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# The Political Economy of Property Rights In China: Local Officials, Incentive Structure, And Private Enterprises

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**THE POLITICAL ECONOMY OF PROPERTY RIGHTS IN CHINA: LOCAL  
OFFICIALS, INCENTIVE STRUCTURE, AND PRIVATE ENTERPRISES**

by

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Submitted in Partial Fulfillment of the Requirements

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DEDICATION

*To My Parents and Son Immanuel*

## ACKNOWLEDGEMENTS

I would like to express my special thanks to my committee members. Professor John Fuh-sheng Hsieh, my committee chair, has given me his guidance with his patience and intellectual expertise in the preparation and writing of this dissertation. He led me to the research field of comparative political economy and gave me much needed encouragement and inspiration. Professor Lee D. Walker has offered me great support and valuable insights, which helped me improve the scientific rigor in this project. Dr. Gordon B. Smith and Dr. Gerald A. McDermott provided help on both arguments and empirical analysis, read my dissertation at various stages, and offered critical comments and suggestions.

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## ABSTRACT

My dissertation tries to solve two puzzling questions in China's economic miracle: why some private firms enjoy better property rights protection than others under similar political and economic institutional conditions. Secondly, under the incentive structure designed by the central government, why some local officials in some localities actively protected private property rights than others hence foster local economic development. Existing literature either emphasizes social networks or focuses on fiscal decentralization and personnel control system. But neither these accounts is able to systematically explain the considerable variation of private property rights protection across regions and over time.

I develop a game-theoretical model to study the political economy of property rights in China, that is, a bargaining game between a firm and a local political official to explain these empirical puzzles. Under the current institutional arrangements, resources and constraints created by the incentive structure of the Cadre Evaluation System (CES) affect goals and strategies of both local political officials and private investors in that bargaining relationship. A firm with a high level of Firm Specific Assets (FSAs) may possess strong post-entry bargaining power, and thus enjoy better protection of the local official, but a weak firm is vulnerable to the local officials' predatory activities, and

therefore needs to rely on other mechanisms, such as their social networks or bribery, to overcome the commitment problem. In particular, all else being equal, the availability of an exit option greatly enhances the private firms' post-entry bargaining power vis-à-vis local political actors.

In addition, the degree of symbiotic relationship between the local officials and indigenous private entrepreneurs determines the level of private property protection. Compared to rotated officials, native local officials have fewer political connections with higher-level officials and therefore have less chance to be promoted in the power hierarchy. This condition makes them seek the support of local economic actors for their political survival. Moreover, native local political leaders who were born in their jurisdiction have lower transaction costs, and therefore a symbiotic relationship between native local officials and local private entrepreneurs is feasible. The chances were high that the native leaders would have close ties to local economic actors and face more strict social constraints; therefore, they were more likely to protect local property rights.

I statistically test the effects of firms' characteristics on the security of property rights using different types of evidence including a nationwide survey data in 2012 and media reports on government-related property rights expropriation cases. With the proxy of property rights protection, I also provide systematic empirical evidence from Guangdong province both cross-sectionally and over time to test the effects of different types of local political leaders by investigating the characteristics of 203 prefecture-level political leaders between 1992 and 2008. A detailed case study of local B&B industry



policymaking in Xiamen, Fujian province, utilizing government reports, news reports, as well as interview notes of fieldwork, further supports the model.

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## LIST OF ABBREVIATIONS

B&B .....	Bed and Breakfast
CCP .....	Chinese Communist Party
CES .....	Cadre Evaluation System
COEs .....	Collective-Owned Enterprises
CPC .....	City People's Congress
DOO .....	Department of Organization
FDI .....	Foreign Direct Investment
FIEs .....	Foreign Invested Enterprises
FSAs .....	Firm Specific Assets
GDP .....	Gross Domestic Product
GSMC .....	Gulangyu-Wanshi Scenic Management Committee
MNCs .....	Multinational Corporations
OBM .....	Obsolescing Bargain Model
PBM .....	Political Bargain Model
SOEs .....	State-Owned Enterprises

# CHAPTER 1

## INTRODUCTION

### *The Puzzle of Property Rights Protection in China*

Property rights are believed to be a critical factor fostering economic growth (North 1990). And yet, authoritarian governments often have difficulty in making credible commitments to protect property rights, thus negatively affecting economic development (Acemoglu et al. 2001; Weingast 1995). Nonetheless, and contrary to conventional wisdom, China has been able to achieve an economic miracle despite the absence of credible institutions to protect property rights. The case of China poses an intellectual puzzle. Private ownership has been increasing dramatically without the rule of law to overcome the commitment problem. China enacted its first law to explicitly protect private property in 2007, but the law does not provide enough details or effective enforcement mechanisms. With one-party communist rule and no independent judicial system to protect property rights, private investors, especially those indigenous private entrepreneurs, may appear to be taking a big risk.

To solve the puzzle, several explanations have been offered to account for how China has been able to overcome its institutional deficiencies and make credible commitments to investors. Research on property rights in China often resorts to social networks (Nee and Oppen 2012; Wang 2013; Tsai 2002; Wang 2002; Wank 1999), fiscal federalism (Oi 1999; Qian and Weingast 1997; Weingast 1995), or the personnel control



system (Li and Zhou 2005). Despite all the efforts, we have little knowledge about why some private firms enjoy better property rights protection than others under similar political and economic institutional conditions. Under the incentive structure designed by the central government, why did some local officials in some localities actively protect private property rights more than their counterparts hence fostering economic development?

Instead of looking for reasons of economic growth or China's economic miracle, which has been studied extensively by existing literature, this research is interested in the solutions to overcome the commitment problem in China. I provide a political-economic explanation that shows some solutions may result from strategic interactions among political and economic actors at the local level rather than solely as a result of a commitment device from above. Studying these questions with focus on local institutions is not to suggest that the central government has lost its imperative grips over economic matter. Rather, this research is to specify the mechanisms that have fostered the de facto property rights under political institutions designed by the central government. Local agents have reached a relatively stable equilibrium under certain conditions and with various resources.

### **1.1 Local Officials and Variations in Property Rights Protection**

The development of the private sector in China has gone through an uneven path of institutional and structural changes. From the perspective of local economic actors, market-oriented policy and 2007 law of property rights are clear signals regarding the central authority's commitment for the development of private economy. But with occasional "left" and "right" ideological swing and no independent judicial system, the

government could not make that commitment credible in terms of property rights protection.

China's policy was favorable toward Foreign Direct Investment (FDI) not only because China needs capital, technology, and access to the global market but also because China wants to show its commitment to be open to the outside world. In this way, China's policy toward FDI as a self-enforcing mechanism addresses the commitment problem.

Less favorable than foreign investors, however, domestic private entrepreneurs have been facing a more difficult situation in which the commitment problem is the major one. As with most of China's economic reforms, policies governing the private sector have evolved in an experimental, incremental, and sometimes contradictory manner. As a result, private entrepreneurs can only rely on themselves in protecting their property rights.

Although there are similar formal institutional arrangements at subnational levels in China, each locality still enjoys a certain degree of autonomy. Generally, operations of private firms are embedded in complex local institutions and social networks that affect the day-to-day interactions between local political actors and private firms. While the central government has demonstrated their commitment to a market economy and thus reduced the political risks faced by private firms, local governments often emerge as a major source of uncertainty for the firms. Moreover, because of the "local autonomy" nature of the personnel control system and the moral hazard problem inherent in a principal-agent relationship between different levels of government, whether local governments play "grabbing hands," "helping hands," or "steady hands" really depends

on the individual local officials. Without an effective institutional mechanism to tie local political actors' hands, private investors would face a significant risk because once their investments are in place, their bargaining power diminishes, local governments may not stick to their promises, and local political leaders with their great deal of discretionary power may pursue their own political and economic goals vis-à-vis the private firms.

## **1.2 The Theoretical Framework: A Bargaining Game**

This research starts from the point that most Chinese local political actors are supervisors of the governments (both central and local) and simultaneously principal of their immediate subordinates at lower levels. The most powerful incentive that drives these local agents is their concern to get more power through promotion in the multi-layered power hierarchy. The “competition for promotion” literature assumes that the primary goal of local political leaders is to be promoted to a higher rank (Li and Zhou 2005). I relax this assumption by including economic interests. The local official is thus assumed to be an expected utility-maximizer. His/her goals include not only promotion (career concerns) but also monetary interests. Local political actors' economic interests are achieved through the pursuit of political power due to the unique career pattern in China. Chapter 2 will show three distinct features of the career patterns of political actors within the Chinese power hierarchy: 1) almost permanent tenure as long as secured in an office; 2) almost no job options outside the political career once you are in; 3) age limits for mandatory retirement (Li and Zhou 2005).

As Chapter 2 details, the Cadre Evaluation System (CES) is widely believed to be an incentive structure designed by the central government to help control local officials in the administrative hierarchy. It can be used to discipline local party and government

leaders and increase their compliance with the policies made by higher-level governments (O'Brien and Li 1999; Whiting 2001; 2004; Edin 2003; Tsui and Wang 2004; Heimer 2006; Minzner 2009). The CES powerfully shaped the behavior of Chinese local officials by linking both monetary interests and promotion incentives to their performance on the tasks listed in the system.

Scholars identify four important factors that determine the prospect of further promotion of local officials: 1) job performance within the jurisdiction; 2) education; 3) age; 4) personal ties with one's superior in charge of promotion. For some scholars, the first one is one of the most important factors (Li & Zhou 2005), while others argue the last one (Zhong 2003). One thing worth noting is that local officials will be rewarded according to how well they meet the standard but rarely be punished (demoted) if they don't.<sup>1</sup>

For building up an effective control and incentive mechanism, term limits and rotation system were introduced that intends to solve the problem of asymmetric information, shirking, and monitoring. Both term limits and the cadre rotation system are expected to serve the purpose of aligning divergent preferences and reducing asymmetric information. More specifically, the rotation system is expected to prevent tie-cultivation in the hierarchical power structure and local protectionism (Chen and Zhao 1996; Blanchard and Shleifer 2001; Zhong 2003).

In discussing the role of local political officials on economic growth, the existing literature often confuses the goals of local political leaders and that of local government. I detach political actors from government because the goals of government are not always

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<sup>1</sup> This is due to the first distinct feature of the career pattern in China administrative hierarchy.

identical with those of political actors and hence I reconsider the role of local political leaders on economic development in general and property rights protection in particular.

There are three players in the local economy, Government (G) is the principal, the local political official serves (S) as the supervisor and the Private entrepreneur (P) is the agent. In the context of China, I identify political actors as local political leaders, economic actors as indigenous private entrepreneurs, and government includes central and local.

I make an extremely simple assumption that the goal of government and political actors may not be the same. Government (G), both central and local, cares about tax revenue and the primary and foremost concern of local political leaders (S) is to stay in office and be promoted to a higher rank. The ultimate goal of local officials, however, is to acquire more wealth and secure their possessions. In other words, the pursuit of political power is the means to achieve the end (wealth acquisition). The old saying “*shengguan facai*” (more power more money)<sup>2</sup> demonstrates the logic of career concerns with Chinese characteristics. For the indigenous private entrepreneur (P), what he/she wants is not only to maximize profit but also to secure property rights.

The theoretical literature indicates that the solution to the commitment problem may result from strategic interactions among political and economic actors rather than solely as a result of a commitment device (Weimer 2001). Chapter 2 presents a simple bargaining game between a private firm and a local official following the literature of the Obsolescing Bargain Model (OBM) and the Political Bargaining Model (PBM), which explain bargaining relations between a FDI firm and a host country (Vernon 1971; Eden et al. 2005). Chapter 2 and Chapter 3 discuss in detail the resources and constraints of

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<sup>2</sup> The old saying *Shengguan Facai* implies that if the power not for money, why power?

local political officials under the current personnel control system and private sector investors, and show how these conditions and constraints determine their bargaining power in the bargaining process.

I model the relationship as a bargaining game with conflicting goals, and hypothesize that a firm has strong bargaining power at the time of entry when the local official, under the pressure of the performance-based evaluation by his or her immediate superiors, understands that the firm has other options. However, once the firm has made sector-specific investment, its capability to resist the official's predatory actions relies upon its firm-specific characteristics. Chapter 3 identifies the mechanisms that may resolve the credible commitment problem and shows how the incentive structure designed by the central government constrains the predatory activities of the local officials in dealing with private firms with a high level of Firm Specific Assets (FSAs). In this way, the incentive structure provided by the CES, worked together with the firm-specific characteristics, results in a stable condition for the protection of property rights. While a firm with a high level of FSAs may possess strong post-entry bargaining power, and thus enjoy the protection of the local official, a weak firm has to rely on other mechanisms, such as its social networks, to overcome the hurdle.

Another equilibrium that emerges from the symbiotic relationship between local political officials and economic agents, which creates conditions similar to secure property rights at the local level. The degree of symbiotic relationship between the local officials and indigenous private entrepreneurs determines the level of private property protection. Compared to transferred officials, native local officials have fewer political connections with higher level officials and therefore have less chance to be promoted in

the power hierarchy. This condition makes them seek the support of local economic actors for their political survival. Moreover, native local political leaders who were born in their jurisdiction have lower transaction costs, and therefore a symbiotic relationship between native local officials and local private entrepreneurs is feasible and easier. The chances were high that the native leaders would have close ties to local economic actors and face more strict social constraints; therefore, they were more likely to protect property rights.

### **1.3 What Is Property Rights? An Operational Definition**

The term “property rights” has two traditions in the economic literature. One is defined as the ability to enjoy a piece of property (Alchian 1965, 1987; Cheung 1969). The other older definition stresses that “what the state assigns to a person” or the enforcement of rights (Ellickson 1991; Barzel 1997). Barzel calls the first “economic property rights” and the second “legal property rights.” He argues that “economic rights are the end (that is, what people ultimately seek), whereas legal rights are the means to achieve the end” (Barzel 1997: 3).

I use the definition that includes both economic rights and legal rights with focus on legal rights and the enforcement of rights. This is especially relevant as China is still a socialist state despite decades of economic reform. The Chinese Communist Party (CCP) tried very hard to eliminate private property rights since it seized power in 1949. Before the Reform era starting in 1978, private property was strictly forbidden. Anyone who ran a private business would be severely punished, including being arrested and persecuted. Only in 2007, China enacted its first law to explicitly protect private property rights, but it still does not provide enough details for the enforcement of the law.

There are two theoretical traditions that identify the threat to private property rights. In the view of Hobbes, the main threat to property rights is from private actors, and therefore requires strong state institutions as a remedy. Another line of argument lies in the tradition of Locke, which sees the threat to private property rights within the state itself, and therefore implies limiting state power to reduce arbitrary behavior in private property rights. At any rate, preventing the threats from both private actors and the state requires the rule of law.

In addition, the theoretical literature on the interaction of political and economic institutions shows that there is an inherent paradox on the interaction between the strong state and economic development. The problem is that any government strong enough to specify and protect property rights is also strong enough to seize them for its own benefit (North and Weingast 1989). How government can provide a credible commitment to its people is crucial for economic growth to occur in an authoritarian regime. The logic is that unless the government can provide a credible commitment to the population that it will not act in its own short-term interests by seizing property, the population will not invest. If there is no investment, there will be little economic activity, hence no growth.<sup>3</sup> In order to generate economic growth, the government must not only establish the set of rights but also must make a credible commitment to the population.<sup>4</sup>

The core interest of this research is to identify the mechanisms to overcome the commitment problem in China. For this purpose, it will focus on the threats from the state to private property rights. Basically, there are two types of predatory actions that may be

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<sup>3</sup> Stephen Haber, Razo Armando and Maurer Noel. *The Politics of Property Rights* (Cambridge: Cambridge University Press, 2003), p. 2

<sup>4</sup> Douglass North and Barry Weingast, "Constitutions and Commitment: the Evolution of Institutions Governing Public Choice in Seventeenth-Century England", *The Journal of Economic History*, Vol XLIX, Number 4, December 1989.



taken by the state: direct and indirect taking of property. Direct taking of property can take various forms, ranging from outright nationalization on a sectoral basis to the seizure of a firm by the government to outright confiscation of the property (Zheng 2007).<sup>5</sup> In the case of China, indirect expropriations are a common practice manipulated by local officials, which may involve arbitrary fees and fines collected by local governments, or even “charitable contributions” to government-sponsored projects (Nee and Opper 2013).

#### **1.4 Research Contributions**

It is often argued that countries without the rule of law can rely only on other mechanisms to overcome the commitment problem. The current literature identifies several solutions to the credible commitment problem. While the authoritarian system is a big problem for potential investors who are concerned about political risk, dictators with a long time-horizon have encompassing interests and therefore may undertake proactive actions to improve economic institutions in order to raise sustainable tax revenues (Olson 1993; 2000; McGuire and Olson 1996). My study contributes to the literature on how authoritarian governments may be engaged in institution-building to encourage investment and hence to promote economic growth (Olson 1993, 2000). In particular, this research shows how the incentive structure set up by the central government in China constrains the local officials’ predatory activities in dealing with private firms with an exit option.

Second, my work is also related to the studies on selective protection of property rights. Both Greif and Haber et al. show how autocratic rulers enforce property rights selectively as a private good (Greif 2006; Haber et al. 2003). These rulers used different

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<sup>5</sup> Zheng (2007) in his study on FDI discusses expropriation and creeping expropriation according to UNCTAD 2003 (p.65).

strategies, trading the property rights protection of private owners for political support. Similarly, Robinson (2003) and Treisman (2003) demonstrate how the reformers of modern Russia, Argentina, and Brazil made similar deals with special interest groups to promote their reform agendas. Greif (2006) shows how the commitment problem can be solved through reputation or collective reputation, while Haber et al. (2003) focus on the third-party enforcement. Bueno de Mesquita et al. (2003) provide other examples and build a theory of a non-democratic government that is accountable to a selectorate, a group that has the power to determine the fate of the incumbent. Still other scholars suggest that political institutions like legislatures, parties, and even elections could work in a way to “credibly tie the dictator’s hands” against predatory actions, at least against a small group of elite (Gandhi 2008a; Gandhi and Przeworski 2007).

In this research, I provide evidence for the selective protection of property rights in another authoritarian regime, China, where the incentive structure designed by the central government creates conditions for secure property rights. My study reveals that, though facing the same institutional constraints of the CES, different types of local officials may act differently in dealing with private investment with dissimilar firm specific characteristics. Firms with high FSAs may possess strong post-entry bargaining power over local officials, and thus enjoy better protection of the local officials. Those native local officials who have less chance to be promoted are more likely in protecting private property rights, trading the property rights protection for their political survival.

Third, there is heated debate on whether behaviors of Chinese local states are developmental, corporatists, entrepreneurial, and predatory in terms of economic development, or whether economic performance results from inter-jurisdictional

competition or factional politics at the center (Li and Zhou 2005; Cai and Traisman 2006; Shih 2004; Shih et al. 2012). This study contributes to the debate by specifying the conditions under which local officials may play “grabbing hands” (predatory activities), “helping hands” (developmental orientation) (Shleifer and Vishny 1998), or “steady hands” (stable and credible protection of property rights). In particular, this research specifies conditions under which private property rights may be protected in an authoritarian regime. The study proposes a political-economic explanation of secure property rights, where the local political leaders protect private rights when symbiosis between local officials and private entrepreneurs is feasible.

Fourth, in the study of China’s economic development, scholars emphasize China’s political centralization in reducing risks of local protectionism and competition for rents (Blanchard and Shleifer 2000), and central coordination and enforcement capability in exercising macro-economic control over excessive and destructive local autonomy (Huang 1996; Li and Lian 1999). My work shows how the discretionary power resulted by the “local autonomy” feature of the CES led to the positive effects of local protectionism. Native political leaders tend to protect private property rights because they have less chances to be promoted in the power hierarchy and need the support from local economic actors for their political survival.

The study is also related to the literature of evaluating political connections in which the benefits are captured by economic actors with strong connections with political leaders (Fisman 2001; Faccio 2006). But this study also stresses the interdependent relationships between political and economic actors.

