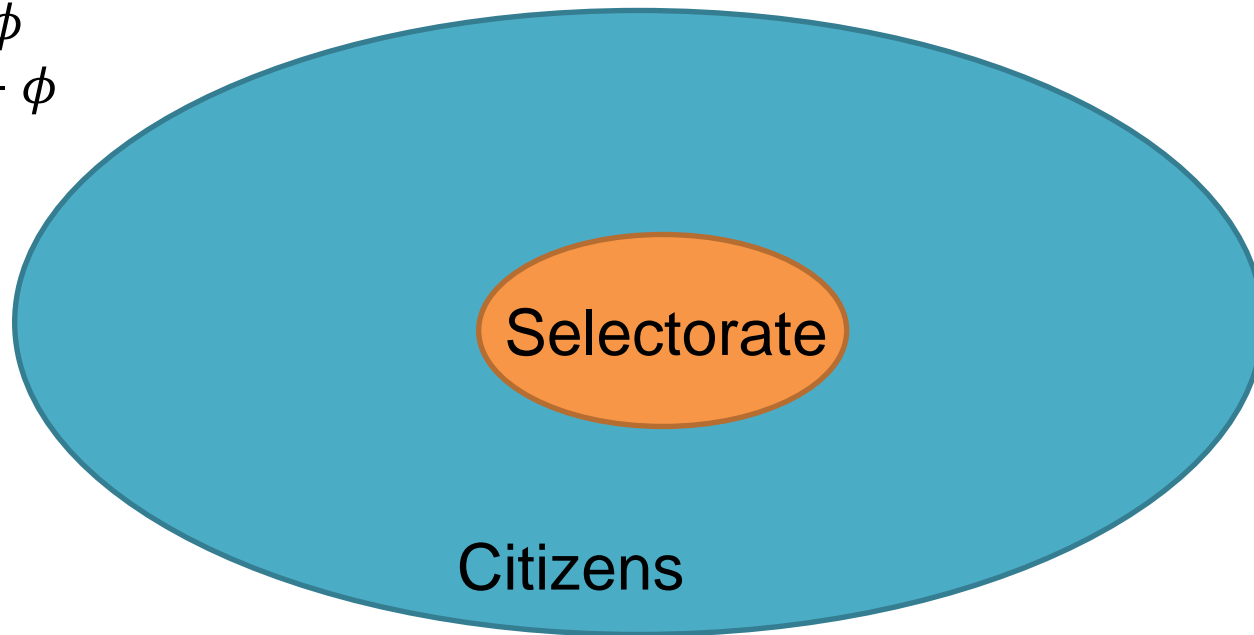
A defector from the selectorate faces the risk that he will be excluded from the selectorate of the new leader in the future. The probability of being essential in the new leader's selectorate is ϕ.

If ϕ is small, there is high risk of exclusion from the new leader's selectorate, and high loyalty of selectorate members.

THE STAGE GAME BETWEEN THE LEADER AND THE SELECTORATE

WEAK SELECTORATE

- Suppose $\phi \leq \dfrac{X}{X + \Delta\pi}$.

- In this case, the selectorate will choose to retain the incumbent leader even if its members are certain the leader is non-congruent, because the probability of being in a newly appointed selectorate in the next period is too minimal.

- In this situation, the selectorate is completely loyal to the leader as its members are afraid of losing their privileges and therefore support the leader regardless of the policy choices she has made.

- The non-congruent leader, knowing that she will always be supported, will choose the inefficient policy.

Strong selectorate

- Suppose $\phi \geq \dfrac{X}{X+\Delta\pi}$.

- When the selectorate is sufficiently large, its members have the incentive to remove the non-congruent incumbent.

- The leader's behavior depends on the rent the leader can extract in the first period.

  – When the rent is very high, the leader may still choose to take the rent, even if she anticipates her removal in the next period.

  – When the rent is very small, the leader will implement the congruent policy. Because the expected payoffs from holding office is greater than today's personal rents, so that the incumbent leader has more to lose from being removed from office.

Selectorate accountability and China's reform

- After Deng Xiaoping returned to his post (July 1977), he laid out a political agenda which proposed a system governed by rules, clear lines of authority and collective decision-making institutions to replace the over-concentration of power and patriarchal rule that had characterized China under Mao.

- All these policies launched by Deng Xiaoping led to a significant expansion in the size of the selectorate, from a tiny coterie of members of the leader's inner circle to a much larger coalition including revolutionary elders, military leaders, younger generation of CCP leaders, members of the Central Committee, and other high-ranking officials of the central or local party and government apparatus.