Finally, this research touches on the issue of corruption. Most studies suggest that the existing corruption levels are detrimental to development (Shleifer and Vishny 1993); yet, some argue for efficiency-enhancing corruption, the effects of which may be positive (Leff 1964; Huntington 1968; Li and Wu 2010). Hopefully, this paper will shed some new light on the coexistence of rapid growth and rising corruption in China (Li and Wu 2010; Wademan 2012). Some studies further distinguish among different types of corruption (Shleifer and Vishny 1993; Sun 2004; Wedeman 1997; Manion 2014). This study will emphasize the mutually beneficial exchange nature of corruption.

### **1.5 Research Design**

This research mainly uses sub-provincial level comparisons combining both qualitative and quantitative approaches. Sub-provincial comparisons can put macro institutional factors under control. Most studies on the role of local officials focus on provincial level officials. However, in countries like China there exists vast regional variation in fiscal arrangement, legal environment, and political and economic conditions. Therefore, it is not an appropriate context to study the empirical puzzling questions in this research. Sub-provincial studies in this research can put the institutional arrangements factor under control.

Sub-provincial level studies will also enable us to see processes such as economic reform or the cadre evaluation system as shown in this research, often have varied effects across the territorially-defined subunits of a political system. Studies on China's economic development often focus on the variation in economic performance between provinces, which does not explain the vast intra-provincial variation.

As for empirical studies, one of the biggest challenges of this research is to gauge variation in property rights protection in China, as there is not much research available to refer to and no indicators ready to use. I use arbitrary fees and fines paid by private firms and collected by the local government as an indicator to measure the degree of property rights expropriation. Chapter 3 provides discussion to justify the measurement.

I also use private investment in fixed assets as an indicator to measure the security of property rights. This is a good proxy for the security of property rights because this kind of investment requires significant immediate costs with only promise of future revenue. Chapter 4 details the justification of the identification as compared to the common use of Gross Domestic Product (GDP) growth rate or GDP per capita measurement in the study of economic development.

The detailed case study provides additional evidence to support my theory. The materials of case study are collected from my fieldwork in Xiamen, China from 2014 to 2015. For the basic facts of policymaking case, I use government reports, news reports, as well as interviews. It is noteworthy that interviews only serve as supplementary sources of information. The validity and reliability of constructed interviews may be questionable with its intervening nature, particular when informants consciously and unconsciously make sense of their research. The examination of media reports and government reports will help to restore an original context that seeks to make concrete reasons state agents give for their actions. My interviewees included officials, B&B business owners, chairmen of B&B associations, journalists, and scholars in Xiamen. To the purpose of methodological reliability in the interviews, I tried to ask the same questions of different people to find common answers.

For the unit of analysis, all the administrators between the central government and the village level are middle level supervisors, and should be included in the pool of observations. But for theory building and empirical studies, I locate the research at the prefecture municipality level. The municipal cities are the third level of China's political hierarchy. The top leaders at the municipal city level are the city Party secretary and the city mayors. This reflects the dual presence of communists Party and government organs at each level of China's political hierarchy.

Moreover, officials at various levels of government may behave differently in accordance with the resources they have in the face of the same incentive structure. For example, provincial officials are not "local officials" in a strict sense because though provincial leaders are the local supervisors immediately under the central government, many of them hold central positions simultaneously, like seating in the Politburo, or the Central Committee of the CCP. This arrangement demonstrates that they are under tight political control by the central government and share more common interests with the Center than lower level officials. Therefore, the behavior patterns of provincial officials with regards to local economic affairs cannot be applied to lower levels' officials.

Finally, prefecture-level governments enjoy more discretionary power over local industry policymaking than county level governments. Also, municipal city leaders have authority in managing fixed investment, land development, price setting for land lease, and even tax collection, and therefore enjoy more autonomy than those at lower levels of authority.

## **1.6 The Structure of the Dissertation**

In this introductory chapter, I first discuss the empirical puzzle, and then outline the research question driving this project and offer my theory. I also address the theoretical contributions of my study and its methodology.

The property rights protection in China to a large degree results from a bargaining game between private investors and local officials conditioned under the political and personnel control system. The next chapter provides the theoretical model for arguments made throughout subsequent chapters. I first briefly review the existing literature on the Chinese economic miracle and commitment problem. Then I examine the dual nature of Cadre Evaluation System (CES) and political control system that determine a local official's career with a brief review of the competing views on the effects of CES on economic growth. With their one-sided conclusions, previous studies are unable to tell on what conditions the CES can provide property rights protection (constrain or induce property rights predatory behaviors). I suggest a bargaining game under the principal-agent model by looking into how the CES shapes the prospect of further promotion of local officials—the most important incentives of Chinese officials. I conclude this chapter by arguing that the resources and constraints behind the bargaining power of private investors and local officials could provide property rights protection from rational choice perspective.

Chapter 3 discusses the bargaining game between private investors and local officials with focus on the examination of the private sectors' resources and argues that a private firm's features determine its post-entry bargaining power with local officials and therefore affect local officials predatory behaviors over private property rights. Finally,

this chapter provides two types of empirical evidence to test the proposed hypotheses quantitatively.

Chapter 4 examines the bargaining game under principal-agent model with focus on local officials' resources and argues that native local officials with fewer connections and more constraints have weakened bargaining power in relation to the local private sector and therefore are more likely in protecting private property rights in exchange for their support. In other words, all else being equal, native local political leaders who have less chance to be promoted in the power hierarchy have lower transaction costs, face more social constraints, and gain extra benefits in establishing symbiotic relationship with local private entrepreneurs and therefore tend to protect private property rights more than those transferred ones. This chapter also tests the proposed hypotheses by providing systematic empirical evidence from Guangdong province both cross-sectionally and over time by investigating the characteristics of 263 prefecture-level local political leaders between 1992 and 2008, and find that native political leaders promoted substantially higher level of private investment—the proxy for the protection of private property rights. The results are robust to various alternative specifications, including a model that accounts for heterogeneous regional characteristics, initial economic conditions, and socioeconomic factors.

Chapter 5 studies local industry policymaking in Xiamen. This detailed case study shows how local industry policymaking affects property rights protection. More importantly, it examines how policy choices of local officials in consideration of officials' promotion endeavor conditioned with their resources (no connection). It demonstrates that other things being equal, compared with transferred officials, native



local officials with less resources are more likely to promote private sector hence increase the level of property rights protection.

In the sixth and concluding chapter, I reiterate my theory of political economy of property rights with main empirical findings. Then I provide several general conclusions about property rights in China. Finally, I suggest areas for future research.

## CHAPTER 2

### **LOCAL OFFICIALS, INCENTIVE STRUCTURE, AND SECURE PROPERTY RIGHTS**

This chapter starts from a brief review of the property rights and commitment problem and locates the contribution that this research hopes to make to existing literature. I then provide a game-theoretical explanation under principal-agent framework for arguments made throughout subsequent chapters by examining the Cadre Evaluation System (*ganbu kaohe zhidu*), which determines local officials' careers through appointment, promotion, tenure, and removal from the 1980s to present. This is followed by a discussion of term limits and the rotation system in Chinese bureaucratic system. These systems are very powerful, because they have shaped local officials' behaviors, incentives, and ways of pursuing the benefits contained in the incentive structure. Following the theoretical framework, I propose a bargaining game between local officials and private investors under the principal-agent relationships and show how resources and constraints of both parties have affected the bargaining power, which determines the security of property rights at local level. The following chapters will be empirical studies and a case study to test the major hypotheses.

#### **2.1 The Existing Studies of Property Rights**

The current literature identifies several solutions to the credible commitment problem in countries without the rule of law. Theoretically speaking, the authoritarian system is a big problem for potential investors who are concerned about political risks.

But dictators with a long time-horizon have incentive to improve economic institutions for sustainable tax revenues (Olson 1993; 2000; McGuire and Olson 1996). However, dictators are under constant threats from their challengers and always worry about immediate political concerns (Svolik 2012; Wintrobe 1998). In the case of China, political leaders face constant factional power struggle as a result of party-state system where “collective leadership” rather a single dictator is in charge. Moreover, the introduction of compulsory retirements in 1980s and the rotation system in 1990s significantly shorten political leaders’ time-horizon and produced shortsighted behaviors.

Similarly, some scholars suggest that political institutions like legislatures, parties, and even elections could work in a way to credibly constrain the dictator’s predatory actions (Gandhi 2008a; Gandhi and Przeworski 2007). The logic is that these formal institutions can help enhance governance, addressing the commitment problem by imposing self-constraints. These institutions have been served as political signals making a credible commitment to potential investors that their investment will not be easily expropriated one day in the future (Gehlbach and Keefer 2009; Magaloni 2008; Myerson 2008; Svolik 2012). Bueno de Mesquita et al. (2003) provide other examples and build a theory of a non-democratic government that is accountable to a selectorate, a small group that has the power to determine the fate of the incumbent.

However, empirical studies show authoritarian countries with these institutions do not perform well economically than countries without such institutions (Gandhi 2008b; Wright 2008). This is especially the case in China, where the Party-state has enjoyed unprecedented economic growth for the past three decades without the rule of law and aforementioned institutions. More importantly, China’s contemporary history

demonstrates no institutions really deter the Party to honor its promises to its supporters and population as it kept breaking its promises through a series of ideological campaigns.

Another way to solve the credibility problem is to rely on an exogenous commitment device that raises the costs of expropriation. These mechanisms neither require the rule of law nor a stable polity. What they require is credible threats of retaliation by investors (Haber et al. 2003). Scholars show how autocratic rulers enforce property rights selectively as a private good (Greif 2006; Haber et al. 2003, Robinson 2003; Treisman 2003). Both Robinson (2003) and Treisman (2003) illustrate how these rulers used divide-and-rule strategies, trading the property rights protection of private owners for political support. Greif (2006) argues how the commitment problem can be solved through reputation or collective reputation, while Haber et al. (2003) focus on the third-party enforcement. However, these credible threats may only work in the countries where the government is weak and unstable. In countries like China, neither intervention, nor financial hostage, nor the third party can be placed upon it.

As China has achieved the amazing economic miracle for almost four decades, several explanations have been offered to explain how China has been able to overcome its institutional deficiencies and make credible commitments to investors. A popular view is to attribute economic development to market-reform policies and institutional changes since 1978 (Shirk 1993; Huang 2008). It has been, for example, argued that fiscal decentralization has created an environment for local governments to protect local businesses, and hence to promote economic growth. That is, to compete for investment with other localities, each local government has an incentive to demonstrate credible commitment to maintaining an environment favorable to economic growth. In other

words, the competition among local governments for revenue growth could help to limit government's predatory behavior in China (Oi 1992; 1999; Montinola et al. 1995; Qian and Weingast 1997).<sup>6</sup>

While fiscal decentralization provides useful insights on the commitment problem in China, it cannot explain why there exists tremendous regional variations in economic growth. Empirical studies suggest great variations among local governments in their attitudes towards the private sector, which can be developmental and predatory at the same time (Blecher and Shue 2001; Saich 2002; Tsai 2003). In particular, these studies did not elaborate why private entrepreneurs view the political and policy signals as credible in the face of frequent ideological swing between “socialism” and “capitalism.” In fact, we have little knowledge about why some private firms enjoy better property rights protection than others under similar political and economic institutional conditions, and why some local officials in some localities are more likely than their counterparts to support the private sector and protect private property rights.

More importantly, fiscal extraction at local levels can be worked in a way of property rights expropriation by local government. This is especially the case after the fiscal reform of 1990s, which has greatly weakened local government's ability to implement policy tasks set from above (Tao and Yang 2008; Yang 2006). Local governments are under tremendous pressure and actively pursue extra-budgetary revenue in the disguise of fees and fines from private sector to satisfy the policy tasks from higher-level governments due to their limited autonomy in local taxes and revenues for local development.

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<sup>6</sup> Qian and Weingast (1997) called this arrangement as Chinese style market-preserving federalism, while Oi (1999) called the emergence of non-state enterprises as the result of local state corporatism.

Unlike the top-down perspective, other literature focuses on coping strategies of the private entrepreneurs or local officials to bypass the restrictions imposed by the unfavorable formal institutional setting (Tsai 2007), such as “wearing a red hat” by private firms whereby private businesses disguised themselves as collective firms (Oi and Walder 1999; Tsai 2007), raising funds via underground finance (Tsai 2002), and participating in politics to obtain political patronage (Li et al. 2006).

One line of argument focuses on social networks or flexible clientelism that has been used to substitute for legal protection and to secure business opportunities for foreign and domestic investors (Wank 1999; Wang 2002; Tsai 2002; Nee and Opper 2012). However, these arguments tend to overemphasize the rent-seeking relationship between local political actors and private sector actors. In addition, the coping strategies and informal connections that provide the mechanism to overcome the commitment problem with regards to private property rights are unstable and may easily fall apart. Furthermore, these informal coping strategies might have worked in the early years of the Reform era, but as the Reform has gone deeper, especially the privatization in 1990s and the clarification and lawmaking of private property rights in 2000s, private firms with these strategies found themselves in big trouble. Empirical evidence in Chapter 3 demonstrates that “red hat” firms are easily involved in property rights disputes with local government, and therefore are more vulnerable to government-related property rights expropriations.

The emerging literature suggests that local governments are not homogenous in responding to the incentives created by the central government (Whiting 2001; Segal 2003; Donaldson 2011). To explain regional variation, many scholars studied different

local geographical conditions and other social and cultural features in explaining the vast variation in local economic performance (Liu 1992; Parris 1993; Forster 1990). However, these accounts mainly focus on inter-province variation, which cannot explain the vast intra-provincial variation. Still other researchers emphasize the importance of historical legacy, such as patterns of state investment inherited from the past (1950-1978), working together with other institutional and non-institutional factors, in shaping the incentives, capacities, and constraints of economic actors after 1978 (Qian and Xu 1993; Whiting 2001; Oi 1995; Xu and Zhuang 1998; Yang 1996; Perry and Wong 1985). But this literature cannot explain variations at the same locality over time. In addition, some empirical works suggest great variations among local governments with regards to the private sector, which can be developmental, corporatist, entrepreneurial, and predatory (Blecher and Shue 2001; Saich 2002; Tsai 2003).

Another influential explanation for inter-provincial variation examines personnel control systems designed by the central government to direct local government officials to promote economic growth. Huang (1996) argues that despite economic decentralization, the central government's control over personnel allocation plays a critical role in its ability to control local investment and thus runaway inflation (Huang 1996). This line of empirical work argues that the chances for a provincial leader to be promoted to a higher-level position are significantly and positively correlated with the GDP growth rate of the local official's jurisdiction (Li and Zhou 2005). However, these findings have been challenged. One group of scholars, for instance, demonstrate that personal connections associated with factional competition in the central government

play a critical role in promotion and therefore encourage economic growth in their jurisdictions (Cai and Traisman 2006; Shih 2004; Shih et al. 2012).

The incentive structure designed by the central government in the CES does play a role in influencing local officials' behavior towards economic growth. But the CES alone does not solve the commitment problem and protect the property rights. This line of argument assumes that local officials under the CES will automatically protect private property rights. However, it isn't necessarily the case. In particular, as this study will show, local officials under the CES with different resources and constraints may behave very differently with regards to private sector.

Also, self-interested and promotion-oriented local leaders tend to pursue their own political goals in addition to the policy targets listed in the CES, taking advantage of asymmetric information they possess over the upper level governments. To make the situation even worse, local leaders may collude with private firms at the expense of the government, as corruption in the form of theft indicates (Shleifer and Vishny, 1993).

More importantly, local officials as individuals may have goals different from those of the local governments they serve. Under the current institutional arrangements, local leaders possess a great deal of discretionary power, thus allowing them to pursue their own political and economic interests strategically in dealing with private investment. As a result, individual local officials rather than the governments (central or local) become a major source of uncertainty for private firms in China. Thus, how local government disciplines and monitors local officials' behavior becomes a critical issue in ensuring that local officials will pursue the same goals as those of the local governments.



## 2.2 The Nature of the Cadre Evaluation System

The Cadre Evaluation System (CES) is widely believed to be an incentive structure designed by the central government to help control local officials in the administrative hierarchy. The CES is one of the most important government personnel control systems in China. It assesses local party and government leaders based on performance criteria set by their immediate superior level of government. The CES powerfully shaped the behavior of Chinese local officials by linking both monetary interests and promotion incentive to their performance on the tasks listed in the system.

Before the Reform Era, the most important factor that determines Chinese political actors' promotion is political royalty or political affinity (Zhong 2003). In addition to political affinity, three new elements were introduced to the evaluation process since the Reform Era. Officials have to be of a young age, have good education, and above all, have the ability to promote local economic growth. The last one has become one of the most important criteria for higher-level officials to assess the work of their subordinates (Bo 2002; Huang 1996; Landry 2008; Shih 2004; Li & Zhou 2005).

Also, as the study of factionalism in Chinese politics, social connections are believed to play a critical role in one's promotion (Nathan 1973; Dittmer 1995; Zhong 2003; Shih 2004; Bo 2007; Shih et al. 2012). If so, the question then become whether economic growth still matters for promotion once social connections are account for (Opper and Brehm 2007; Shih et al. 2012). Some scholar argue that the connections and economic growth are complements for political leader's promotion (Jia 2012). At any rate, if a local leader has social connections with his/her superiors, he/she will become a strong candidate and his/her promotion prospect will be significantly enhanced. Since political

affinity is easily to perform and has become less important during the Reform Era, it is safe to say that four important factors determine the prospect of local officials' promotion.

The decentralization process of China's personnel management has transformed the personnel control system from "two-level down" to "one-level down" administrative hierarchy. Under the current system, the CES operates in a one-level down fashion (O'Brien and Li 1999; Landry 2008). That means each level of local government has full authority to evaluate the leading officials of the immediate subordinate level. For example, provincial governments have full authority to assess prefectural party secretaries or mayors without approval from the central organization departments. Prefectural governments and county governments are authorized to evaluate their immediate subordinate level of party secretaries and heads of government without seeking approval from higher-level organization department. Working in this way, the final decisions are actually made in a centralized way by a handful of people leading the party committee at each level. Therefore, local political leaders enjoy a great deal of leeway to pursue their own objectives in appointing local leaders (Wang 2013).

Some scholars argue that the discretion of local leaders is an unintended consequence of the CES due to conflicting priorities or due to the moral hazard problem inherent in a principal-agent relationship between central and local governments (Edin 2003; O'Brien and Li 1999; Whiting 2001; 2004). O'Brien and Li's (1999) study shows that local officials possess a certain amount of discretionary power to implement policy selectively in accordance with their own preferences. By studying governments at the prefecture and county levels, Wang (2013) argues that in addition to the top-down

control, the CES is also characterized by a high degree of local autonomy that enables local leaders to bargain with the higher-level government over the specifics of evaluation standards.

With regards to the commitment problem, the central government has a strong incentive to keep its promise on private investment, but it is not easy to fulfill the task without local governments' compliance. Because local autonomy is inherent in the CES, local officials have choices to formulate local policies and implement policies selectively to suit their own goals. Moreover, officials at various levels of government may behave differently in accordance with the resources they have in the face of the same incentive structure.

### **2.3 Term Limits and Rotation System**

In addition to the CES, two more systems have been introduced to be a mechanism in shaping incentives, capacities, and constraints of local political officials. Since the 1990s, China has developed a control system that intends to solve the problem of asymmetric information, shirking, and monitoring. Both term limits and the cadre rotation system are expected to serve the purpose of aligning divergent preferences and reducing asymmetric information. The two systems largely shorten the career horizon of local leaders and many economic targets are often out of control of the local officials, and the provision of local public goods has reinforced the revenue extraction pressure facing local leaders.<sup>7</sup>

The system of compulsory retirements was introduced in 1982. The main feature of the system is to set the age limits to retirement for local officials. The practice on

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<sup>7</sup> Susan H. Whiting, *Power and Wealth in Rural China: The Political Economy of Institutional Change*, (Cambridge University Press, 2001). p. 72

mandatory stepping down at age 65 for provincial governors was established. A recent policy regulates that for a provincial party secretary, if he/she ends up at the age 63 after a five year term, he/she would not be allowed to serve another round. Mayors of prefectures are usually required to retire at the age of 60. Under this system, young and well-educated officials are favored for further promotion.<sup>8</sup>

The rotation system was originally to rotate provincial officials across provinces and positions beginning in 1990. For some reasons, there was a different policy before 1990, which encouraged localization of governors (Zhang and Gao 2008).<sup>9</sup> More specifically, the rotation system is expected to prevent tie-cultivation in the hierarchical power structure and local protectionism (Chen and Zhao 1996; Blanchard and Shleifer 2001; Zhong 2003). Those who support the rotation system argue that the system reduces corruption and faction formation in local governments (Chen and Zhao 1996) and promotes regional economic development (Liu 1998; Pu 1999). Others are skeptical by focusing on the negative effect of shortsighted rotated officials on local economic development (Gu 2006). The empirical study suggests the positive impact of rotated governors on local economic growth in the eastern provinces (Zhang and Gao 2008).

There are no uniform rules on which who should be included in the rotation system. However, it is discouraged that the key local officials, mostly the “first hand”—the Party secretary, “at the provincial and prefecture levels serve in his or her native province and prefecture (Zhong 2003, p. 118).”<sup>10</sup> Right now, the governments both central and provincial have sped up rotating local officials between localities in order to

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<sup>8</sup> By the current retirement regulations, if someone cannot be climb to the seat of mayor at 55, his/her further promotion prospect is very unlikely.

<sup>9</sup> See Zhang and Gao (2008) for details.

<sup>10</sup> See Zhong (2003) for details.

prevent intense tie-cultivation and local protectionism. This system has reinforced the short-time pressure for local officials to generate impressive economic growth in only 2 to 3 years, so as to impress their superiors to win promotion.

The local officials face great pressure and incentive to satisfy the policy targets assigned by upper level government. This situation on the one hand does motivate better performance from the local officials, which helps to explain the rapid growth in the past to a large degree. But the pressures also produce other unintended consequences from them. Shorter time-horizon in each locality also causes short-term behaviors of local officials eager for instant success. Chapter 5 details that local leaders are fanatic in the so called “achievement projects,” like investing in a symbolic project in the city at the cost of hurting private sector.

In summary, the CES worked with the term limits system has created a distinct career pattern in China’s power hierarchy. First, unlike politicians in democratic regimes, in the case of China, once a person becomes a cadre, he/she will enjoy cadre status until retirement. He loses his position only when he gives up voluntarily, or becomes a convicted felon. Therefore, no matter what job performance he achieved, his position is secured as long as he got there. It is very rare to demote an official because he/she did not meet the targets assigned by the upper level government. Second, because of the almost permanent tenure in an office, there are almost no job options outside the political career once you are in (Li and Zhou 2005). Finally, the age limits have been set to compulsory retirement for local officials.

## **2.4 The Theoretical Framework**

In this section, I present a simple bargaining game between a private firm and a local official following the literature of the Obsolescing Bargain Model (OBM) and the Political Bargaining Model (PBM), which explain bargaining relations between a Foreign Direct Investment (FDI) firm and a host country (Vernon 1971; Eden et al. 2005). The major concerns of the multinational corporations' (MNCs) investment decisions in a developing country include the returns on an investment and the political risk associated with it. One of the risks as shown in the Obsolescing Bargain Model is that the initial bargain favors the foreign investors, but the bargaining power shifts from MNCs to the host countries once the investment is in place. The host governments have incentives to impose higher taxes to squeeze FDI firms' profits or expropriate their assets completely by changing policies at any time. The possibility of direct or indirect expropriation is often the major political risk for MNCs investing in an authoritarian regime.

Private firms in China face similar risks as MNCs do in their investment decisions. More importantly, in the case of China, domestic private enterprises are the most vulnerable in terms of property rights protection as compared to the state-owned enterprises (SOEs) and foreign invested enterprises (FIEs) since the central government sets up a package of preferential policies exclusively for the latter types of firms. As discussed in the previous sections, individual local officials rather than the government (central or local) become a major source of uncertainty for private firms in China. Under the current institutional arrangement, local political leaders possess a great deal of discretionary power, allowing them to pursue their own political and economic interests strategically in regard to private investment.

Before formalizing the bargaining game and the symbiotic logic of secure property rights, I identify the players and their preferences as follows. There are three players in the local economy, Government (G) is the principal, the local political official serves (S) as the supervisor and the Private entrepreneur (P) is the agent. I detach political actors from government because the goals of government are not always identical with political actors. In the context of China, I identify political actors as local political leaders, economic actors as indigenous private entrepreneurs, and government includes central and local.

I make an extremely simple assumption that the goal of government and political actors may not be the same. Government (G), both central and local, cares about tax revenue and the primary and foremost concern of local political leaders (S) is to stay in office and be promoted to a higher rank. The ultimate goal of local officials, however, is to acquire more wealth and secure their possessions. In other words, the pursuit of political power is the means to achieve the end (wealth acquisition). The old saying “*shengguan facai*” (more power more money)<sup>11</sup> demonstrates the logic of career concerns with Chinese characteristics. For the indigenous private entrepreneur (P), what he/she wants is not only to maximize profit but also to secure property rights.

There exist nested games between the three players in the local economy. The principal-agent problem is inherent between different levels of government, as well as between governments, both central and local, and local officials. It is assumed that there exist information asymmetries between the government, local political leaders, and economic actors. In other words, the activities of local political leaders and economic actors cannot be observed by the government, and indigenous private entrepreneurs

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<sup>11</sup> The old saying *Shengguan Facai* implies that if the power not for money, why power?

cannot perfectly monitor the impact of the government's actions or policies upon their property rights. As Figure 2.1 shows, local political leaders engage in the bargaining game with indigenous private investors within the principal-agent relationships between the government and local leaders, and upper level leaders and lower level leaders.

The third assumption I make is that indigenous private entrepreneurs do not necessarily demand efficient property rights. In fact, it is not clear that an individual private entrepreneur should always demand that the government protect everyone's property rights. According to Haber et al. (2003), an indigenous private entrepreneur can receive utility from the secure and efficient property rights, because this makes her asset more liquid, and therefore more valuable. However, if selective enforcement grant the indigenous private entrepreneur more comparative advantage in the market, then it may be more profitable to demand less than universal enforcement. Between these two possibilities, it is assumed that indigenous private entrepreneurs care first and foremost about their own property rights. Any profit-maximizing actor would readily accept the exclusive protection of her property rights, providing that it produced better benefits to that actor.

Finally, the model assumes that local officials are potential predators and private investors are their prey. The predator and prey interact strategically in the context in which the central government or superiors level officials evaluate the subordinate local officials on the basis of the cadre performance evaluation system.



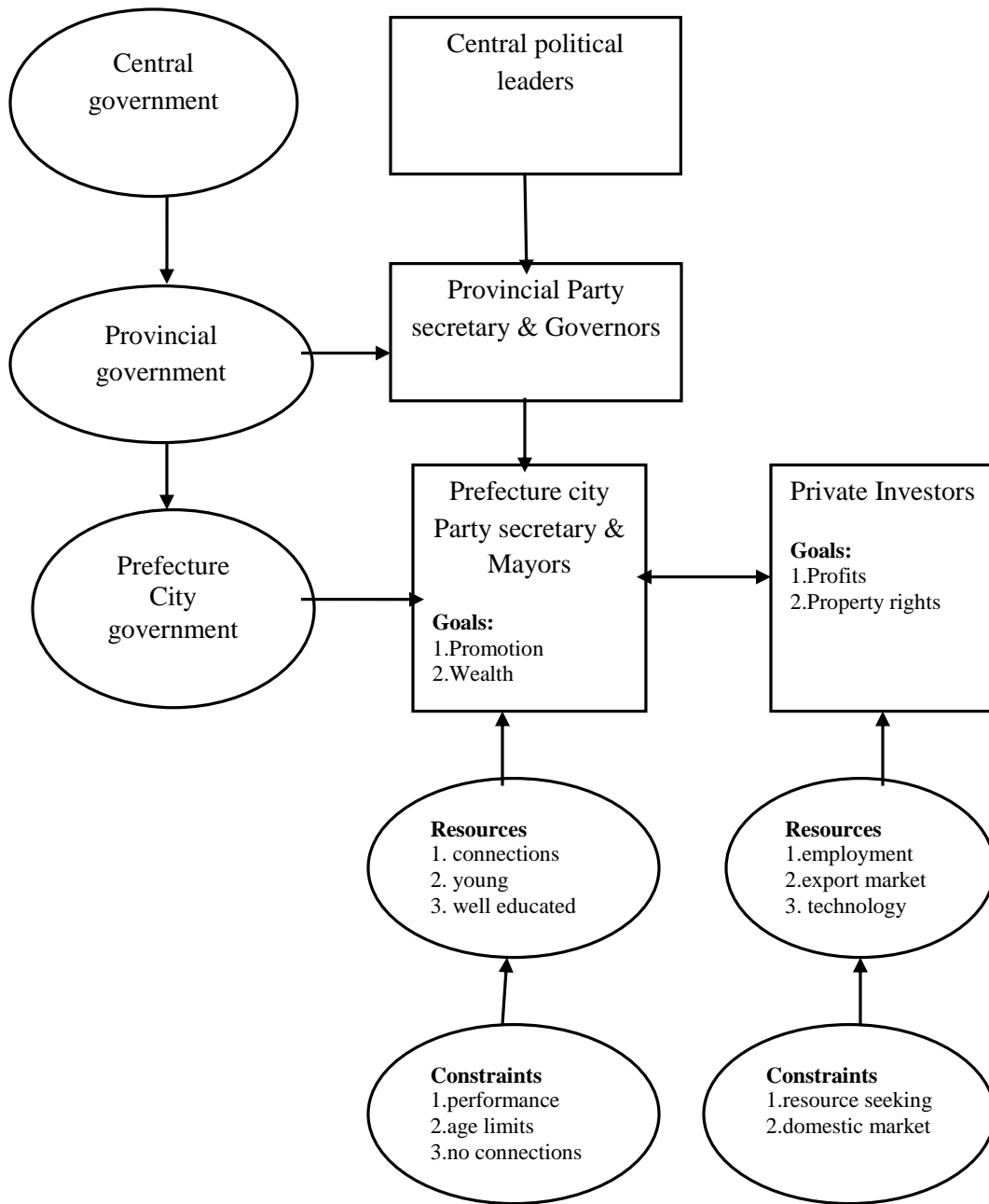


Figure 2.1 A Bargaining Game under the Principal-Agent Relationships

To provide a systematic understanding of the bargaining process between local political actors and private sector investors, I will first describe local political actors' goals and their resources as well as the constraints under the current personnel control

systems. Then, I will discuss private sector investors' goals and resources in the bargaining game with local political leaders. Finally, I delineate the bargaining process between local political actors and private sector investors, and propose theoretical hypotheses.

### **The local political officials' goals, resources, and constraints**

While both central and local governments hope to accomplish broad social, economic and political objectives, local political leaders, in direct contact with private firms, may intend to achieve their personal goals through bargaining with private investors. One of the major goals of the government at both central and local levels is to attract investments, which will generate GDP growth rate, tax revenue, and employment. But for many local political leaders, other goals may be involved in dealing with private investment.

The "competition for promotion" literature assumes that the primary goal of local political leaders is to be promoted to a higher rank (Li and Zhou 2005). I relax this assumption by including economic interests. The local official is thus assumed to be an expected utility-maximizer. His/her goals include not only promotion (career concerns) but also monetary interests.

Although it may be clear that the CES plays a significant role in forming a local political leader's preferences, an individual's background and resources influence his/her goals and strategies toward private investment. As discussed in the previous section, three elements are important for local officials to be promoted to a higher rank: youth, education, and the ability to promote economic growth. Youth became a critical factor in determining one's political career when the age-based mandatory retirement rule was

implemented in 1982. So if a local leader is near retirement age, then he/she will have nearly zero chance to be promoted despite his/her expertise in local economic growth. As a result, his goal towards private investment will not be the same as the goals of those who are young and/or well-educated. Quite likely, the near-retiring officials may be more interested in monetary fortunes than in prospects for promotion.

Also, as discussed in previous sections, according to career concern studies, it is not clear whether job performance measured by GDP growth rate, political connections, or a mix of performance and connections matters most for one's promotion. From the perspective of "faction politics", those who have connections with provincial leaders, will be promoted no matter what job performance they achieved. For those who don't, there are several strategies to maximize their likelihood of promotion, such as bribery to their superior or simply buy an office (Zhu 2008). Chapter 4 will show how these resources and constraints affect local officials' behaviors in the bargaining relationship with indigenous private investors.

### **Private investors' goals, resources, and constraints**

Private firms in China are more vulnerable than the State-Owned Enterprises (SOEs) and Foreign Invested Enterprises (FIEs). The development of the private sector in China went through an uneven path of institutional and structural changes. Before 1978, private businesses were strictly forbidden. Anyone who ran a private business would be severely punished, including being arrested and persecuted. Between 1978 and 1988, the private sector was not allowed officially except for "individual entrepreneurs" (*getihu*) engaging in small businesses with less than eight employees. The 1988 regulations allowed businesses with more than eight employees to be registered as "private

enterprise” (*siying qiye*), but the Tiananmen Incident of 1989 dashed the inception of private businesses. Deng Xiaoping’s “Southern Tour Talk” in early 1992 and the introduction of the Company Law in 1993 reignited and accelerated the development of the private sector during the 1990’s. However, discrimination against the private sector continued until the 1999 Constitutional Amendments accorded private enterprises legal status. It was only after the 2004 Constitutional Amendments that lawful private property was protected and equal legal status was offered for private firms and state-owned enterprises. In 2007, China enacted its first law to explicitly protect private property, but it does not provide enough details or effective enforcement mechanisms.

The major goal of a private sector investor is to secure business opportunities and make profits. But if the profits will be expropriated by the government, investors will not invest. Therefore, the security of property rights is also under consideration. In general, private sector investor’s choice to invest in a particular place is determined by a variety of objectives and considerations. Business opportunities, market expansion, social networks, tax incentives, fiscal subsidies, cheap land, labor force, and legal environment are all factors that private investors will take into account in their investment decisions. Which factor is weighted more heavily than others depends very much upon post-entry bargaining power, referring to the relative bargaining power vis-à-vis the local government after the investment is made. And a private sector investor’s post-entry bargaining power is in turn determined by firm specific characteristics and the degree to which he/she will need from the local government, such as licensing requirements, permissions, resources, domestic market, and public-goods provisions.

The literature on international business shows that firm-specific advantages affect multinational corporations' investment decisions in different host countries (Helpman 1984; Markusen 2002; Hansen et al. 2005; Zheng 2007). In particular, the OBM literature indicates that OBM may only be applied to the natural resources sector such as copper mining and the oil industry (Vernon 1971; Gilpin 1975), while manufacturing industries may be less vulnerable to the risk of expropriation because of their ability to adjust to the local environment and to renew production technologies to balance against the erosion of bargaining power. Some scholars find that the multinational corporation's bargaining power with the host country does not obsolesce for the high technology sector (Kobrin 1987), while others suggest that in some capital-intensive manufacturing such as the automobile industry, a firm's ability to establish an industry cluster and its technological assets could enhance its bargaining power (Bennett and Sharpe 1979).

As the critics of OBM question the usefulness of the model, scholars propose the political bargaining model (PBM) to revitalize OBM by incorporating post-entry political strategies with host government through iterative bargaining (Eden et al. 2005). The PBM argues that the competitive advantage of MNCs comes from their Firm Specific Assets (FSAs) or resources "if they are rare, hard to imitate, have no direct substitutes, and enable companies to pursue opportunities or avoid threats" (Eden et al. 2005, p. 12).

In the case of China, as a general rule, labor-intensive, export-oriented manufacturing firms and high technology firms enjoy competitive advantage, while resource-intensive and local market seeking firms are in a disadvantageous position in bargaining with local governments. I will come back to this point and discuss firms' characteristics extensively in Chapter 3.

## 2.5 The Bargaining Game

Initially, the relative bargaining power favors private investors vis-à-vis local officials because, first, local officials are trying to attract investment under the pressure of the performance-based evaluation, and second, investors may have other options even for resource-intensive firms. After a decision is made, the relative bargaining power may shift. That is, once an investor has made firm-specific investment in a locality, his/her resources may be held hostage by an opportunistic local official. The local government would then be in a position to impose new requirements on the firm, which might more than offset the initial incentives. Moreover, in the context of China, private entrepreneurs risk not only outright expropriation but also a host of other predatory actions taken by the local government in the guise of fines, taxes, and/or “charitable contributions” to government-sponsored projects (Nee and Oppen 2012).

However, if a private investor’s post-entry bargaining power is strong, he/she will be able to protect his/her bargains. The degree to which the investor will be able to do so depends on the level of Firm Specific Assets (FSAs) and the degree to which he/she will need from the local government for, say, licensing, permissions, resources, and public-goods provisions. In particular, private firms with an exit option will enjoy sufficient protection because they possess high levels of FSAs. The outright expropriation of this type of firm does no good to the government or to the local political leaders. Political and social considerations at both central and local governments with the incentive structure embedded in the CES have thus set up relatively stable conditions for these types of investment, which appears to facilitate a self-enforcing solution to the commitment problem. In this situation, everyone benefits and no one has the incentive to deviate.

On the one hand, both central and local governments have strong incentives to keep their promises since these firms can generate higher GDP growth, tax revenue, and employment. Although private firms in general may have an incentive to conceal real profits and hence decrease the taxes they pay to the government, it is more difficult for labor-intensive, export-oriented manufacturing firms and high technology firms to do so.

On the other hand, due to relatively short tenure in office (e.g., less than three years, on average, for local mayors), local officials are under enormous pressure to show their ability to produce economic growth quickly (Pei 2012). Thus, local political leaders have strong incentives to maintain a collaborative relationship with these firms because it is an easy way to demonstrate their job performance. Also, knowing that this type of firm has an exit option even if it is expensive for them to do so, and that the worst scenario of resistance to predatory actions will severely damage their reputation, local political actors will restrain their predatory behavior.

For investors with rapidly obsolescing post-entry bargaining power, however, there is no self-enforcing commitment. Private firms without an exit option such as resource-intensive and local market seeking firms are in a disadvantageous position to overcome the commitment problem. This type of firms' FSAs is low as its firm-specific assets are common, easy to be imitated and substituted, and hard to transfer. They need more government-related resources for their projects. Investors may prefer a better legal environment to constrain the predatory activities or rely on personal networks (*guanxi*) or bribing local officials to protect their investments.

For local officials, the political risk of direct expropriation of private firms without an exit option may be low due to the moral hazard problem. For instance, the predatory

actions may not be seen as personal. It may be done in the name of the local government. In addition, a local official could assign his/her protégé to take over the firm and to run the business as usual. After the outright expropriation, the local government still retains GDP growth, tax revenue and employment opportunities. Moreover, the local official receives private benefits from the outright expropriation as well. No matter who is going to take over the firm, the new owner will owe a favor to the official, and will pay back in some form of revenue. Therefore, private investors who engage in low-level FSAs investments without an exit option will, from time to time, rely on their personal networks (*guanxi*) or bribery to protect their property rights.

If the local official chooses not to expropriate directly but to be engaged in indirect expropriation such as collecting fees, fines, forced apportionment of funds (*tanpai*), or forced contribution of government sponsored projects, the firm with no exit option has little bargaining power and has no choice but to give in with either direct payments or bribes. In this case, the local official receives both higher merit and private benefits with no risk of the exit of the firm. Chapter 3 presents the model that illustrates the prisoner's dilemma situation in the bargaining relationship between local officials and private investors, and test the hypotheses statistically.

Local political leaders' decision of whether or not prey on the private sector is determined by a firm's resources and constraints. However, as discussed in previous section, local officials are also under strict constraints within the personnel control systems. If the local official is near 55, or less educated, or has no political connections, he/she will desperately need the private sector's support for political survival. This symbiotic relationship between native local political officials and private entrepreneurs



creates conditions similar to secure property rights at the local level. The degree of symbiotic relationship between the local officials and indigenous private entrepreneurs determines the level of private property rights protection.