- As the size grows, we expect an increased role of the selectorate in constraining the leader's behavior, and this was exactly the case in China during Deng's era.

CONSIDER AN EXTENSION

- After the 1989 Tiananmen Incident, the political reform was trapped. The selectorate became more likely to be subordinate to the central leadership rather than a disciplinary device.

- But only after a short economic contraction period in the following two years, after Deng Xiaoping's famous southern tour in 1992, the Chinese government continued to promote economic growth and deepened the market economic reform, the governance had improved and the policies had become more people centered.

- Question: Why could the Chinese government be accountable even when the selectorate was captured?

- The accountability of the Chinese leaders after the 1980s might come from the pressures outside the regime --- the citizens and their potential revolutionary threats, because the leaders want to use high economic growth to maintain social stability.

Number of Labor Disputes and Estimated Number of Mass Incidents in China
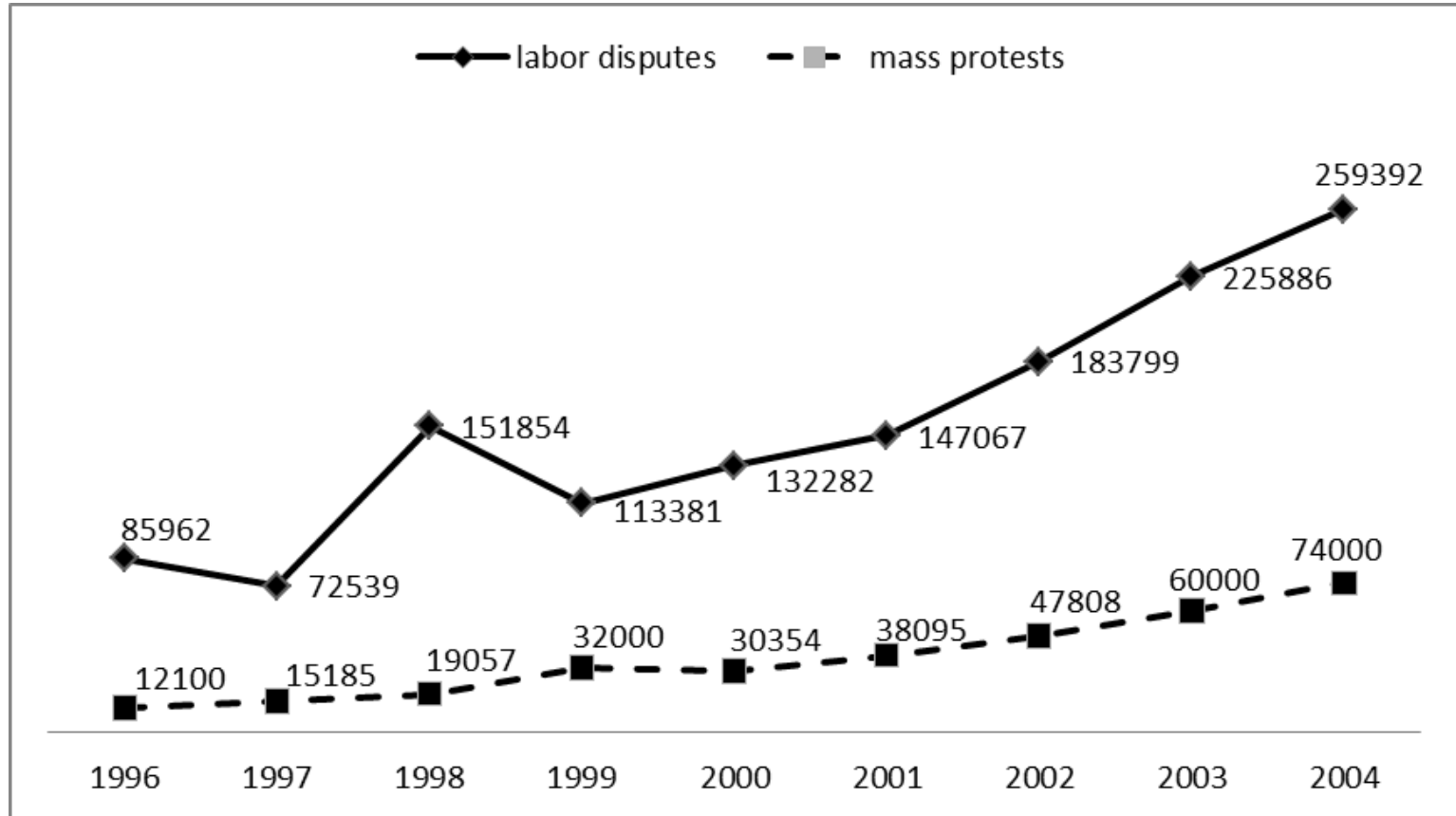
Reference: Yuan Li, 2014, *The Economics of Transition*, 22(1), p. 69–103.