Native local officials have lower transaction costs and therefore a symbiotic relationship between native local officials and local private firms is easier. Compared to rotated local leaders, native local political leaders have more incentives to protect private property rights in order to get political and economic benefits as well as none-material rewards. I will show how these resources and constraints created by the political control systems affect local officials' behaviors in the bargaining relationship with indigenous private investors and test the hypothesis in Chapter 4.

## **2.6 Summary**

This chapter briefly reviews the existing studies of property rights with special attention on the personnel control systems including the cadre evaluation system, term limits, and rotation system, and provides a game theoretical explanation to the property rights protection in China. I theorize the endogenous property rights as a bargaining game between a private investor and a local official. Resources and constraints of both actors affect their bargaining power in the bargaining relationship and hence determine the level of property rights protection. Private firms with high levels of FSAs and especially with an exit option possess strong post-entry bargaining power, and thus enjoy better property rights protection, but weak firms are vulnerable to the local officials' predatory activities, and therefore needs to rely upon other mechanism, such as their social networks or bribery, to overcome the commitment problem.

Another source that could overcome the commitment problem emerges from the symbiotic relationship between the local officials and indigenous entrepreneurs. Native local political actors, who are less favorable to the promotion prospect, are more likely to protect private property rights. The logic is that compared to transferred officials, native local officials have fewer political connections with higher-level officials and therefore have less chance to be promoted in the power hierarchy. This condition makes them seek the support of local economic actors for their political survival. Moreover, native local political leaders who were born in their jurisdiction have lower transaction costs, and therefore a symbiotic relationship between native local officials and local private entrepreneurs is feasible. The chances were high that the native leaders would have close ties to local economic actors and face more strict social constraints; therefore, they were more likely to protect local property rights.

## CHAPTER 3

### **THE GAME OF PROPERTY RIGHTS: CREDIBLE COMMITMENT IN CHINA**

This chapter explores the resources and constraints of private firms under the institutional arrangements by examining the firms' characteristics. According to the theoretical framework presented in Chapter 2, these conditions will determine the bargaining power in the bargaining relationship with local officials in terms of property rights protection. Then, I test the effects of firms' characteristics on the security of private property rights quantitatively.

As discussed in Chapter 2, I theorize the endogenous property rights as a bargaining game between a private firm and a local political actor. I model the relationship as a one-shot game with conflicting goals, and hypothesize that a firm is in a strong bargaining position at the time of entry when the local official, under the pressure of the performance-based evaluation by his or her immediate superiors, understands that the firm has other options. However, once the firm has made sector-specific investment, its capability to resist the official's predatory actions relies upon certain firm-specific characteristics. More specifically, in the post-entry situation, the availability or unavailability of an exit option for a private firm affects the local political actor's behavior with regard to the protection of private property rights. These hypotheses are supported by a statistical analysis of a nationwide firm-level survey on privately owned enterprises and the data I collected from the media reports of government-related property rights expropriation cases.

The remainder of this chapter is organized as follows. The next section provides a close examination of firms' resources and constraints created by their characteristics under the current institutional arrangements. Section 2 provides a simple bargaining game between a private firm and a local official with hypotheses that guide the empirical analysis. Then, I present a model that illustrates the dominant strategies for different types of private firms and local officials. Section 4 describes the data. Section 5 discusses the research design and provides empirical tests. Section 6 presents the analysis of media reports of government-related property rights expropriation cases. Section 7 concludes.

### **3.1 Firms' Characteristics as a Source of Property Rights Protection**

As the discussion of the Cadre Evaluation System (CES) demonstrates, local officials are under the pressure of the performance-based evaluation by their immediate superiors. They have to show their ability to accomplish the tasks listed in CES, which include Gross Domestic Product (GDP) growth rate, employment creation, and tax revenue. Labor-intensive, export-oriented manufacturing firms and high technology firms can create more jobs, contribute stable fiscal revenue, and generate higher economic growth. All of these are major political tasks on the basis of which local political officials' job performance is evaluated. If these firms choose to relocate their investment elsewhere, local governments will lose all the benefits they can get, and local political leaders will also fail in cadre evaluation which is closely tied to their future career. As one of the fallen local political leaders in Southern China bitterly complains, "Some firms always threaten to relocate their headquarters. Let them leave. See if they could move to

heaven.”<sup>12</sup> Indeed, the availability of an exit option, even if unused, can be a powerful tool that greatly enhances a private firm’s bargaining power vis-à-vis local political actors.

Labor-intensive, export-oriented manufacturing firms even in the period of labor shortage can retain their advantage. For example, many Chinese factories have struggled to find enough people to operate the assembly lines since the labor shortage first occurred in 2004. Labor shortage was so acute in 2012 that it forced many firms to turn to the local government for help. However, this does not seem to decrease the bargaining power of these private sector actors vis-à-vis the local governments. Rather, in order to attract and retain the investment, many local governments promise to help to recruit workers for them (Lin 2013).<sup>13</sup>

However, if labor-intensive firms in resource-intensive and local market seeking sectors, such as mining industry, or steel industry, even if they generate the same benefits for local governments as the above-mentioned labor-intensive, export-oriented manufacturing firms do, they may lose their advantage. The key factor is that these firms have no option to relocate their businesses. If they choose to exit, they will lose all.

Like labor-intensive, export-oriented manufacturing firms, resource-intensive and local market seeking firms can contribute to employment creation, fiscal revenue, and economic growth. But this type of firms relies heavily on government-related resources. More importantly, without an exit option, local political actors may gain more bargaining power over private firms in protecting their properties. Knowing that these firms have no place to relocate their investment, local political actors tend to prey on them as compared to those firms with an exit option.

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<sup>12</sup> See [http://news.xinhuanet.com/lianzheng/2014-07/03/c\\_126703996.htm](http://news.xinhuanet.com/lianzheng/2014-07/03/c_126703996.htm) (accessed July 17, 2014).

<sup>13</sup> Lin Liyao, “Migrant Worker Shortage Intensifies,” [http://www.china.org.cn/china/2013-11/12/content\\_30574062.htm](http://www.china.org.cn/china/2013-11/12/content_30574062.htm)

Traditionally, capital-intensive firms are vulnerable to political risks because these firms involve a large amount of capital for machinery and infrastructure, and therefore need longer time to make a profit. But if these capital-intensive firms are in labor-intensive, export-oriented manufacturing sector or high technology sector so as to provide them with an exit option, they will be able to retain their advantage. If capital-intensive firms are in resource-intensive sectors, such as oil industry, energy industry, or real estate industry, which leave them no option to exit, they will lose their advantage.

In summary, firms with resources that are hard to substitute in regard to skilled labor force, access to foreign market, or technology know-how are considered to be high-level Firm Specific Assets (FSAs) firms, and will be in a better position to bargain with the government. In particular, it is the availability of an exit option that, to a large extent, determines the post-entry bargaining power of private sector actors over local political actors in protecting their property rights.

### **3.2 A Bargaining Game**

As discussed in Chapter 2, the relative bargaining power at the time of entry favors private investors vis-à-vis local officials because, first, local officials are trying to attract investment under the pressure of the performance-based evaluation, and second, investors may have other options even for resource-intensive firms. However, once an investor has made firm-specific investment in a locality, the relative bargaining power may shift to local officials. In the post-entry situation, his/her investment may be held hostage by an opportunistic local official. The local government would then take advantage of it so as to impose new requirements on the firm, which might more than offset the initial incentives. Moreover, in the context of China, private entrepreneurs risk

not only outright expropriation but also a host of other predatory actions taken by the local government in the guise of fines, taxes, and/or “charitable contributions” to government-sponsored projects (Nee and Oppen 2012).

However, a firm’s specific characteristics can greatly empower its bargaining power, and if a private investor’s post-entry bargaining power is strong, he/she will be able to protect his/her bargains. The degree to which the investor will be able to resist local officials’ predatory actions depends on the level of Firm Specific Assets (FSAs) and the degree he/she will need from the local government for, say, licensing, permissions, resources, and public-goods provisions.

As discussed in previous section, private firms with an exit option will enjoy sufficient protection because they possess high levels of FSAs. The outright expropriation of this type of firm will hurt the government or affect the local political leaders negatively in terms of performance based evaluation measured by real figures like tax revenue, employment creation, and GDP growth rate. Political and social considerations at both central and local governments with the incentive structure embedded in the CES have thus created relatively stable conditions for these types of investment, which appears to facilitate a self-enforcing solution to the commitment problem. In this situation, everyone benefits and no one has the incentive to deviate.

Governments, both central and local, have strong incentives to keep their promises since these firms can generate higher GDP growth, tax revenue, and employment. Although private firms in general may have an incentive to conceal real profits and hence decrease the taxes they pay to the government, it is more difficult for

high level FSAs firms, such as labor-intensive, export-oriented manufacturing firms and high technology firms to do so.

For local officials, due to relatively short tenure in office (e.g., less than three years, on average, for local mayors), they are under enormous pressure to show their ability to produce economic growth quickly (Pei 2012). Thus, local political leaders have strong incentives to maintain a collaborative relationship with these firms because it is an easy way to demonstrate their job performance. Also, knowing that this type of firm has an exit option even if it is expensive for them to do so, and that the worst scenario of resistance to predatory actions will severely damage their reputation, local political actors will restrain their predatory behaviors.

However, there is no self-enforcing commitment for investors with rapidly obsolescing post-entry bargaining power. Private firms without an exit option, such as resource-intensive and local market seeking firms, are in a disadvantageous position to overcome the commitment problem. This type of firm's FSAs is low as its firm-specific assets are common, easy to be imitated and substituted, and hard to transfer. They need more government-related resources for their projects. Investors may prefer a better legal environment to constrain the predatory activities or rely on personal networks (*guanxi*) or bribing local officials to protect their investments.

More importantly, for local officials, the political risk of direct expropriation of private firms without an exit option may be low due to the moral hazard problem. For instance, the predatory actions may not be seen as personal responsibility. It may be done in the name of the local government. In addition, a local official could assign his/her protégé to take over the firm and to run the business as usual. After the outright



expropriation, the local government still retains GDP growth, tax revenue and employment opportunities. Moreover, the local official receives private benefits from the outright expropriation as well. No matter who is going to take over the firm, the new owner will owe a favor to the official, and will pay back in some form of revenue. Therefore, private investors who engage in low-level FSA investments without an exit option will, from time to time, rely on their personal networks (*guanxi*) or bribery to protect their property rights.

If the local official chooses not to expropriate directly but to be engaged in indirect expropriation, such as collecting fees, fines, forced apportionment of funds (*tanpai*), or forced contribution of government sponsored projects, the firm with no exit option has little bargaining power and has no choice but to give in with either direct payments or bribes. In this case, the local official receives both higher merit and private benefits with no risk of the exit of the firm.

Given the above discussion, I come up with two hypotheses:

**Hypothesis 1:** All else being equal, private firms with an exit option and high level of FSAs enjoy sufficient property rights protection.

**Hypothesis 2:** All else being equal, private firms with no exit option and low level of FSAs are vulnerable to local officials' predatory activities.

### **3.3 The Model**

As noted earlier, the situation in which a resource-intensive and local market seeking firm on the one hand, or a labor-intensive, export-oriented manufacturing firm or a high technology firm on the other may find itself being treated differently. The major difference between the two lies in the fact that the former does not have an exit option while the latter does. The situations can be illustrated by the Prisoner's Dilemma game.

The traditional prisoner’s dilemma is a game that shows why two purely “rational” individuals might not cooperate, even if it is in their mutual interests to do so. In the one-shot game, a private investor and a local official may find themselves in a situation very much like the prisoner’s dilemma. Table 3.1 shows the two players’ payoff matrix. By cooperate, I mean actors play by the rules. Defect means actors evade the rules. In this case, for the firm, evading the rules means the firm conceal real profits so that decreases the taxes it pays to the government, as well as it decides to relocate its assets. For the local official, evading the rules means he/she preys on the firm ranging from outright taking of investment to arbitrary fees and fines collected by the government, or forced “charitable contributions” to the government projects.

Table 3.1 Payoffs of a Private Firm and a Local Official in a One-shot Game

A private firm \ A local official	Cooperate	Defect
Cooperate	<b>Scenario 1</b> B <sub>1</sub> , B <sub>2</sub>	<b>Scenario 2</b> D <sub>1</sub> , A <sub>2</sub>
Defect	<b>Scenario 3</b> A <sub>1</sub> , D <sub>2</sub>	<b>Scenario 4</b> C <sub>1</sub> , C <sub>2</sub>

### 3.1 The situation involving a private firm with low level of FSAs and no exit option

#### Scenario 1:

In this scenario, suppose that both the firm and the local official choose to comply with the rules—explicit or implicit—governing normal market transactions. Then, the payoffs of the two players in a one-shot game are as follows. The firm will get net profit

$B_1$  after deducting the cost and tax paid to the governments. The local official will get the bundle benefits  $B_2$  he/she intends to achieve as an official including the policy tasks such as GDP growth rate, tax revenue, and employment creation, assigned by higher governments for the political survival and the monetary interests consist of wages and pensions.

**Scenario 2:**

In scenario 2, suppose that the firm complies with the rules, but the local official decides to exploit. The payoffs change to as follows. The firm will get  $D_1$ , in which net profit deducts the loss of property exploited by the local official ranging from part of the expected profit to all of the investment as well as many types of fees, fines, and “contributions.” The local official will get  $A_2$  that includes the bundle benefits plus the benefits from the exploitation and deducting the cost of the probability of being caught for any wrongdoings with a penalty. Generally, the probability of being caught is very small. And the predatory action is often done in the name of the government or the “public.” Thus, there is also a moral hazard problem.

**Scenario 3:**

Scenario 3 is the situation in which the firm tries to evade while the local official decides to abide by the rules. The payoffs thus become as follows. The firm will get  $A_1$  that includes net profit plus the extra benefits for evading the rules, and deducts the cost of the probability of being caught with a penalty. The local official will get  $D_2$ , in which the bundle benefits deduct the loss of tax revenue and other benefits as a consequence of the firm’s choice.

#### **Scenario 4:**

In scenario 4, suppose that both the firm and the local official choose not to comply with the rules. The payoffs may then turn out to be as follows. The firm will get  $C_1$ , in which the net profit deducts the loss of property exploited by the local official plus the extra benefits for evading the rules, and deducts the cost of the probability of being caught with a penalty. The local official will get  $C_2$ , in which the bundle benefits plus the benefits from exploitation for the firm, and deduct the loss of tax revenue and other benefits as a consequence of the firm's choice and the cost of the probability of being caught with a penalty.

The payoff relationship is as following:

$$A > B > C > D$$

Therefore, each player has a dominant strategy, and the game has an obvious solution as follows.

For the firm, scenario 3 is better than scenario 1 if the extra benefits for evading the rules deduct the cost of the probability of being caught with a penalty is bigger than 0. Scenario 4 is better than scenario 2 if the extra benefits for evading the rules deduct the cost of the probability of being caught with a penalty is bigger than 0. The strategic choice made by the firm would be this:

$$\text{scenario 3} > \text{scenario 1} > \text{scenario 4} > \text{scenario 2}$$

For the local official, scenario 2 is better than scenario 1 if the benefits from exploitation for the firm deduct the cost of the probability of being caught for any

wrongdoings with a penalty is bigger than 0. Scenario 4 is better than scenario 3 if the benefits from exploitation for the firm deduct the cost of the probability of being caught for any wrongdoings with a penalty is bigger than 0. The strategic choice made by the local official would be this:

scenario 2 > scenario 1 > scenario 4 > scenario 3

Thus, if the chances of being caught are sufficiently small, both the firm and the local official will choose the dominant strategy that is to evade the rules in the one-shot game, and therefore end up in scenario 4. This is a prisoners' dilemma game. Clearly, in the payoff relationship  $A > D$ , scenario 1 is better than scenario 4.

Given that the probability of being caught for the firm is bigger than the firm's extra benefits for evading the rules deducting the level of exploitation by the local official and the probability of being caught for the local official is bigger than benefits from exploitation for local official deducting the loss of tax revenue and other benefits as a consequence of the firm's choice, or chances of being caught are sufficiently high, the choice of complying with the rules by both players will be the "common interest." Then, in an infinitely repeated version of the game, the "common interest" may be realized if both players choose to play, for example, a trigger strategy.

### **3.2 The situation involving a private firm with high level of FSAs and an exit option**

This game is similar to the previous one except that the firm has an exit option, that is, as the exploitation becomes intolerable, the firm may opt to leave the market so as to minimize the costs. Thus, we need to add additional terms in the payoffs for each player under the second and fourth scenarios mentioned above. Let us call this the benefit

of exiting for the firm as  $r$ , (e.g., recovering the whole or part of the investment and receiving potential gains from outside opportunities, minus the loss of relocation) and the cost of losing a valuable asset for the firm to stand for as  $e$ . Then, the new payoffs are as follows. Table 3.2 shows the new payoff matrix for the two players.

Table 3.2 Payoffs of a Private Firm with an Exit Option and a Local Official in a One-shot Game

A local official A private firm with an exit option	Cooperate	Defect
Cooperate	<b>Scenario 1</b> $B_1, B_2$	<b>Scenario 2</b> $D_1 - e, A_2$
Defect	<b>Scenario 3</b> $A_1, D_2$	<b>Scenario 4</b> $C_1 - e + r, C_2 - e$

**Scenario 2:**

Scenario 2 is the situation where the firm chooses to comply with the rules, but the local official decides to exploit. For the firm, it will get the net profit  $D_1$  deducts the loss of property  $e$  exploited by the local official. For the local official, the bundle benefit  $A_2$  plus the benefits from exploitation and deduct the probability of being caught.

**Scenario 4:**

Scenario 4 is the situation where both the firm and the local official choose not to comply with the rules, and the firm also chooses to relocate the investment for recovering the severe expropriation. For the firm, the net profit  $C_1$  deducts the loss of property  $e$  exploited by the local official, plus the extra benefits for evading the rules, deduct the

probability of being caught, and plus the benefit of exiting  $r$ . For the local official, the bundle benefits  $C_2$  plus the benefits from exploitation, but deduct the loss of tax revenue and the loss of other benefits as a consequence of the firm's choice, the probability of being caught and the cost of losing a valuable asset for the firm  $e$ .

**Solution:**

As a result, for the firm, scenario 3 is better than scenario 1 if the extra benefit for evading the rules is bigger than the probability of being caught, and scenario 4 is better than scenario 2 if the extra benefit for evading the rules is bigger than the probability of being caught. The strategic choice made by the firm would be this:

scenario 3 > scenario 1 > scenario 4 > scenario 2

For the local official, scenario 1 is worse than scenario 2 if the benefit from exploitation for the firm is smaller than the probability of being caught plus the cost of losing a valuable asset for the firm, and scenario 4 is worse than scenario 3 if the benefit from exploitation for the firm is smaller than the probability of being caught plus the cost of losing a valuable asset for the firm. The strategic choice made by the local official would be this:

scenario 2 > scenario 1 > scenario 3 > scenario 4

That is, if the cost of losing a valuable asset for the firm is sufficiently large, there exists a pure strategy equilibrium in which the firm chooses to evade while the local official abides by the rules, as scenario 3 demonstrates.

It is also likely that business transactions for this type of firm may be transparent to the extent that it is difficult for them to evade the rules. Consequently, the extra benefit

for evading the rules is 0; so is the probability of being caught. Then, in addition to the previous equilibrium, there is another pure strategy equilibrium in which both players abide by the rules, as scenario 1 shows.

At any rate, both scenarios indicate the better property rights protection, which addresses the commitment problem at the local level. The two games demonstrate that firms' characteristics affect the local officials' behavior with regards to their treatment of the private firms.

### **3.4 Data**

The quality of data is a major challenge for studies on the political economy of contemporary China since local officials can easily manipulate the statistics. In this study, I rely upon two kinds of evidence. The first type of data comes from a nationwide survey of private firms conducted in 2012 jointly by the All-China Federation of Industry and Commerce (ACFIC), the State Administration of Industry and Commerce (SAIC), the United Front Work Department (UFWD), and the Institute of Chinese Private Economy at the Chinese Academy of Social Sciences (CASS). Appendix A discusses the survey in detail and the potential weaknesses. The survey collected information on 4,747 firms from thirty-one provinces. Since there are some missing responses for almost every question, I kept only 3,397 observations in which data on basic financial indicators, such as sales revenue and total number of employees, were available.

The second type of data we use is the media reports of government-related property rights expropriation cases involving local officials and private firms, which were collected from major news media in China. Appendix B provides more information on the collection of cases in greater detail and the limitations of our cases.



### 3.5 Empirical Test and Research Design

In this section, I test hypotheses generated from the model by analyzing the data of a nationwide survey of private firms in 2012. I first discuss the research design and variables, and then I present the main empirical results.

#### Research Design

Before I precede the analyses of empirical evidence, I first discuss briefly my main dependent variable—government-related property rights expropriation. Basically, there are two types of predatory actions that may be taken by local political actors: direct and indirect taking of property. Direct taking of property can take various forms, ranging from outright nationalization on a sectoral basis to the seizure of land or a firm by the government to outright confiscation of the property.<sup>14</sup> In the case of China, indirect expropriations are a common practice manipulated by local officials, which may involve arbitrary fees and fines collected by local government, or “charitable contributions” to government-sponsored projects (Nee and Oppen 2012). In my statistical analysis of firm-level survey, I use arbitrary fees and fines collected by local government as a proxy to measure the level of local political actors’ predatory actions. As for the media reports of government-related property rights expropriation cases, the 279 expropriation cases I documented between 1992 and 2010 are exclusively direct taking of property.

Following existing literature, I use one indicator to measure my dependent variable—the level of local political actors’ predatory actions (Nee and Oppen 2012).<sup>15</sup> First, I use the information on all sorts of arbitrary fees and fines collected by local

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<sup>14</sup> Zheng (2007) in his study on FDI discusses expropriation and creeping expropriation according to UNCTAD 2003 (p.65).

<sup>15</sup> Donations (*juanzeng*) may be considered as an indicator of government-related property rights expropriations. However, it is hard to distinguish which donation was voluntarily contributed by the firms or forced to pay.

government in addition to taxes in 2011. Then I created a new variable coded as ratio-fees, which calculates the proportion of arbitrary fees and fines collected by local government on firm's total sales revenue. Arbitrary fees and fines is a perfect indicator of government-related property rights expropriations because firms must pay these fees and fines at the local level even though the central government has issued several orders to stop them.<sup>16</sup>

The key independent variable is the firm characteristics. What I am looking for is the availability of exit option a firm has. The survey listed eighteen industry sectors and asked firm owners what sector your firm's business is in. The full list of industry sectors in the survey includes agriculture such as farming, forestry, livestock husbandry, and fishing, mining, manufacturing, energy such as electricity, gas, and water, construction, transportation, information services, retail, hotel & restaurant, finance, real estate, rental & commercial services, science & technology, public infrastructure, resident services, education, public health, and culture & sports. There is one sector named others, which means that firms are not clearly specified their business type in the survey thus I am not able to identify the availability of exit option. Therefore, I omitted this sector in my study. Also, it is worth noting that firms in manufacturing sector include both those have an exit option and no exit option.<sup>17</sup> Finally, I choose agriculture sector as the baseline category in the model.

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<sup>16</sup> The "three disorders" or *sanluan* (improper levying of fees, arbitrary fines, and forced apportionment of funds) have long been major harassments to private firms' operating business acted by local government. The central government has issued several orders to stop them since 1990s. The forced apportionment of funds (*tanpai*) may be considered as another indicator of government-related property rights expropriations. However, there are two problems in using this measurement. First, it has large proportions of missing responses, and zero response in the data set. Also, we run a regression to test and found *tanpai* is highly correlated with owners' political background. All of these suggest this variable may be better indicator of political connections of firm rather than local political actor's predatory actions.

<sup>17</sup> Firms I classified into category of firm without an exit option follow one simple principle that if the firm is mobile. If the firm's production factor cannot be move out no matter how much it costs, then the firm was coded as firm without

A host of control variables, mainly including economic conditions and variables both at firm and entrepreneur levels, are also involved in the model (Dickson 2008). With respect to economic conditions, I first use firm's postcode to identify which province a firm is in. Then I code the top ten GDP per capita provinces as a rich region and the lowest 10 as a poor region according to the *China Statistical Year Book* of 2012. Finally, I created the first dummy variable Region1 identifying whether a firm belongs to a rich province (rich=1, otherwise=0). The second dummy Region2 was created to capture whether a firm belongs to a poor province (poor=1, otherwise=0).

Firm-level variables include firm size measured by the total number of employees in 2011, and the historical ties between the sample firm and the local government of its locality measured by a binary variable indicating whether the firm was transformed from an SOE.

At the entrepreneur level, I control for firm owners' political backgrounds, measured by Chinese Communist Party (CCP) and minor Democratic Party membership, a binary variable indicating whether owners used to be public officials, and a dummy variable indicating whether owners are legislative members including members of People's Congress and People's Political Consultative Conference at both national and local levels. I also control for entrepreneurs' education attainment.

Table 3.3 provides a statistical summary for all variables.

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an exit option. However, the firm with exit option is not that easy to classify because the costs will be take into account. For example, a firm in manufacturing or hotel & restaurant sector may have an exit option but with heavy costs. Therefore, I classified firms with an exit option only conditioned with slightly costs, such as firms in IT services. Those with heavy costs fell into the third category.

Table 3.3 Statistical Description of Variables

	Obs.	Mean	Std. Err.	Min.	Max.
<i>Firm level</i>					
Ratio-fee	3784	0.0302384	0.2294989	0	11.76471
Arbitrary fees and fines	4031	66.44514	485.6483	0	19041
Total sales revenue in 2011	4691	14271.65	134599.8	0	6761939
Numbers of employees in 2011	4952	218.5971	1135.873	0	53000
Former SOE status	4988	0.058741	0.2351628	0	1
<i>Entrepreneur level</i>					
Education	4980	3.949799	1.116389	1	6
CCP membership	4886	0.3401555	0.4738098	0	1
Democratic party membership	4886	0.3964388	0.4892076	0	1
Legislative member	4835	0.422544	0.4940152	0	1
Former government official	4861	0.3953919	0.488985	0	1

*Source:* Survey on Privately Owned Enterprises in China, 2012 (see Appendix A)

*Note:* The unit for all financial variables is 10,000 RMB yuan.

### Main Empirical Results

I employ a simple linear regression model to estimate the effects of firms' characteristics on the level of local political actors' predatory actions on firms' property rights. Table 3.4 presents main empirical results. Using the proportion of arbitrary fees and fines collected by local government on firm's total sales revenue as the dependent variable, after controlling for economic conditions and firms' and entrepreneurs' backgrounds, I find the value of R-square is quiet low, suggesting arbitrary fees ad fines are not that arbitrary as the public has perceived. However, two sectors indeed show some unfair treatment with regards to arbitrary fees and fines. Mining and construction

industry has a significant and positive effect on the proportion of arbitrary fees and fines collected by local government on firm's total sales revenue, suggesting if a firm has no exit option, then this firm had higher arbitrary fees and fines collected by local government. Mining industry is clearly a resource-intensive sector and construction industry is a local market attached sector. These two industries share the same feature of no exit option. A firm in either these two sectors if choose to relocate its business will lose everything; therefore it is more likely to be subjected to local political actors' predatory actions.

Table 3.4 OLS Regression Results

The proportion of arbitrary fees on firm's total sales revenue	
	Ratio-fees
Mining	2.3** (0.022)
Manufacturing	-0.82 (0.41)
Energy	-0.12 (0.906)
Construction	2.28** (0.023)
Transportation	0.39 (0.689)
Information service	0.19 (0.851)
Retail	-0.41 (0.681)
Hotel & Restaurant	0.17 (0.867)
Finance	-0.17 (0.865)
Real Estate	0.12 (0.904)
Rental & Commercial services	0.44

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	(0.658)
Science & Technology	0.03
	(0.973)
Infrastructure	0.15
	(0.878)
Resident services	-0.2
	(0.843)
Education	-0.13
	(0.896)
Health	-0.33
	(0.741)
Culture & Sport	0.27
	(0.79)
Region1	-1.03
(rich=1, other=0)	(0.305)
Region2	0.96
(poor=1, other=0)	(0.336)
Number of employees	0.01
	(0.995)
Former SOE status	-0.54
(yes=1, no=0)	(0.589)
CCP membership	0.07
(yes=1, no=0)	(0.947)
Democratic Part membership	-0.8
(yes=1, no=0)	(0.426)
Legislative mebers	0.87
(yes=1, no=0)	(0.386)
Former officials	2.15**
(yes=1, no=0)	(0.032)
Education attainment	-2.71***
	(0.007)
Constant	3.4***
	(0.001)
<i>N</i>	3300
<i>R</i> <sup>2</sup>	0.0097
<i>F-value</i>	1.23

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Notes: *p*-values are in parentheses. \**p* < 0.10, \*\**p* < 0.05, \*\*\**p* < 0.01

Among the control variables, firm owner's political background has a significant and positive effect on arbitrary fees and fines collected by local government. Firm owner's education attainment has a significant and negative effect on the proportion of

arbitrary fees and fines collected by local government on firm's total sales revenue. This means that if a firm owner's education level is lower, then the firm had higher arbitrary fees and fines collected by local government. In other words, the level of firm owner's education attainment affects local political actors' predatory actions on its firms' property rights.

In general, the regression results confirm the theoretical predictions. The positive correlation between the availability of firm's exit option and the level of local political actors' predatory actions on this firm suggests firm's characteristics have a far-reaching influence on local political actors' predatory behaviors. Since the firms without exit option have no place to move out their business, this feature greatly weakens the private firms' post-entry bargaining power vis-à-vis local political actors and makes firms vulnerable to the local officials' predatory activities, and therefore need to rely on other mechanisms, such as social networks or bribery, to overcome the commitment problem.

### **3.6 Analysis of Media Reports of Property Rights Expropriation Cases**

This empirical investigation relies on media exposure of government-related property rights expropriation cases involving local officials and private firms. I documented a total of 279 cases based on news reports from major newspapers, magazines and news portals in China. Appendix B discusses the collection of cases in greater detail and the limitations of the cases.

That being said, the 279 cases we documented between 1992 and 2010 are adequate to test the two hypotheses: (1) private firms with a high level of FSAs and an exit option, such as labor-intensive, export-oriented manufacturing firms, and high technology firms, enjoy sufficient property rights protection; and (2) private firms with a

low level of FSAs and no exit option, such as resource-intensive and local market seeking firms are vulnerable as the targets of local officials' predatory activities.

As table 3.5 shows, 243 out of 279 outright expropriation cases are in the energy industry (including the coal industry, petroleum industry, and electrical power industry), 14 in real estate development, 14 in manufacturing industry, 4 in transportation and construction, and 4 in the retail and service industry. A total of 92.12% of outright expropriations are resource-intensive and local market seeking firms, a result confirming my hypotheses.

Table 3.5 Media Exposure of Government-Related Property Rights Expropriations

	Expropriation		
	Cases (%)	1988-1998	1999-2010
Energy Industry	243 (87.10%)	0	243
Real Estate Development	14 (5.02%)	2	12
Manufacturing	14 (5.02%)	4	10
Transportation and Construction	4 (1.43%)	2	2
Retail and Service	4 (1.43%)	0	4
Total	279 (100.00%)	8	271

*Source:* Compiled by author.

My cases also reveal that the number of government-related expropriations has increased sharply in the natural resources sector after 1999. This may have something to do with the national government's change of policies toward the coal mining and oil industries since the 1990s. Before 1999, both the central government and the various provincial governments encouraged private investment in the coal mining and oil drilling



industries. Afterwards, the national government decided to take over or shut down small mines and drilling firms in the name of mining safety or the restructuring of the oil industry. The process of nationalization on these two natural resource sectors provided opportunities for local governments to engage in direct expropriation or creeping expropriation activities. As a result, a large number of property rights disputes has stemmed from the policy changes in coal mining and oil sectors.

Due to the nature of government-related property rights expropriation in the coal mining and oil industries, I exclude the cases in the energy industry to test the hypotheses. As shown in table 3.6, 38.89% of expropriation cases are in the manufacturing industry, and a total of 61.11% of expropriations are resource-intensive and local market seeking firms, again confirming our hypotheses.

Table 3.6 Media Exposure of Government-Related Property Rights Expropriations (Without Energy Industry)

	Expropriation		
	Cases (%)	1988-1998	1999-2010
Real Estate Development	14 (38.89%)	2	12
Manufacturing	14 (38.89%)	4	10
Transportation and Construction	4 (11.11%)	2	2
Retail and Service	4 (11.11%)	0	4
Total	36 (100.00%)	8	28

Source: Compiled by author.

With respect to the manufacturing firms, table 3.7 shows that 7 out of 14 cases were “red-hat enterprises”<sup>18</sup>, 4 involved privatizing SOEs or collective-owned enterprises (COEs)<sup>19</sup>, and 3 were in the food industry. Among the food-manufacturing cases, one was related to land acquisition, in which the local government used forced eviction to seize the factory building for real estate development; and another involved the crackdown on “organized crime” in Chongqing, in which the private entrepreneur was sentenced to capital punishment with a penalty of 100 million RMB. Although these food firms can be characterized as labor-intensive manufacturing firms, they are all local market seeking with a low degree of FSAs. My cases show that there are no government-related appropriation cases involving labor-intensive, export-oriented manufacturing firms, and high technology firms.

Table 3.7 Media Exposure of Government-Related Property Rights Expropriations (Manufacturing Industry)

	Expropriation
	Cases (%)
Red-hat	7 (50%)
Restructuring SOEs or COEs	4 (28.57%)
Food Industry	3 (21.43%)
Total	14 (100.00%)

Source: Compiled by author.

<sup>18</sup> The red-hat enterprises are private firms in which those owners disguised their private ownership and registered as public-owned firms in the early years of market transition in order to evade the “eight employees” restriction. As discussed in section 4.2, between 1978 and 1988, private businesses were not allowed officially except for “individual entrepreneurs” (*getihu*) with less than eight employees. For details of this literature see Chen (2007).

<sup>19</sup> The collective-owned enterprises mainly refer to Township and Village Enterprises (TVEs). According to Tian (2000), a Chinese collective enterprise is characterized by two main features: property rights are vaguely defined and there is significant involvement of government officials.

Summarizing the cases of government-related property rights expropriation, it is evident that labor-intensive, export-oriented manufacturing firms, and high technology firms enjoy sufficient property rights protection, and resource-intensive and local market seeking firms are vulnerable as targets of local officials' predatory activities. Therefore, the empirical evidence lends support to what I would expect from my model.

Interestingly, despite the external policy shock imposed on the mining and energy industries, my cases still show that the number of government-related expropriations have increased sharply after 1999, the turning point in the development of private property rights, when the Constitutional Amendments affirmed the legal status of private enterprises. The improvement in the legal status of private businesses does not seem to offer sufficient protection of private property rights. This provides further evidence to support my thesis that local political officials enjoy great leeway in choosing to abide by the rules and implement the policies.

Another interesting phenomenon as shown in these cases is that compared to other manufacturing firms, "red-hat" firms are most vulnerable in terms of property rights protection. Indeed, it is easy for this type of private entrepreneur to get into a property rights dispute with local governments. This happens as a consequence of the very nature of this type of enterprise. They are private firms, but their owners disguised their private ownership and registered as public-owned firms in the early years of market transition in order to evade the "eight employees" restriction. After 1988, when businesses with more than eight employees could be registered as private enterprise, many owners of the "red-hat" firms intended to take off the hat. But since the property rights of such firms were vaguely defined, these owners often found themselves in dispute with local governments.

The ownership change of manufacturing firms through the privatization of SOEs and COEs also makes such firms vulnerable. The issue involved in this kind of property rights dispute is the drain on state owned property. The process of privatization in China was often accompanied by the drain on state assets because of the agency problem. The local government may want to secretly privatize SOEs under its control or even encourage spontaneous privatization (Qian 1996). Under such circumstances, local officials can easily manipulate the value of the firm and its ownership structure, and facilitate the illicit asset transfer of such enterprises (Smyth 2000).<sup>20</sup> The problems in the process of privatization of SOEs and COEs also set the stage for disputes over property rights.

### **3.7 Conclusion**

This study provides a game-theoretic model to study the political economy of property rights in China, that is, a bargaining game between a firm and a local political official following the literature of the Obsolescing Bargain Model. The model assumes that local officials are potential predators and private firms are their prey. The predator and prey interact strategically in the context in which the central government evaluates the local officials on the basis of the cadre performance evaluation system.

I identify the mechanisms that may resolve the credible commitment problem. I show how the incentive structure provided by the Cadre Evaluation System, together with the firm-specific characteristics, results in a relatively stable condition for the protection of property rights for private firms. While firms with strong post-entry bargaining power enjoy a high level of credible commitment from the local government, weak firms are

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<sup>20</sup> Smyth (2000) examines the problem of the drain on state assets while Ding (2000) discusses the illicit asset stripping of Chinese state firms.

vulnerable to the local political officials' predatory activities, and therefore need to rely on other mechanism, such as social networks (*guanxi*) or bribery, to overcome the commitment problem. In particular, the availability of an exit option greatly enhances the private firms' post-entry bargaining power over local political actors in protecting their property rights.

My model demonstrates that private firms without an exit option may find themselves in a situation very much like a prisoner's dilemma in the bargaining relationship with local officials. Both the firm and the local official will choose the dominant strategy that is to evade the rules in the one-shot game and end up in the worse situation, where the firm tries to conceal real profits so that decreases the taxes it pays to the government, and the local official tries to exploit the firm. The empirical tests both in quantitative and qualitative study support the hypotheses generated from the model.

## CHAPTER 4

### **THE CHINESE STYLE OF SECURE PROPERTY RIGHTS**

This chapter explores the resources and constraints of local political officials created by the incentive structure. According to the framework presented in Chapter 2, these conditions will have an impact on local political officials' behaviors in the bargaining relationship with indigenous private investors in terms of property rights protection. Then, I test the effects of different types of local political leaders on the security of private property rights quantitatively.

The local political leaders protect private property rights when symbiosis between local officials and private entrepreneurs is feasible. In this framework, the symbiotic relationship between local political officials and private entrepreneurs creates conditions similar to secure property rights at the local level. The degree of symbiotic relationship between the local officials and indigenous private entrepreneurs determines the level of private property rights protection. Lower transaction costs make symbiotic relationships feasible, hence increasing the level of property rights protection. A native political leader of a locality has lower transaction costs of symbiotic relationship, and therefore symbiotic relationship between native local officials and local private firms is easier.

Using panel data covering detailed information for all political leaders in 21 prefecture-level cities in Guangdong province between 1992 and 2008, I test the hypothesis and find a positive impact on the secure private property rights of native local

political leaders. 166 out of 201 political leaders at prefecture-level municipality are native. By native, I mean those who were born in Guangdong province. Those who were born outside Guangdong province are coded as rotated political leaders. Political leaders include both the Party secretary (the first hand) and the Mayor of the municipal cities.

One common measure used to judge economic development and property rights is Gross Domestic Product (GDP) growth rate or GDP per capita. GDP measurement may be a good way to measure the overall economic performance but in an authoritarian regime like China, it is not an accurate indicator to measure the development of private economy, let alone the security of property rights. I use private investment in fixed assets as an indicator to measure the security of property rights. This is a good proxy for the security of property rights because this kind of investment requires significant immediate costs with only the promise of future revenue. I collect a dataset on private investment in fixed assets from 1992 to 2008 in 21 prefecture-level cities in Guangdong province.

To see if the main results and inferences are robust, I run two models and conduct a robust regression. I also conducted the third model, which examines the effects of nativity on the proportion of private investment in fixed assets on total investment in fixed assets, and the results are even more robust. All of the findings suggest that having a native political leader increase private investment substantially.

The remainder of this chapter is organized as follows. The next section sets out a theoretical framework with a close examination of local political leaders' characteristics that guides the empirical analysis. Then I describe research design and the dataset. Section 4 presents the main empirical results. Section 4 provides robustness checks. Section 5 concludes with a summary of the study.