THE REDUCED COST OF REVOLUTION

- In the past, the cost of revolution was enormous because Chinese authorities used to attribute social unrest to enemy conspiracies and suppressed them with tough means.

- But gradually, they begin to embrace the economic causes of the unrest and recognize that it was no longer possible to force protests back down to the very low rates.

- Nowadays the central leadership even tolerates the small scale riots, thus making the cost of revolution smaller.

- For the post‐2000 period, the internet has facilitated revolt in many countries. It facilitates the coordination among the citizens thus reduce the cost of revolution further.

Yuan Li (2014). Downward Accountability in Response to Collective Actions: The Political Economy of Public Goods Provision in China. *The Economics of Transition.*

- **GENERAL QUESTION :**
  - If political survival is the main concern of the leaders, will they implement policies to satisfy the people's demands in response to collective actions by the people?
- **COLLECTIVE ACTIONS :**
  - Labor disputes
- **PEOPLE'S DEMANDS :**
  - Freedom to have babies
  - Health care
  - Education

THE STAGE GAME BETWEEN THE LEADER, THE SELECTORATE, AND THE CITIZENS
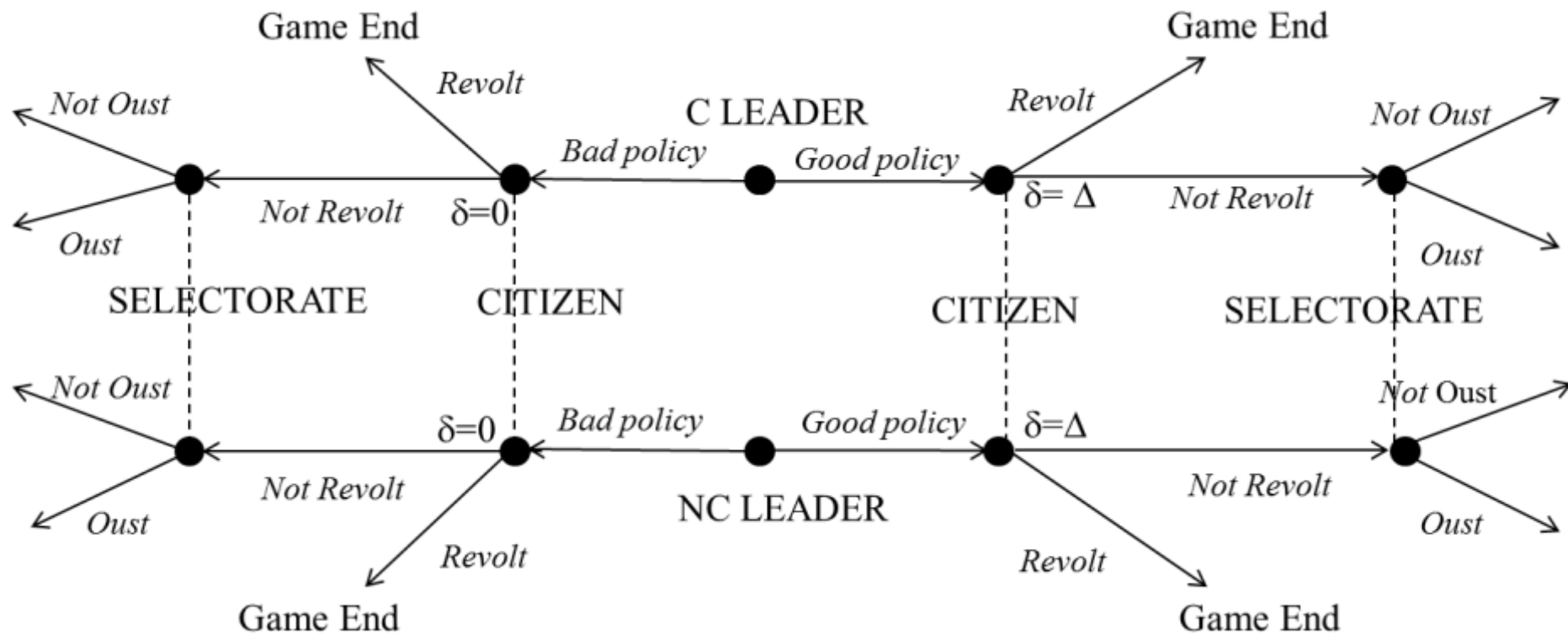
Reference: Yuan Li and Mario Gilli, 2014, *Journal of Institutional and Theoretical Economics,* 170(4), 616-645.