#### **4.1 The Theoretical Framework**

As Chapter 3 has shown, local political leaders' decision of whether or not prey on private sector is determined by firm's resources and constraints. Meanwhile, as discussed in Chapter 2, local officials are also under strict constraints within the personnel control systems such as the Cadre Evaluation System (CES), the term limits system, and the rotation system. If the local official is near 55, or less educated, or no political connections, he/she will desperately need private sector's support for his/her political survival. This symbiotic relationship between less favorable to be promoted local political officials and private entrepreneurs creates conditions similar to secure property rights at the local level. The degree of symbiotic relationship between the local officials and indigenous private entrepreneurs determines the level of private property rights protection.

Native local officials have lower transaction costs and therefore symbiotic relationship between native local officials and local private firms is easier. Compare to rotated local leaders, native local political leaders have more incentives to protect private property rights in order to get political and economic benefits as well as none material rewards.

Those local officials who are native face different social constraints from those rotated leaders. First, for native prefecture-level officials, they had crafted broad and complex personal webs long before they came to this position from a county or township level position. Some native local political leaders just don't want to be promoted to a higher rank if that position does not have real authority to utilize resources. As a result, they will promote local economy in order to get economic interests, whether for their



family businesses or direct money transfers from local firms. They may provide the public good of localized property rights protection so that they could get closer connections with local economic elites for their own economic interests.

Second, since the loyalty-based long term relationships and regional affinity are crucial in establishing political connections, those native local political leaders who do not have connections but want to be promoted have to establish a new political connection with provincial leaders. The development of the private sector will serve two purposes for native local political leaders. On the one hand, the good performance of local private economy proves their ability to promote local economic growth. On the other hand, native local political leaders depend on the development of private economy because what they have for exchange is local economic resources. They will rely on local private firms to provide economic resources to achieve their goal of being promoted.

Third, from the perspective of local economic actors, market-oriented policy and 2007 law of property rights are clear signal regarding the central authority's commitment for the development of private economy. But occasional "left" and "right" ideological swing and no independent judicial system could not make that commitment credible in terms of property rights protection. Predatory activities may come from both public and private actors. Having a native local political leader will be an assurance of property rights protection because they are weak in comparison to rotated officials. Defective behaviors and opportunism will cost them much politically, economically and socially. In the worst scenario, for local private entrepreneurs it is much easier to utilize punishment to native political leaders rather than rotated ones, as their tenure normally is less than three years, on average, for local mayors. The ability of retaliation by local private

entrepreneurs creates stable conditions of property rights protection at the local level and hence influences private entrepreneurs' investment decisions.

Finally, local protectionism can be seen as a bad thing in the view of the central government or provincial government in terms of central coordination, policy compliances, and destructive local autonomy. It is true that this is the very reason behind the introduction of term limits and the rotation system by the central government. However, for indigenous private entrepreneurs, this is one source that helps to overcome the commitment problem and becomes an assurance of protection for their investment.

In sum, for any local official, he/she cares about his/her own payoff that includes his/her wages and potential transfers from the local firms, money or favors. But those local officials who are native are more likely to protect private property rights since their political and economic interests are intertwined more closely with the private entrepreneurs. The credible threats of retaliation to potential predatory activities by local indigenous private entrepreneurs creates stable conditions of property rights protection at local level and hence encourages private investment and economic development.

As discussed in Chapter 2, I argue that those local political leaders who are native are more likely to protect private property rights since the interests of local political actors and economic actors are intertwined closely. Native political leaders have less chance to be promoted and have more incentives to protect private investment in order to get political support as well as economic benefits.

### **Players**

Before formalizing the symbiosis logic of secure property rights, I identify the players and their preferences as follows. There are three players in the local economy,

Government ( $G$ ) is the principal, the local political official serves ( $S$ ) as the supervisor and the Private entrepreneur ( $P$ ) is the agent. In the context of China, I identify political actors as local political leaders, economic actors as indigenous private entrepreneurs, and government includes central and local.

### **Preferences**

I make an extremely simple assumption that the goal of the government and political actors may not be the same. Government ( $G$ ), both central and local, cares about tax revenue. The primary and foremost concern of local political leaders ( $S$ ) is to stay in an office and being promoted to a higher rank. But the ultimate goal of local political leaders is to acquire more wealth and secure their possessions. In other words, the pursuit of political power is the means to achieve the end (wealth acquisition). For the indigenous private entrepreneur ( $P$ ), what he/she wants is not only to maximize profit but also to secure their property rights. For the later goal, economic actors are willing to pay the costs ( $C^p$ ) as long as they expect some positive level of profits in compensation.

$G$  cares about tax revenue ( $t$ ).

$S$  cares about his own payoff, which includes his wages ( $w$ ) and potential transfers from the Firms ( $T^s$ ).

$P$  cares about maximizing its own profits ( $r$ ) while minimizing costs ( $c$ ).

The second assumption I make is that indigenous private entrepreneurs do not necessarily demand efficient property rights. In fact, it is not clear that an individual private entrepreneur should always demand that the government protect everyone's property rights. According to Haber et al. (2003), an indigenous private entrepreneur can receive utility from the secure and efficient property rights, because this makes her asset

more liquid, and therefore more valuable. However, if selective enforcement grants the indigenous private entrepreneur more comparative advantage in the market, then it may be more profitable to demand less than universal enforcement. Between these two possibilities, it is assumed that indigenous private entrepreneurs care first and foremost about their own property rights. Any profit-maximizing actor would readily accept the exclusive protection of her property rights, providing that it produced better benefits to that actor.

Finally, it is assumed that there exist information asymmetries between the government, local political leaders, and economic actors. In other words, the activities of local political leaders and economic actors cannot be observed by the government, and indigenous private entrepreneurs cannot perfectly monitor the impact of the government's actions or policies upon their property rights.

### **The Costs of Secure Property Rights ( $C^P$ )**

Producer ( $P$ ) chooses whether or not to invest with anticipated tax rate  $t \geq 0$ , and expected revenue  $r > c > 0$ , where  $r$  is the revenue,  $c$  the cost, and  $t$  the tax rate. To make an investment,  $P$  needs to get connected with  $S$  to protect its property. The costs of property rights are tolerated as long as  $P$  expects some positive level of profits in compensation ( $ep$ ). This expected compensation can be a tax discount or special market access. To sum up,

1. Producer ( $P$ ) choose whether or not to invest with anticipated tax rate  $t \geq 0$ ;  $r > c > 0$
2. Government ( $G$ ) sets tax rate  $t$ ,  $0 \leq t \leq 1$
3. Game ends with payoffs:

$$G: t \cdot r$$

S:  $w + T^s$

P:  $\begin{cases} (1-t)r - c - C^p + ep & \text{if investment made} \\ 0 & \text{if investment not made} \end{cases}$

For any potential investment,  $P$  can choose to get connected with  $S$  to get protection for her investment or not to do so. The profit for not getting connected is  $r - tr - c > 0$  with the risk of being predated  $k$ . The profit for getting connected is  $r - tr - c - C^p + ep > 0$  with property protection. Parameters  $r$  and  $tr$  are known to  $S$  and  $P$  but cannot be observed by  $G$ . To lower the risk of predation,  $P$  needs to get connected with  $S$  to get property protection. I assume that  $P$  cannot get connected with  $G$  for property protection. (In the real world, it is impossible to get connected with the central government and local government because under authoritarian rule it is almost impossible to access the government through formal institutions. In other words, it is much easier to access the government through political actors). This assumption can be relaxed by assuming that it is very costly to reach  $G$  for protection.

To secure property rights,  $P$  and  $S$  can cooperate by signing a contract.\* In cooperation,  $P$  pays  $S$ . However, they face some transaction costs to agree with this arrangement. I assume that  $S$  can get part of  $T^s = iC^p$  where  $0 \leq i \leq 1$  and  $(1-i)C^p$ , which indicates the transaction costs of symbiotic relationship.

In this context, the wage of  $S$  is a constant  $w$ . When  $S$  failed in political struggles, she/he loses her/his wage  $w$ . The probability of being punished is  $mnp$ , where  $m$  denotes the failure probability in political struggle and  $n$  denotes the detection probability.

## Investment Decision

For any potential investment,  $P$  can choose whether or not to invest with an anticipated tax rate  $t \geq 0$ . She can also choose to get connected with  $S$  to get protection for her investment.

If she chooses not to get connected, her problem is as follows:

$$r-tr-c > 0 \text{ with the risk of being predated } k. \quad (1)$$

If she chooses to get connected, her problems become as follows:

$$r-tr-c-C^p+ep > 0 \quad (2)$$

subject to the participation constraint of  $S$ :

$$T^s = iC^p \geq mnpw \quad (3)$$

Thus,

$$ep-C^p \geq \frac{mnpw}{i} \quad (4)$$

In the current framework, a symbiotic relationship is more likely for higher  $i$  and thus the private investment growth rates are higher for higher  $i$ . This can be seen from equation (4), as the right-hand side is decreasing in  $i$ . This simple framework generates the main hypothesis regarding the symbiotic property protection and I will test with data as follows.

*Hypothesis:* Symbiotic relationship between political and economic actors at the local level is more likely to happen when local political officials are native and hence the private investment growth rates are higher.

## 4.2 Research Design

To assess the determinants of property rights protection, the general model tested

is *Private investment*

$$\begin{aligned} &= f \text{Nativity} \\ &+ \beta_2 \text{Private} \\ &+ \beta_3 \text{Total} \\ &+ \beta_4 \text{Region} \\ &+ \beta_5 \text{Education} \\ &+ \beta_6 \text{Edu1} \\ &+ \beta_7 \text{Firstjob} \\ &+ \beta_8 \text{Partyschool} \\ &+ \beta_9 \text{Age} \\ &+ \text{Error term} \end{aligned}$$

### **Dependent Variable**

Private investment is my dependent variable and an indicator of property rights protection. I use private investment in fixed assets as an indicator to measure the security of property rights. This is a good proxy for secure property rights because this kind of private investment requires significant immediate costs with only promises of future revenue. I also created a new variable coded as ratio-private, which calculates the proportion of private investment in fixed assets on total investment in fixed assets to gauge the level of private property rights protection in a locality.

One common measure used to judge economic development and property rights is GDP growth rate and GDP per capita (Liu et al. 2012). GDP measurement may be a good way to measure the overall economic performance but is not a good indicator to measure the security of property rights. Scholars argue that China's economic development largely relies on large-scale investment to facilitate high GDP growth rate. Investment can be categorized into two types, that concerning infrastructure and real estate properties, and

that in corporate development. The high GDP growth rate does not necessarily indicate the growth rate of private investment because this investment-led growth shows the large part of investment are government fund infrastructure projects and real estate properties rather than private investment. It may well be the case that the cities with higher economic growth rates had received more economic resources from higher authorities or borrowed money from state-owned banks to finance infrastructure projects.

Despite the contribution of previous studies, the common problem in these empirical studies is the GDP measurement as an indicator of property rights protection. GDP growth rate or GDP per capita does not necessarily mean the development of private economy or the security of property rights for several reasons. First, before 1978, private economy was strictly forbidden. Anyone who did private business would be severely punished including being arrested and persecuted. The major contribution of GDP was from the state sector. Between 1978 and 1988, the private sector was not allowed officially except “individual entrepreneurs” (*getihu*) doing small business with less than eight employees. This is why other literature places more emphasis on the informal and coping strategies of the private entrepreneurs or local officials to get around the restrictions imposed by the unfavorable formal institutions, such as disguising their operations as collective enterprises or foreign firms in order to protect themselves (Tsai 2007; Oi and Walder 1999; Sull 2005). The 1988 regulations allowed businesses with more than eight employees to be registered as “private enterprise” (*siying qiye*), but it was only after the introduction of the Company Law in 1993 that paved the way to the rapid development in private sector during the 1990’s. Therefore, any empirical study on



the development of private economy and property rights in China using GDP measurement does not distinguish these three time periods will distort the picture.

Second, China is a mixed-market economy in which the state sector still plays an important role. For example, in 2010, the private investment in fixed assets made 13.7% of Guangdong province's total investment in fixed assets. After including the investment of self-employed individuals, other limited liability and share holding firms, all four kinds of investment made 45.83% of total investment in fixed assets.<sup>21</sup>

Finally, under the cadre rotation system and political officials' relatively short tenure in one position before promotion or rotation (less than three years, on average, for local mayors), local officials are under enormous pressure to show their ability to produce economic growth quickly. One way of generating quick economic growth is to borrow money from banks to finance massive infrastructure projects. The typical way is by selling land or using land as collateral to borrow large sums of money from state-owned banks. The abusive land requisitions and forced evictions caused by local "land finance" have produced great grievances among rural peasants, urban dwellers, and small business owners. The worst example is the Chongqing model, where GDP growth rate is high and property rights violence prevalent. During Bo Xilai's tenure, his administration borrowed the equivalent of more than 50% of local GDP to finance the construction projects. At the same period, many private entrepreneurs were imprisoned and billions in private properties were confiscated in the name of the campaign "signing red songs and crackdown black gangs" (*Changhongdahei*) (Pei 2012).

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<sup>21</sup> Guangdong Bureau of Statistics. *Guangdong Statistical Yearbook 2011*. Beijing: Statistical Press of China.

Because GDP measurement is not an accurate indicator to measure the development of private economy and the security of property rights, I use private investment in fixed assets as an indicator to measure the security of property rights. This is a good proxy for the security of property rights because this kind of investment requires significant risk with only promises of future revenue in an authoritarian regime. I collect a dataset on private investment in fixed assets from 1992 to 2008 in 21 prefecture-level cities in Guangdong province.

### **Explanatory Variable**

I explore the degree of symbiotic relationship between political and economic actors by examining the biographical information of the prefecture level political leaders in 21 municipality cities in Guangdong province. These local political leaders include 111 mayors and 92 party secretaries. I trace the careers of all the 203 political leaders of 21 municipalities between 1992 and 2008. I proxy the transaction costs of symbiotic relationship by whether the top leaders of prefecture-level cities are native and create one dummy variable nativity. Nativity identifies whether a mayor or party secretary was born in Guangdong province, which takes a value of 1, otherwise its value is 0. Once a municipality had local political leaders who were born in Guangdong province, the chances were high that the leaders would have close ties to local economic actors and face more strict social constraints; therefore, they were more likely to protect property rights. In contrast, rotated local political leaders would have close ties to the higher authorities so that they would lack the incentives to protect the private property rights. Thus, the dummy variable I constructed would have a positive effect on the dependent variables.

## **Control Variables**

A host of control variables are also involved in my model. I include initial economic variables, geographical variables, and some socioeconomic variables. According to the literature, initial economic conditions will have positive effects on economic development (Solow 1956). In the model with the private investment in fixed assets from 1992 to 2008 as the dependent variable, I control private investment in fixed assets in 1992 and total investment in fixed assets in 1992.

With respect to geographical variables, I create a dummy variable region (PRD=1, other=0) identifying whether a municipality belongs to Pearl River Delta (PRD) region, Eastern coast, Western coast, or Mountain area. This dummy variable is to control the location advantage of a municipality and the effects PRD on the economic growth of a municipality.

I create five dummy variables in order to control socioeconomic factors that may have impacts on the dependent variable. One is education (education in Guangdong=1, otherwise=0). This variable is created to catch the phenomenon of those local leaders who were not born in Guangdong province but pursued their higher education in Guangdong. According to the literature of social connections, locality of origin, classmates, and job-related colleagues are common ways to establish social networks in China (Guo 2001; Luo 2007). Therefore, those rotated political leaders who studies in Guangdong would have established close ties to local elites. I also created a dummy variable edu1 (college degree=1, otherwise=0) to control local political leaders' education attainment as an indicator for individual human capital.

Likewise, the dummy variable (first job in Guangdong=1, otherwise=0) is to control job-related social networks. And party school experience (Yes=1, No=0) is to detect the common practice where local political leaders strive to establish new political connections with higher officials during their study in party schools since the party school is the best place to meet other political leaders. Finally, I created a dummy variable age to control local political leaders age effect on their behaviors.

### **4.3 Data**

I collected a dataset on private investment growth rate, the prefecture-level of political leaders for 21 municipality cities in Guangdong province between 1992 and 2008. I focus on Guangdong province because Guangdong province is one of the most prosperous in China with the highest GDP among all the provinces, but the disparity within the province is larger than between provinces.

There are 21 municipality cities in Guangdong province, 9 in PRD region, 4 in eastern coast, 3 in western coast, and 5 in mountain areas. A prefecture-level municipality is subject to the jurisdiction of a provincial government, and directly controls some urban districts while overseeing some counties or smaller cities on behalf of the provincial government.

The data used in this paper comes from two primary sources: First, the data of private investment in fixed assets between 1992 and 2008 come from *Guangdong Statistical Yearbook*. It is worth noting that the data of the Yunfu municipality only covers from 1996 to 2008 because Yunfu was a newly created prefecture-level city in 1996.

Second, the data and CVs on 203 municipality's leaders between 1992 and 2008 come from government website of Guangdong province, People's Daily online, and municipality newspapers. Information on two mayors and one party secretary are missing in this dataset. Table 4.1 presents a descriptive statistics of variables.

As shown in Table 4.1, the average length in office of prefectural level officials is round 3 years. The average age is 51.5 years old, where the youngest local leader is at 38; and the oldest at 66. The average of private investment in fixed assets is around 14.63 (1.463 billion RMB Yuan); the average of total investment in fixed assets is around 206.55 (20.655 billion RMB Yuan). The average ratio private investment on total investment is 0.147, which means the average percentage of private investment on total investment is 14.7%.

Table 4.1 Statistical Description of Variables

Variables	Obs	Mean	Std. Dev.	Min	Max
Tenure	197	3.395939	1.891329	1	11
Age	599	51.50918	4.919027	38	66
Private investment	664	14.62557	11.11922	0.19	71.86
Total investment	665	206.5487	312.5168	7.19	2101.45
Nativity	657	0.8219178	0.3828734	0	1
Region	666	0.4324324	0.4957859	0	1
Education	413	0.748184	0.4345825	0	1
Education attainment	590	0.5	0.5004243	0	1
First job	532	0.862782	0.3444012	0	1
Party school	519	0.5722543	0.4952291	0	1
Ratio-private	663	0.1474508	0.1012198	0.0001476	0.4584749

*Source:* Compiled by author.

*Note:* The unit for all financial variables is 100.000.000 RMB yuan.

As a comparison, Table 4.2 and Table 4.3 present descriptive statistics on native local officials and rotated officials. The average length in office is very close for native mayors or the Party secretaries and rotated ones, around 3 years. The average age is also very close for native local political leaders and rotated ones, around 51 years old.

The average of private investment in fixed assets between 1992 and 2008 is 15.13 (1.513 billion RMB Yuan) for places where have native officials, but 12.70 (1.27 billion RMB Yuan) for rotated officials. The municipality cities with native political leaders have higher private investment than the cities with rotated leader about 20%. In contrast, the average of total investment in the cities with rotated leaders is 454.41 (45.441 billion RMB Yuan), but it is only 154.61 (15.461 billion RMB Yuan) with native leader, which is higher almost 3 times.

Table 4.2 Statistical Description of Variables on Native Prefecture-level Political Leaders

	Obs	Mean	Std. Dev.	Min	Max
Tenure	153	3.529412	1.970369	1	11
Age	482	51.66805	4.974966	38	66
Private investment	540	15.13476	11.31886	0.32	71.86
Total investment	539	154.6141	211.6711	7.19	1687.11
Nativity	540	1	0	1	1
Region	540	0.3685185	0.4828503	0	1
Education	306	0.8823529	0.3227175	0	1
Education attainment	476	0.4390756	0.4967965	0	1
First job	421	0.9714964	0.1666044	0	1
Party school	405	0.6049383	0.4894686	0	1
Ratio-private	539	0.1615698	0.1004819	0.004481	0.4584749

*Source:* Compiled by author.

*Note:* The unit for all financial variables is 100.000.000 RMB yuan.