Maintain Social Stability, A New Source of Accountability

- Maintaining stability has become the top priority of the top leadership in China (Shirk 2007).

- Pursing high economic growth to maintain social stability has become the best choice to solve the current problems, because robust economic growth improves living standards and creates new opportunities to promote general optimism and acceptance of the current system. (Liberthal 2004)

- This strategic vision at the top of the political system has guided the reform along its process. From Jiang Zeming's initiation of the "Development of the West" campaign, to Hu Jingtao's proclaimed goal of a "harmonious society", all of them intended to improve the lives of Chinese poor citizens and thus steer China away from the looming social volcano.

QUESTION

- Is a too strong selectorate good?
- Is a too small cost of revolution good?

- Collateral finding by exploring the interaction of two mechanisms that might constrain the power of dictators
  - The threat of both coups and revolutions have non-monotonic effects on the dictator's incentives because they only deter a dictator from implementing inefficient policies within some range of parameters.

POLICY OUTCOMES IN AUTOCRATIC REGIMES
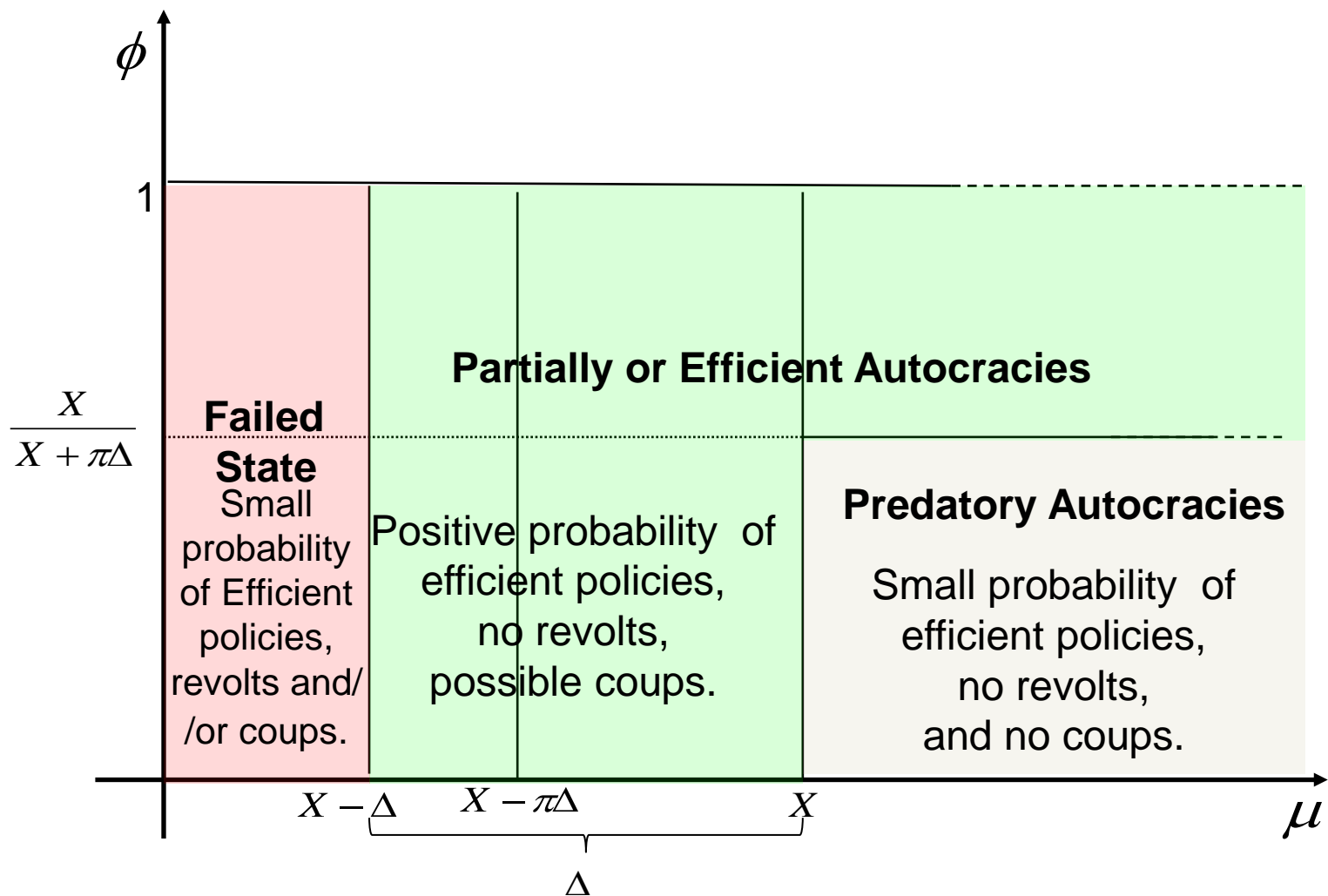
Reference: Mario Gilli and Yuan Li, 2015. Coups, Revolutions, and Efficient Policies in Autocracies. *European Journal of Political Economy*, 39, 109–124.

THIRD

Why the Chinese leaders accept formal, institutional constraints on their authority?

Examples of formal institutions in China

- The highest leading body of the Party is the National Congress and the Central Committee elected by it. The National Congress of the Party is held once every five years and convened by the Central Committee. The Central Committee of the Party is elected for a term of five years. The Political Bureau, the Standing Committee of the Political Bureau and the General Secretary are elected by the Central Committee at the plenary session. (Constitution of the Communist Party of China)

- President of China is the head of the state, who is elected by the National People's Congress. The term of office of the president and vice president is 5 year, and they shall serve no more than two consecutive terms. (Constitution of the PRC)

- Mandatory retirement ages at various levels of the government hierarchy.

DECISION MAKING INSTITUTIONS

- "Collective leadership" within the Party and the government.

- "Delegation by Consensus"
  - If the agents agree, the decision is automatically ratified by the higher level.
  - if the agents cannot agree, then the authorities step in to make the decision, or the matter is dropped or tabled until consensus can be achieved.

- Why have institutions such as collective leadership effectively constrained the last two generations of Chinese leaders?

- More generally, why would any dictator accept formal, institutional constraints on his authority?

- Institutions contribute to authoritarian stability (Svolik, 2012, *The Politics of Authoritarian Rule, Ch. 4.*).

INSTITUTIONS AS COMMITMENT DEVISE

In much of economic theory actors try to:

Maximize utility

    subject to: Budget constraint (scarce means)

In economic theory <u>with institutions</u> actors try to:

Maximize utility

    subject to: Budget constraint (scarce means)

<u>AND</u>

    subject to: Institutional restrictions

(why would "humans <u>device</u> *constraints* that shape interaction"? Because, they can be beneficial).

THE VALUE OF COMMITMENT

The possibility to commit to behaving in a certain way in the future is potentially beneficial.

We all recognize the problem that we sometimes want to take some action but when it comes to actually doing it we perceive the situation a little differently and sometimes fail to go through with it.

Examples include going for a run, losing weight, stop smoking, get out of bed, go vote, new year resolution etc.

AUTHORITARIAN POWER-SHARING

- Authoritarian power-sharing refers to agreements over the sharing of the spoils from joint rule.

- Moral hazard problem or commitment problem.

- The dictator is always tempted to betray his allies by defecting on his promise to share the spoils of joint rule.

- Because dictatorships
  - inherently lack an independent authority that could enforce agreements among the ruling elites.
  - violence is the ultimate arbiter of political conflicts.

- Therefore,
  - misperceptions of the dictator's actions may easily breed suspicions that spawn intra-elite confrontations that needlessly bring down a dictator or even an entire regime.

INSTITUTIONS ALLEVIATE COMMITMENT AND MONITORING PROBLEMS

- Authoritarian regimes benefit from establishing political institutions that alleviate commitment and monitoring problems in authoritarian power-sharing.

- Institutionalized power-sharing increase the transparency among the authoritarian elites.

- Greater transparency among the ruling elites prevents misperceptions of the dictator's actions from escalating into regime-destabilizing confrontations.

But formal Institution can fail

- In fact, formal institutions for "collective leadership" were put in place already under Mao, but these formal institutions failed to prevent Mao's arbitrary exercise of power.

- According to some observers, "collective leadership" also failed to effectively constrain Deng Xiaoping himself, although it was advocated by Deng after Mao's death.