Table 4.3 Statistical Description of Variables on Rotated Prefecture-level Political Leaders

	Obs	Mean	Std. Dev.	Min	Max
Tenure	39	3.076923	1.528408	1	6
Age	117	50.8547	4.644732	40	60
Private investment	115	12.6973	10.01239	0.19	68.39
Total investment	117	454.41	524.4573	16.21	2101.45
Nativity	117	0	0	0	0
Region	117	0.7008547	0.459853	0	1
Education	107	0.364486	0.4835506	0	1
Education attainment	114	0.754386	0.4323511	0	1
First job	111	0.4504505	0.4997952	0	1
Party school	114	0.4561404	0.5002716	0	1
Ratio-private	115	0.0841656	0.0808905	0.0001476	0.4017234

*Source:* Compiled by author.

*Note:* The unit for all financial variables is 100.000.000 RMB yuan.

It is worth noting that the average proportion of private investment in fixed assets on total investment in cities with native political leaders is 16.16%, but in cities with rotated political leaders is only 8.4%. All these figures suggest that the prefectural cities with rotated political leaders have lower private investment but much higher total investment.

#### 4.4 Main Empirical Results

The estimation results are presented in Table 4.4. I first estimate the correlation coefficients between the dependent variable and the independent variable. In model 1, the dependent variable nativity has a positive (2.14) and significant ( $P < 0.033$ ) effect on private investment, which is consistent with the theoretical expectation.

Table 4.4 OLS Regression Results

	Dependent variable: Private investment		Ratio-private
	Model 1	Model 2	Model 3
Nativity	2.14*	3.33***	3.97***
(native=1, other=0)	(0.033)	(0.001)	(0.000)
92private		6.72***	3.8***
		(0.000)	(0.000)
92total		-3.38***	-4.91***
		(0.001)	(0.000)
Region		0.17	-7.3***
		(0.862)	(0.000)
Education		-1.04	1.36
(Guangdong=1, other=0)		(0.301)	(0.174)
Education attainment		3.94***	0.67
(college=1, other=0)		(0.000)	(0.503)
Firstjob		-0.85	-4.69***
(Guangdong=1, other=0)		(0.398)	(0.000)
Partyschool		2.92**	1.58
(yes=1, no=0)		(0.004)	(0.114)
Age		0.88	-2.04*
		(0.381)	(0.042)
Constant	12.26	-0.16	5.25***
	0.000	(0.874)	(0.000)
N	655	353	352
$R^2$	0.007	0.2184	0.4794
F-value	4.57	10.65	35

P-values are in parentheses.

\* $p < 0.05$ , \*\* $p < 0.01$ , \*\*\* $p < 0.001$

In model 2, after controlling for the initial economic variables, geographical features, and socioeconomic factors, we can see that the correlation coefficient between private investment and nativity is positive (3.33) and highly significant ( $P < 0.001$ ), indicating that having a native political leader has positive effect on private investment in fixed assets. In other words, if a city has a native political leader, then this city has higher



private investment, suggesting private firms in this city enjoys better property rights protection.

Among the control variables, the initial economic conditions have a significant effect on private investment. But what is interesting is that private investment in 1992 has a positive effect whereas total investment in 1992 has a negative effect on private investment. As for socioeconomic variables, the coefficient of education is insignificant; suggesting whether a local political leader studied in Guangdong did not affect private investment. However, the level of education attainment has a positive effect on private investment. Also, party school experience has a positive and significant effect on private investment. Those local political leaders who have higher education and those who have party school experience promote local private economy. The geographical variable has no significant effect, which indicates that whether a city is in PRD, east coast, west coast, or mountain areas is not important to private investment in Guangdong province.

Overall, the regression results are very consistent to my theoretical prediction. Native local political leaders are more likely to protect private property rights and hence encourage local private economy. Since the native political leaders in the province had more close ties with local economic elites, they would have more incentives to promote the development of private economy.

#### **4.5 Robust Test**

I ran the third model, where the independent variable is ration-private, the proportion of private investment in fixed assets on total investment in fixed assets. The results are even more robust. The correlation coefficient between private investment and nativity is positive (3.97) and highly significant ( $P < 0.000$ ), indicating that having a native

political leader has strong positive effect on private investment. However, there are different results between the model 2 and the model 3 among the control variables. First, the level of education has a positive effect on private investment, but has no effect on the ratio private investment. Second, those leaders who had their first job in Guangdong have no effect on private investment, but have a negative effect on the ratio private investment. Third, party school experience has a positive and significant effect on private investment, but has no effect on ration private investment. Finally, local political leaders' age has no effect on private investment, but has a slightly negative effect on ratio private investment.

To see if the above results and inferences are robust, I ran two models. Comparing model 1 and model 2, we find that they are similar in terms of the effects of the independent variables and explanation power indicating that the relationship between property rights protection and nativity of local political leaders are stable and my specification are robust. I also conducted the third model, which examines the effects of nativity on the ratio private investment and the results are even more robust. All of the findings confirm the theoretical prediction that having native local political leaders increase private investment substantially.

#### **4.6 Conclusion**

My study tries to explore the micro-foundations of the credible commitment logic by formalizing symbiotic logic in property rights protection and provides some empirical evidence for it. I have shown that when there were no credible commitment to protect property rights, native local political leaders had incentives of supporting local private entrepreneurship for political, economic, and reputation building. Indigenous local private entrepreneurs were more likely to invest in the localities with native local political

leaders because in a small community with dense social connections they could monitor the potential predatory activities and provide credible threats of retaliation. The transaction costs in the symbiotic relationship between native local political leaders and indigenous private entrepreneurs are low, and therefore this relationship is more likely to happen. The interactions between political and economic actors created conditions similar to secure property rights, and hence encouraged the development of private economy. Though property rights protection afforded by this logic is unstable and localized, in places where secure and efficient property rights are missing, this mechanism has been effective in fostering local economic development.

Two main challenges for this study are measurement and data quality. For the challenge of measurement, I used private investment as an indicator to measure the security of property rights. This is a better proxy than GDP measurement since this kind of investment bears considerable risks with only promises of future revenue whereas GDP growth may not require the commitment to protect private property rights, as long as the local leaders could gain economic resources for higher authorities or state-owned financial institutions.

Data quality is a common concern to any study on contemporary China. I test the hypothesis of the model using various sources of data: biographies of local political leaders, statistical yearbooks, and the media reports. Empirical results I tested in this paper are consistent with the theoretical prediction. All the findings suggest having native local political leaders promoted a substantially higher level of private investment. While my study focuses on Guangdong province, the symbiotic logic can apply to other provinces as well.

## CHAPTER 5

### LOCAL INDUSTRY POLICYMAKING AS A SOURCE OF PROPERTY RIGHTS

#### A Case Study of B&B Industry Policymaking in Xiamen

This chapter provides a case study of local B&B industry policymaking that further support the second hypothesis generated from the model—the bargaining game between private investors and local officials, presented in Chapter 2. It shows how different types of local officials make very different local industry policy choices under the same incentive structure, and, therefore, create a condition that allows for property rights protection or expropriation.<sup>22</sup>

A large body of literature has attributed China’s economic miracle to the direct consequences of fiscal and political institutions rather than economic institutions such as the property rights regime. Growth-driven activities pursued by local governments or local officials were directly shaped by incentive structures, such as fiscal arrangement and cadre performance evaluation system, designed by the central government. But the incentive structure itself cannot explain different behaviors of local governments, ranging from developmental, corporatists, entrepreneurial, and predatory, which led to variations in local economic performance.

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<sup>22</sup> The basic facts in this paper were collected from news reports, government reports, as well as interviews. It is noteworthy that interviews only serve as supplementary sources of information. The validity and reliability of constructed interviews may be questionable with its intervening nature, particular when informants consciously and unconsciously make sense of their research. The examination of media reports and government reports will help to restore an original scene that seeks to make intelligible reasons state agents give for their actions. My interviewees included officials, B&B business owners, chairmen of B&B associations, journalists, and scholars in Xiamen. To the purpose of methodological reliability in the interviews, I tried to ask the same questions of different people to find common answers.

Local industry policymaking has been treated as the local states' or local officials' rational response to a problem, a simple strategic action to faction power struggles, or muddling through bureaucratic politics decision-making. The role local officials play in the local industry policy initiatives and policymaking and its effects on property rights is not clear. Local officials may pursue very diverse industry policy choices in accordance with the conditions and constraints placed on them. As Chapter 2 and Chapter 4 have shown, personal characteristics of local officials under the same institutional setting as the Cadre Evaluation System (CES) create advantages and constraints, which influence local officials' behaviors toward private property rights in order to achieve their career concerns and monetary interests.

My theory argues that native local officials are more likely to respond to their local "support" constituency's interests in local policy making than transferred/rotated officials,<sup>23</sup> especially those who transferred from the central agencies. Whether or not local state becomes predatory or developmental depends on what types of key local officials and whether they are native or have been rotated/transferred from outside that locality. Compared with native local officials, the rotated/transferred local officials tend to be predatory to private property rights regardless of their orientations toward economic growth as a result of the cadre performance evaluation system.

In addition to the empirical test in Chapter 4, this chapter further provides the support by examining the role of different types of local officials in local industry policymaking or initiative and policy changes. Taking policy changes of B&B industry in Xiamen as an example, this chapter shows that under the current institutional arrangements, local leaders possess a great deal of autonomy over local industry policy

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<sup>23</sup> The idea of "support" constituency comes from the "dual constituency" hypothesis (Fiorina 1974).

making thus allowing them to pursue their own preferences, and political and economic interests strategically in dealing with private sector. As a result, individual local officials rather than the governments (central or local) become a major source of uncertainty for private property rights in China even though the central government enacted the Property Rights Law in 2005.

This chapter attempts to answer the following questions: Why and how the local industry policy on B&B business has been made? Why is there a dramatic change in local industry policy toward B&B business in Gulangyu? Why the change of local industry policy is possible? How was this policy change implemented?

The case study constitutes four sections. The first section introduces the development of the B&B sector in Xiamen. The second section demonstrates policy change of B&B industry and shows that the problem of “doing business without license” and “fine and detention of B&B owners” are direct consequences of local industry policy changes. The third section presents how and why two contradictory local industry policies took place, the logics behind such changes, and their outcomes. The fourth concludes.

### **5.1 The Development of the Bed & Breakfast Industry in Gulangyu, Xiamen**

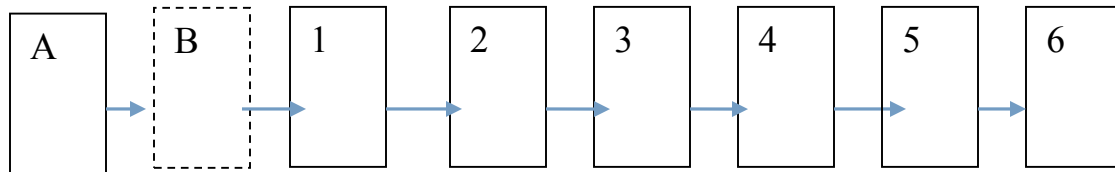
The bed-and-breakfast (B&B) business has been increasing dramatically throughout the world. In China, the B&B industry emerged as a new phenomenon in the late 1990s with the development of domestic tourism. Like elsewhere, the nature of B&B business has resulted in a great variety of establishments, as well as what constitutes a B&B (Jones & Guan 2011). In the most cases, a B&B often refers to a homestay, or a “family hotel” (an English translation of the Chinese name 家庭旅馆) as it is often an owner-occupied

private home with a number of guest rooms. But increasingly, more and more Chinese B&B hostels are under the operation of private entrepreneurs who are not owners but entered the business through investing private capital. In either case, the B&B presents a great opportunity for the growth of entrepreneurship in China. In this study, I use the term B&B hostel that includes both owner-occupied “family hotels” and non-owner invested inns or lodges.

B&B hostels in China are usually located around famous scenic spots or attractive tourism destinations, and achieved great success (Zheng & Li 2007; Lu 2007). In general, local government encouraged residents to operate B&B businesses to relieve the stress on tourist accommodation and to facilitate local economic development. But as the case of the Gulangyu B&B industry shows, local political leaders’ attitudes toward B&B industry are very different and hence affect their policy choices on the industry’s development and private investment.

The hotel business has been categorized as a special sector in China. Theoretically speaking, anyone who wants to enter the hotel business should apply for a special permit after the facility meets several requirements set by different government agencies. The process of so-called “six licenses” of a B&B hostel takes at least six months to complete. As a result, most B&B owners started their investment for the business when they got the first permission from the local sub-district government. Table 5.1 shows the application process of a B&B hostel in Gulangyu, Xiamen.

Table 5.1 The Process of Six-License Application for a B&B Hostel in Xiamen



- A. Pre-permission from Gulangyu sub-district government
- B. Permission from GSMC (beginning in May 2010)
- 1. License 1—Fire Certificate from Siming district Fire department
- 2. License 2—Special Sector Permission from Siming district police station
- 3. License 3—Industry and Commerce Business License from Siming district Administration of Industry and Commerce
- 4. License 4—Tax Certificate
- 5. License 5—Sanitary Certificate
- 6. License 6—Environmental Protection Certificate

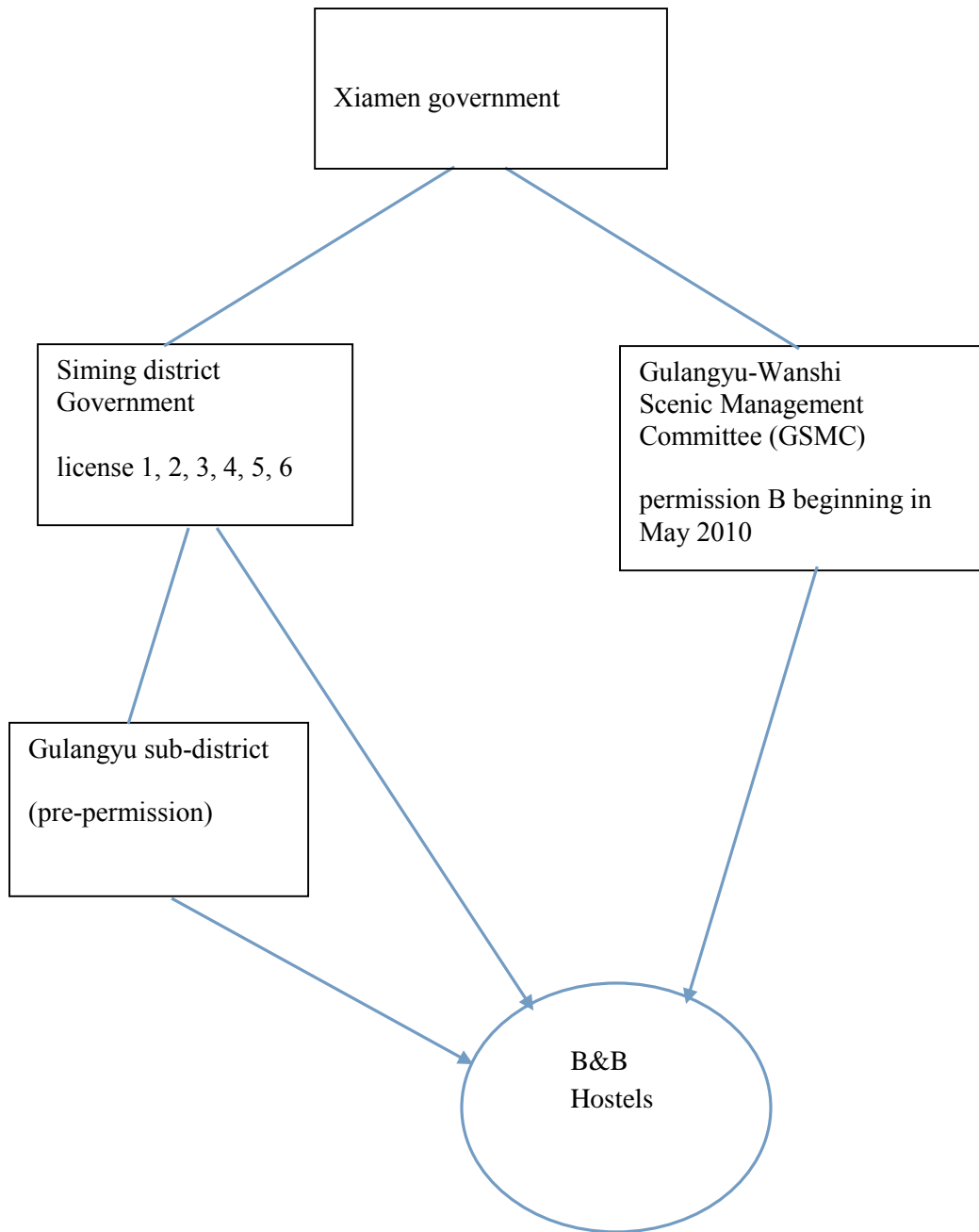
*Source:* Cai Changchun, “Gualngyu Shengyi zhongde Minzi ‘Ermeng’” [Private Investment’s ‘Nightmare’ in Gulangyu’s World Heritage Application Process], *Fazhizhoume* [Rule by Law Weekend], 09-04-2013.

Gulangyu is an island off the southwest coast of Xiamen city, which is an old port city in Fujian province in southern China and has been one of five Special Economic Zones (SEZs) since 1980. As a place of residence for Westerners during the China’s colonial past, it is famous for its colonial architecture and for hosting more than 600 pianos, giving it the nickname of “Piano Island.” The island is on China’s top list of National Scenic Spots and is one of the most popular domestic tourist destinations.

Administratively, it forms Gulangyu sub-district of Xiamen’s Siming district government. However, the island is also under the administrative guidance of Gulangyu-Wanshi Scenic Management Committee (GSMC) that is directly controlled by Xiamen government. Table 5.2 shows this unique nature of administrative system.



Table 5.2 The “Duel Administrative System” of Gulangyu



Source of Table 5.2: “The brief introduction of Gulangyu-Wanshi Scenic Management Committee,” at <http://www.gly.cn/zhfxxgk/zhfxxgkml/index.htm?u=/zhfxxgk/zhfxxgkml/gwhgk/index.htm>

GSMC enjoys equal power but shares different administrative responsibilities with Siming district government in the hierarchical government structure. This arrangement can be traced back to 2003 when Gulangyu was originally a district of Xiamen but dissolved and transferred its partial administrative power to Siming district. Under this dual administrative system, the GSMC is responsible for Gulangyu's scenic regulation, preservation, construction and management while Gulangyu sub-district government is responsible for the residents of the island.<sup>24</sup>

The so-called “dual administrative system” has been cited as a factor that affects the development of Gulangyu B&B industry (Huang 2013). However, as this essay will show it is local political leaders' personal policy choices, which determined the change of B&B industry policy, and hence affected the private property rights.

Xiamen's first private owned hostel emerged in the late 1980's in Gulangyu. In 2006, the first B&B hostel started business when the former German counselor's building was renovated and transformed into a B&B hostel. But it was only after the pass of the “Regulations on Gulangyu B&B Industry (Trial)” in 2008 that the industry began to develop rapidly. There were only six B&B hostels in 2008. As of 2013, privately owned B&B hostels have increased to almost four hundred. Figure 5.1 shows the number of B&B in Gulangyu between 2006 and 2013.