QUESTION

- Why have formal institutions of collective leadership successfully governed the tenures of Jiang Zemin and Hu Jintao but failed to constrain the personal authority of Mao Zedong?

TABLE 4.1. *Institutions, Balance of Power, and the Success of Authoritarian Power-Sharing*

| | A Dictator's Power vis-à-vis Allies | | | |
	Low	Medium	Large	Very Large
Need for allies:	Yes	Yes	Yes	No
Credible power-sharing:	With and without institutions	Only with institutions	Not feasible	Neither feasible nor necessary

The effectiveness of institution depends on the credibility of the threat of the ruling elites replace the dictator.
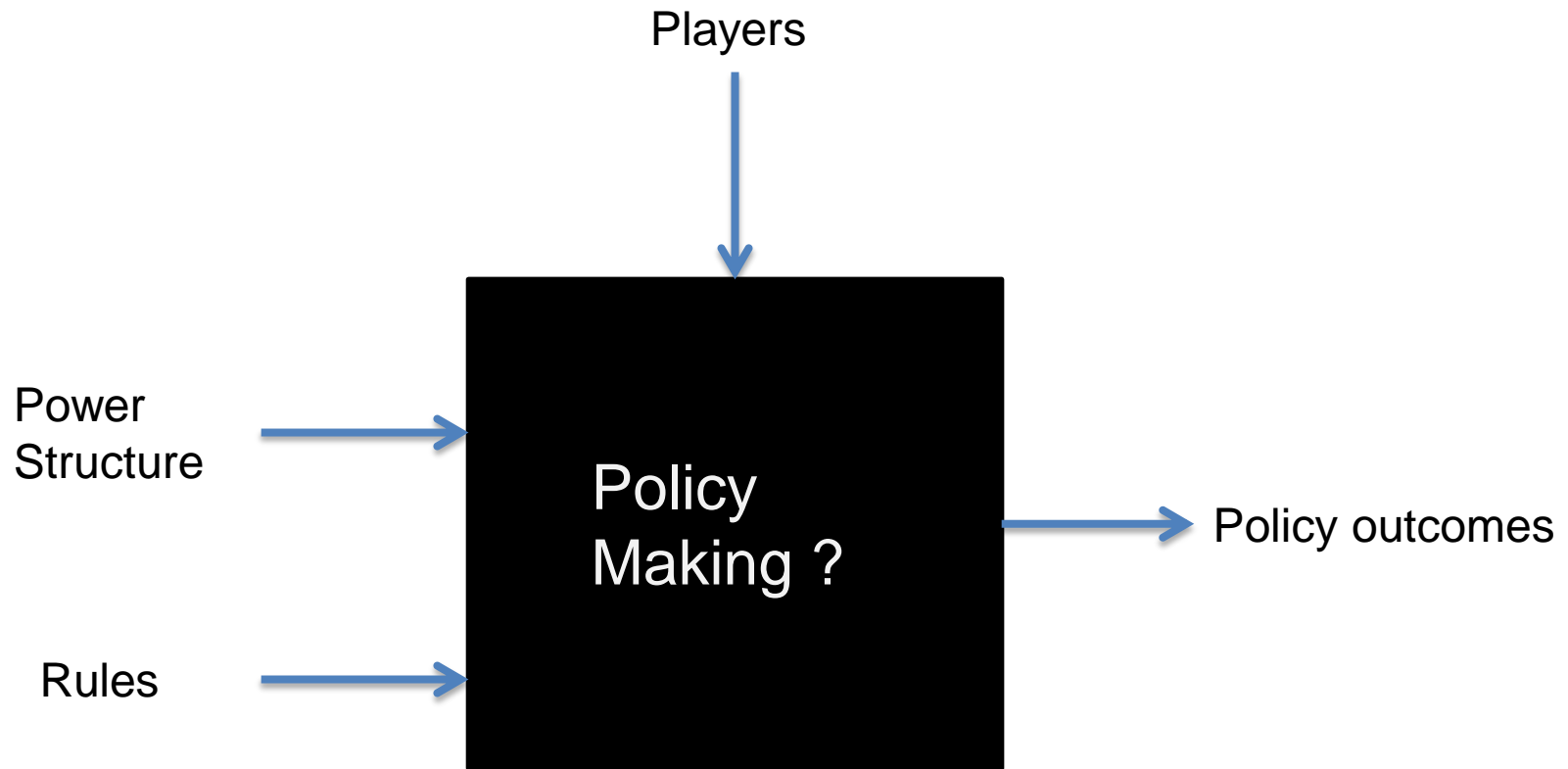
In fact, institution is effective, only when the balances of power between the dictator and the ruling elites is characterized as "medium".

Reference: Svolik, 2012, *The Politics of Authoritarian Rule, Ch. 4.*

FOURTH

Policy-making in China: Logrolling among interest groups

POLICY MAKING BLACK BOX IN CHINA

Players

Power
Structure

Policy
Making ?

Policy outcomes

Rules

This picture (or question) was also mentioned by John de Figueiredo on Monday concerning the policy-making blackbox of the US!

Methods to study policy making in China

China study + Positive approach of political economics

Policy Making in China

- In China, bureaucratic interest groups are stove-piped - meaning they are separate vertical organizations, reaching down from Beijing to the provinces and cities. Each bureaucracy pushes for policies in their own interests - to increase its own budgets, staffing, etc.. The leaders make decisions by log-rolling (or trading favors) with each other. They follow the rule, "I'll go along with what you want to do in your domain, if you let me call the shots in my domain"

<div align="right">---Interview with Susan Shirk</div>

LOGROLLING

The individual may "sell" his vote on a particular issue, securing in return the votes of other individuals on issues of more direct interest.

----The Calculus of Consent, Buchanan and Tullock 1962, p. 92

- Try to explain policy making in autocracy by developing an analytical framework with a specific focus on "logrolling" among groups have parochial interests, both theoretically and empirically.

- Specific question: What is the consequence of logrolling on policy outcome?

- We find government spending on policies under logrolling tend to be inefficiently high and on policies excluded from logrolling tend to be inefficiently low.
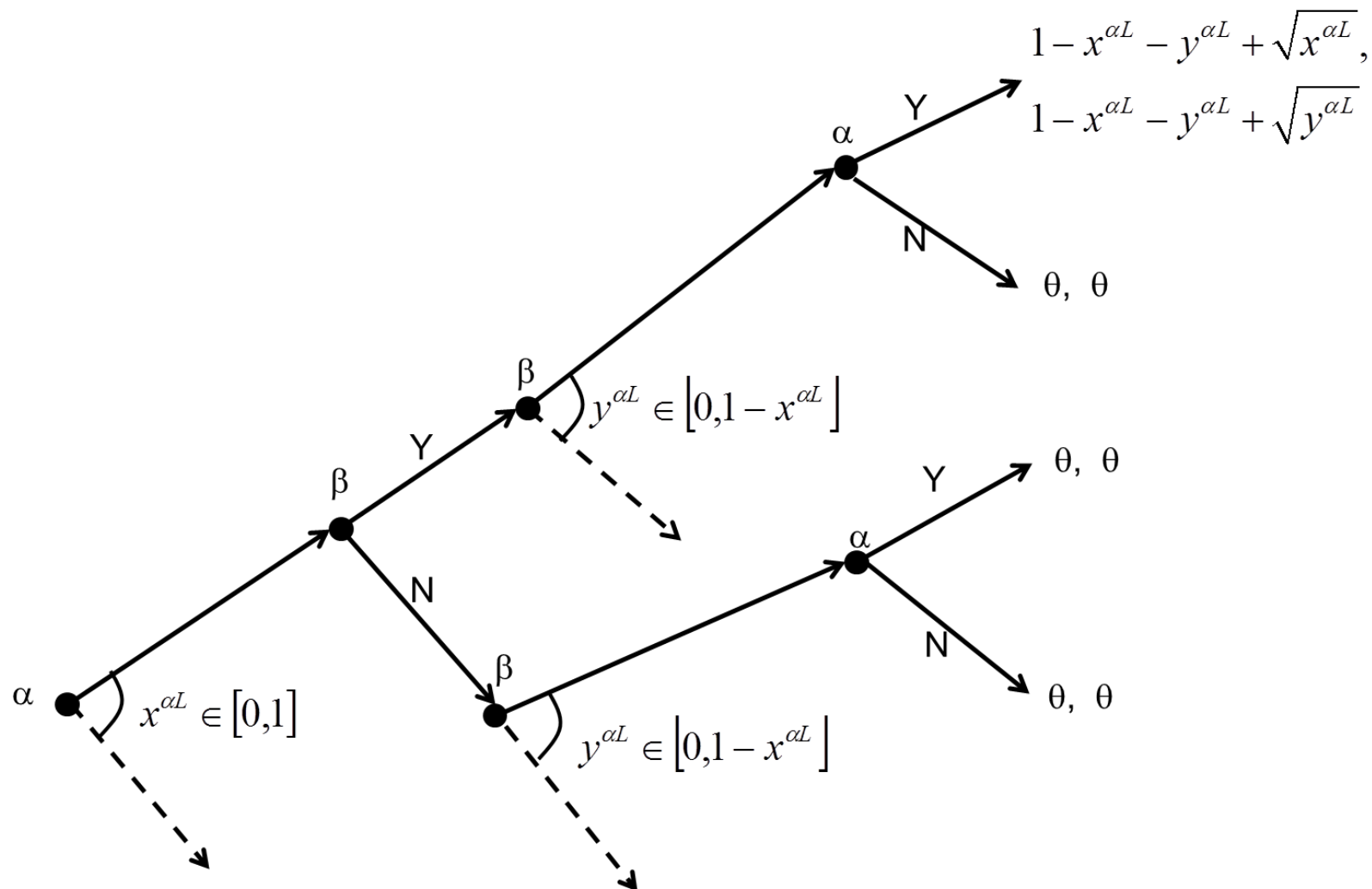
THE MODEL

- Consider a society with distinct but homogeneous interest groups $I \in \{\alpha, \beta\}$, each interest group can be seen as a single player α and β.

- Group α has preferences, $U^\alpha(x, y, h) = h + \sqrt{x}$

- Group β has preferences, $U^\beta(x, y, h) = h + \sqrt{y}$

- h is general public good. $x \in [0,1]$ and $y \in [0,1]$ are group specific good. The resource constraint is x+y+h≤1.

- Each group has more intensive preference over group specific good than public good.

THE MODEL

- We consider the simplest logrolling process

1. α proposes a motion $x^a \in [0,1]$.

2. β chooses whether to support or not α's proposal, i.e. $c^\beta \in \{Y, X\}$.

3. β proposes a motion $y^a \in [0, 1 - x^a]$.

4. α chooses whether to support or not β's proposal, i.e. $c^\alpha \in \{Y, X\}$.

5. If the two players supported each other's proposal, i.e. we say a logroll is forged, and the proposals $(1 - x^a - y^a, x^a, y^a)$ in the logroll are implemented.

6. Otherwise, if any player rejected the other, we say the logrolling failed. Then a default outcome gets implemented, hence both players will get the reserve utility $U^D = \theta \in [0,1]$.

THE GAME TREE OF LOGROLLING

$$1 - x^{\alpha L} - y^{\alpha L} + \sqrt{x^{\alpha L}},$$
$$1 - x^{\alpha L} - y^{\alpha L} + \sqrt{y^{\alpha L}}$$

α Y

N

θ, θ

β

$$y^{\alpha L} \in \left[0, 1 - x^{\alpha L} \right]$$

β Y

N

β

α Y   θ, θ

N

θ, θ

α

$$x^{\alpha L} \in \left[0, 1 \right]$$

$$y^{\alpha L} \in \left[0, 1 - x^{\alpha L} \right]$$

The allocation (h, x, y) under different decision-making rules

- The allocation under utilitarian social planner

$$\left(\frac{7}{8}, \frac{1}{16}, \frac{1}{16}\right)$$

- When decision-making is by a dictator (when one group dominates the other), the allocation is

$\left(\frac{3}{4}, \frac{1}{4}, 0\right)$ or $\left(\frac{3}{4}, 0, \frac{1}{4}\right)$ depending whether α or β is the dictator

- When decision-making is by ultimatum bargaining, the allocation

is

$$\left(\frac{3}{4}, \frac{1}{4}, 0\right) \qquad\qquad if\ \theta = [0, \frac{3}{4}]$$

$$\left(\theta - \frac{1}{2} + \sqrt{\frac{5}{8} - \frac{\theta}{2}}, \frac{5}{8} - \frac{\theta}{2}, \frac{7}{8} - \frac{\theta}{2} + \sqrt{\frac{5}{8} - \frac{\theta}{2}}\right) \quad if\ \theta = [\frac{3}{4}, 1]$$

if α is the first-mover. ·

- When allocation under logrolling is $\left(\frac{1}{2}, \frac{1}{4}, \frac{1}{4}\right)$

THE IMPLICATION

- Our model shows logrolling leads to overspending compared to the bench mark of utilitarian social planner, dictatorship and bargaining.

- We find that through logrolling, there is overreaching in projects that benefit particular interest groups, even though the costs are dispersed throughout the entire populace in the form of deficiency in public goods provision.

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