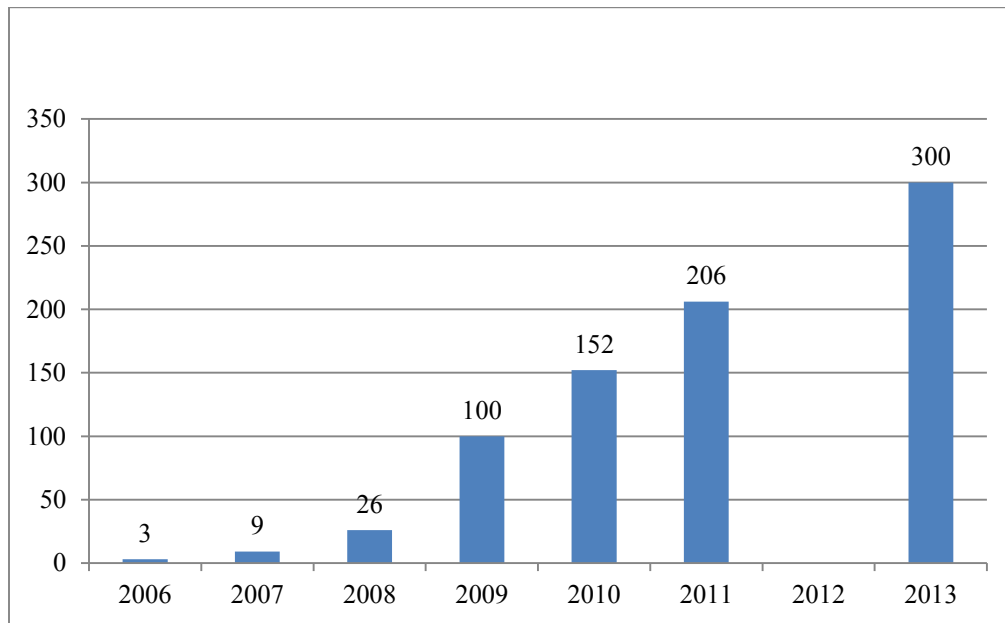
However, of the 400 B&B hostels only 126 are fully licensed. Another 130 B&B hostels are at various stages of the six-licenses application process. The remaining 100 or so hostels are operating without any license. Although 130 hostels only have partial license they still pay all relevant taxes and fees, and received the “proof of temporary tax

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<sup>24</sup> “The brief introduction of Gulangyu-Wanshi Scenic Management Committee”  
<http://www.gly.cn/zhfxxgk/zhfxxgkml/index.htm?u=/zhfxxgk/zhfxxgkml/gwhgk/index.htm>

payment” from relevant local governmental agencies. Figure 5.2 demonstrates the distribution of licensed B&B hostels in Gulangyu by 2013.

Figure 5.1 The Number of Bed & Breakfast Hostels in Gulangyu from 2006 to 2013

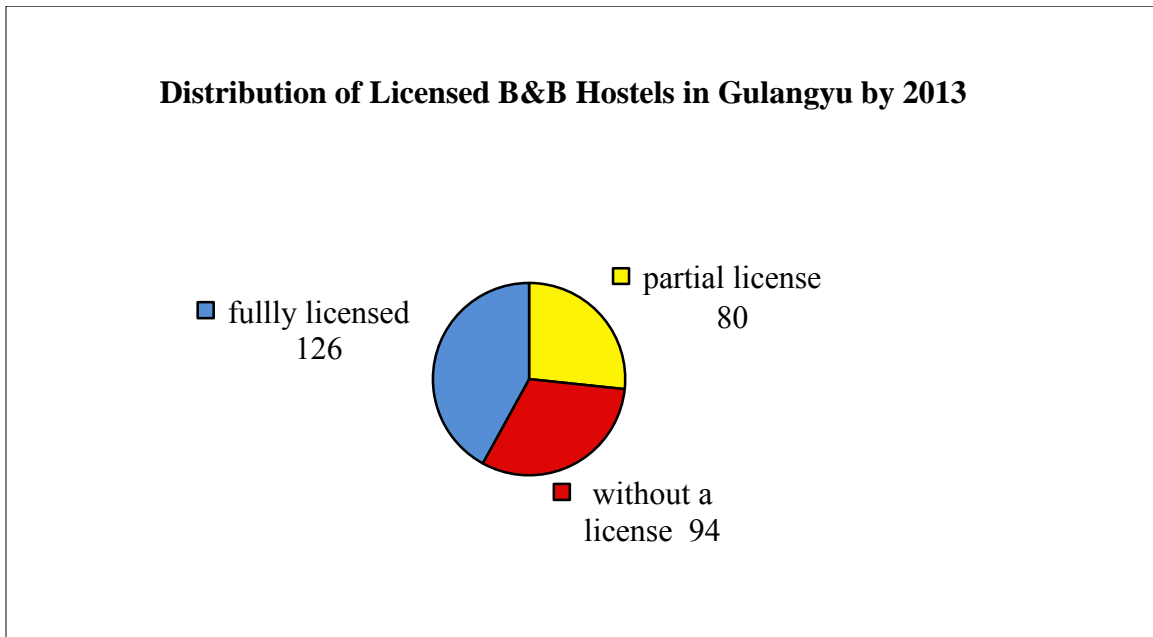


Source: Cai Changchun, “Gulangyu Shengyi zhongde Minzi ‘Ermeng’” [Private Investment’s ‘Nightmare’ in Gulangyu’s World Heritage Application Process], *Fazhizhoume* [Rule by Law Weekend], 09-04-2013, and Xu Yixin, “Gulangyu B&Bs (in Chinese).” The Summit Forum for the Development of B&Bs Across the Strait, September, 2014.

## 5.2 The Change of Local Policy on Gulangyu B&B Industry

With the rapid development of B&B industry in Gulangyu, the local government faced great challenges in managing the fast growing number of tourists and B&B hostels, particularly in regulating the market, and providing public goods. In response to these challenges, local government added extra procedures as a way of managing the B&B industry in Gulangyu in May 2010. In other words, any one who wants to start a B&B business should get approval from GSMC in addition to the six licenses in May 2010.

Figure 5.2 The Distribution of Licensed B&B Hostels in Gulangyu by 2013



*Source:* Cai Changchun, “Gulangyu Shengyi zhongde Minzi ‘Ermeng’” [Private Investment’s ‘Nightmare’ in Gulangyu’s World Heritage Application Process], *Fazhizhoume* [Rule by Law Weekend], 09-04-2013, and Xu Yixin, “Gulangyu B&Bs (in Chinese).” The Summit Forum for the Development of B&Bs Across the Strait, September, 2014.

The problem of “doing business without a license” in the B&B sector in Gulangyu is a direct consequence of local government’s decision to stop processing all B&B applications, no matter at what stage a B&B hostel was in the process of the six-license application, as well as their decision to stop accepting new applications in late 2011. In the first half of 2012, the application process was restarted but it was closed again in July 2012. Because of the long process of the six-licenses application, no single B&B hostel was able to complete its application during this period resulting in 130 B&B hostels at various stages of the application process. Since then, another 100 B&B hostels were established without any license due to this local administrative decision.

In May of 2013, the GSMC issued “Gulangyu Applying for World Cultural Heritage Improvement Projects—A Specific Plan for Gulangyu B&B Industry” (the Plan), which aims to regulate the confusions about the development of the B&B industry in Gulangyu. The plan was drafted by the joint work of GSMC and Siming district government, and ratified by the Planning Department of Xiamen. As the date of the promulgation, all applications and clearance of B&B hostels in Gulangyu should follow the guidance of the Plan. According to the Plan, almost half of all B&B hostels in Gulangyu will be closed down, which means nearly 10 to 20 million private investment will be under threat. The Plan also provides practical guidance to the procedure of shutting down a B&B business. In order to meet the cut-off numbers, the Plan urges regulatory and law enforcement agencies to work hard in checking and closing down those B&B hostels who are “doing business without a license”. Beginning in late 2013, many owners of B&B hostels with partial licenses were fined and detained by local police station for 5 to 15 days.<sup>25</sup>

The above description of the development of the B&B industry in Gulangyu shows very clearly that the problem of “doing business without a license” in the B&B sector in Gulangyu and “fine and detention of B&B owners” in Xiamen are direct consequences of the administrative decision in 2011 and local government agencies’ orders in 2013. But there is no doubt that the development of the Gulangyu B&B industry was a result of local government’s industry policy introduced in 2008.

In the next section, I will show how the local industry policy of B&B sector becomes a source of private property rights protection. A dramatic change in local industry policy toward B&B business in Gulangyu turned out to be a way of private property rights

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<sup>25</sup> Han Yuting “Gulangyu Applies for World Cultural Heritage: Encouraging Private Investment Turned Out Fine and Detention” *Jinjing Guancha Bao* [Economic Review Daily] (Beijing) 09-27-2014.

expropriation. The comparison of two local political leaders' characteristics and career pattern demonstrates how the change of local industry policy is possible and how this policy change was implemented, as well as why that dramatic policy change toward the Gulangyu B&B industry has been made.

### **5.3 Local Industry Policymaking as a Source of Property Rights Protection or Expropriation**

The origin of the B&B sector development in Gulanyu can be traced back to then the “first hand” (number one position) political leader of Xiamen, the Party secretary He Lifeng. Theoretically speaking, government leaders such as governors or mayors are responsible to economic affairs. In practice, the Party secretary has the final say over everything, including policies and personnel placement. This is because the Party and state hierarchies are intertwined in China. In the Chinese political structure, wherever there is a governor or mayor, there is a corresponding Party secretary, except at lower levels where the Party secretary and the executive are sometimes the same person. The Party secretary is usually the number one boss in the jurisdiction due to the working structure of the Party Committee. For example, at the city level, the Party secretary leads the city Party Committee, which consists of the mayor and vice mayors, as well as other officials heading important departments in the Party. The Party Committee members have a clear division of labor, where every member is responsible for certain affairs in the city. But the Party Committee determines all the major issues in the city, and inside the committee the Party secretary has the final say over everything, including policies and personnel placement.

## **The Policymaking of the Gulangyu B&B Industry in Xiamen**

As I will show in this section, the Party secretary of Xiamen, He Lifeng played a decisive role in policy initiative and policy making of the B&B industry in Gulangyu and deserves special notice. Born in 1955 in Xingning, Guangdong province, He went to neighboring Fujian province as a zhiqing (sent down urban youth) when he was eighteen. In 1978, He became a college student studying fiscal finance at the department of economics in Xiamen University. During the school year, He joined the Chinese Communist Party (CCP) in 1981 and continued his study in graduate school in same discipline. In 1984, He got a master degree and started to work in the Xiamen Special Economic Zone's economic institute. After several years working in Xiamen government agencies, He was appointed as Xiamen Xinglin district Party Secretary (first hand) in 1990. Two years later, He was promoted to be Xiamen's vice mayor and stayed in that position for three years. Theoretically speaking, He Lifeng was not a local native official since he was born in the neighboring province and grew up in Guangdong province. However, He lived in Xiamen for twenty years since he was 18 years old. He completed his education and got his first job in Xiamen. In practice, He is considered as a Xiamen local native official. In 1995, He Lifeng was rotated to Xiamen's neighboring city, Quanzhuo, as vice-Party secretary and the acting mayor. Following the usual rule, He turned to be the mayor the following year. Two years later, He Lifeng was promoted to the first hand (the Party secretary) of Quanzhuo city. After another three years as the rotated top official in the province's capital city at the same rank, He was transferred back to Xiamen as the first hand (the Party secretary) native political leader.

Policy making in China often is a product of a combination of rationality, power struggles, and bureaucratic politics.<sup>26</sup> Even being a top leader in Xiamen city, to promote a local industry policy initiative such as B&B industry development still needs a skill for politics in the Chinese political structure to get things done. Early in 2006, the second year of Party Secretary He's tenure in Xiamen as the top local leader, he gave a talk at a tourist industry development conference, encouraging local government to "promote fast development of the emerging B&B industry".<sup>27</sup> As a result, the former German counselor building was renovated and transformed into the first B&B hostel business in Gulangyu at the end of that year. But nothing has really happened since then. In the following year's spring festival, He offered a night tour in Gulangyu to foreign friends (investors) and found out that contrary to his thoughts very few tourists stayed on the island at night because there were no commercial activities or nightlife. Next day, He sent a note to the GSMC indicating that the GSMC should take "some real actions" to promote the development of the B&B industry in Gulangyu.<sup>28</sup>

Although He Lifeng made very clear both in public and private about his ambitions for the B&B industry development in Gulangyu, B&B development was slow until 2008, the third year of He's tenure as a top leader in Xiamen. In May 2008, He made a visiting tour investigating the development of tourism in Gulangyu and figured out there were only 12 B&B hostels established in past two years since his first talk. To express his dissatisfaction about the development of the B&B sector in Gulangyu, He made a statement that set a clear goal of achieving 3000 B&B beds in Gulangyu by the end of

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<sup>26</sup> Policy making in China often attributes to two factors: rationality and faction power struggle. Lieberthal and Oksenberg (1988) introduced the bureaucratic politics in formulating policy.

<sup>27</sup> Shao Fangqing. "Apply for World Cultural Heritage! Save Gulangyu?" *Diyi Caijing* [The First Finance and Economy Daily] 01-07-2011.

<sup>28</sup> Ibid.



2008. At the same time, He called a “major project work leading group” meeting in order to mobilize his colleagues to promote the B&B sector development.<sup>29</sup> In November 2008, the city Party Committee held a special meeting discussing the development of the B&B industry in Gulangyu. In that meeting, the city Party committee discussed “Xiamen Gulangyu B&B Management Regulations (Trial)”, which was drafted by Siming district government. The meeting memo, as a local official document, shows that “Siming district government, the GSMC and other relevant government agencies should work together, make initiative moves and take proactive action, incorporating the application of World Cultural Heritage project, which would support and encourage the development of the B&B industry in Gulangyu.”<sup>30</sup>

In December 2008, the Regulations became a formal local industry policy as Siming district government issued “Xiamen Gulangyu B&B Management Regulations (Trial)” publicly. At the same time, the Xiamen city Party committee and the Xiamen government forwarded the Regulations to different government agencies as well as made a statement indicating that ““Xiamen Gulangyu B&B Industry Management Regulations (Trial)”, which as drafted by Siming district government had been discussed and ratified by the city “major project work leading group” in the 46 meetings, now forwarded to your department, please make the effort to follow and enforce the regulations.”<sup>31</sup> Since the promulgation of the Regulations, B&B hostels have increased dramatically during 2009 and 2010 and reached 152 B&B hostels in Gulangyu with the total private investment 3 to 4 hundred million. By the end of 2013, more than ten million tourists visited Gulangyu

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<sup>29</sup> Leading group has been used as an instrument to bridge top leaders and different sub-ordinate agencies that implement policies. In practice, leading group is outside the view of public but possesses a considerable weight of power in the Chinese politics (Lieberthal 2004).

<sup>30</sup> Cai Changchun, “Gualngyu Shengyi zhongde Minzi ‘Ermeng’” [Private Investment’s ‘Nightmare’ in Gulangyu’s World Heritage Application Process], Fazhizhoume [Rule by Law Weekend], 09-04-2013.

<sup>31</sup> Ibid.

Island and the total number of B&B hostels reached 300 including those without licenses.<sup>32</sup>

### **The Policy Changes of the B&B Industry in Gulangyu**

The development of the B&B sector turned in another direction beginning in the late 2009 as He Lifeng was transferred to Tianjin as a vice Party secretary and the succeeding top leader Yu Weiguo was in charge. Table 5.3 illustrates the policymaking and policy change process directed by two types of local political leaders. It is logical that as the industry developed rapidly government authority would shift its focus from the development policy to the regulation policy. However, the case of Gulangyu B&B shows that local officials' policy choices with regards to the development of a sector are determined by individual leaders' career concerns and their calculations which are conditioned by their resources and constraints.

Like He Lifeng, Yu Weiguo was born in 1955. But his hometown is in Shandong province, eastern China. Similar to He Lifeng, Yu went to a neighboring province when he was eighteen, but became a worker in a chemistry factory in Taicang, Jiangsu province. Yu joined the CCP in 1975 and went to China People's University in Beijing in 1979 studying Chinese literature. In 1983, Yu started to work in a research department at the CCP's Central Committee Secretariat's Office. After several years of research work, Yu was appointed to a *mishu* (personal secretary) of Ding Guangen—the former Head of the CCP's Central Department of Propaganda in 1991. Four years later, at the age of forty, Yu was a *guazhi* (temporary transferred duty)<sup>33</sup> cadre to the Xiamen government as

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<sup>32</sup> GSMC 2013 annual work reports.

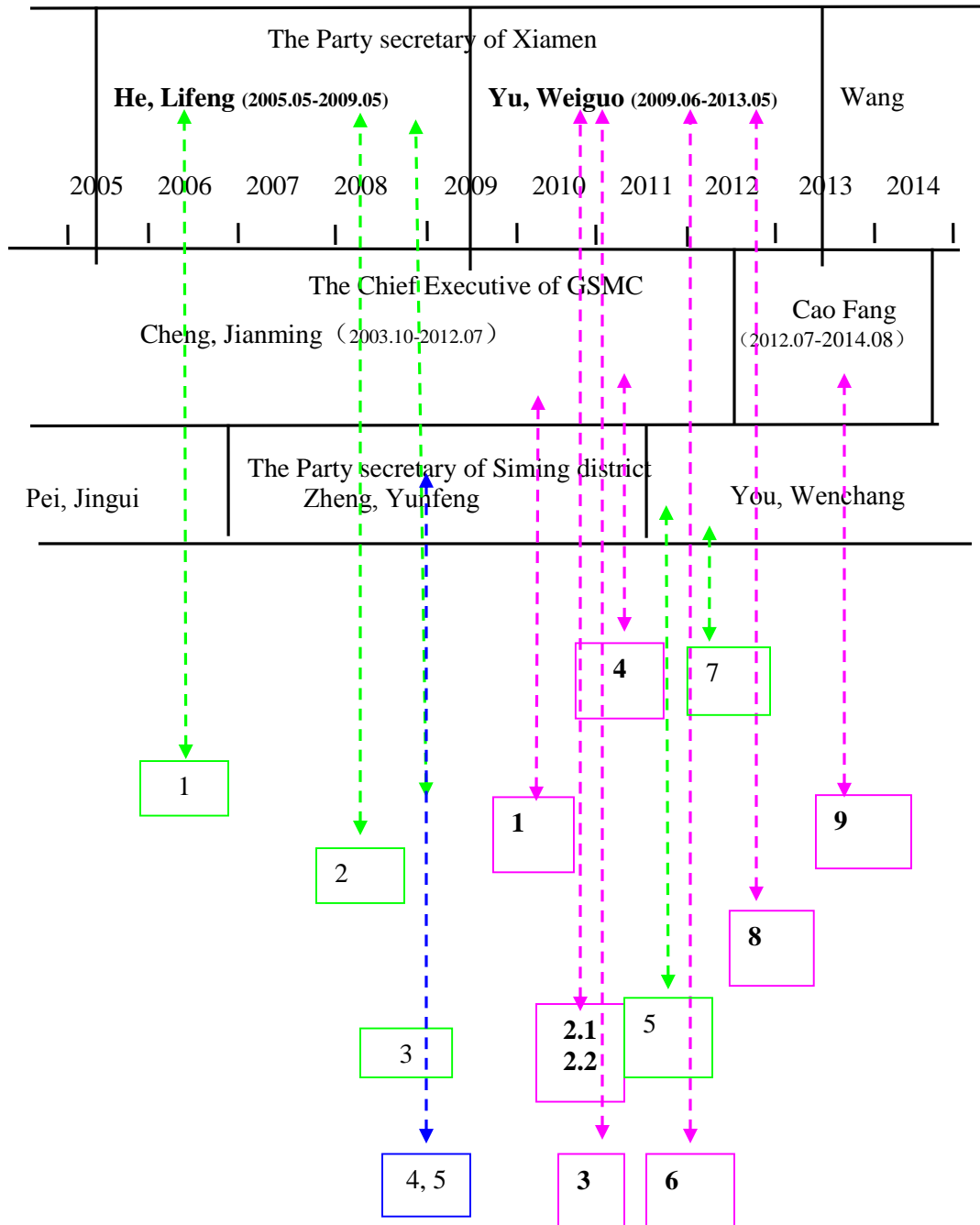
<sup>33</sup> *Gazhi* means higher organization delegates a cadre to lower one and serve in a lower level unit for a period while retaining one's position in the previous unit. It is argued as one of method to attain faster promotion in the Chinese political hierarchy (Kou and Tsai 2014).

the assistant mayor, and two years later was transferred formally to the Xiamen government. He became vice mayor of Xiamen in 1999, and then minister of the Department of Organization (DOO) of Xiamen in 2001 before becoming vice-Party secretary of the city in 2002. In 2005, Yu was promoted to deputy vice-minister of DOO of Fujian, and minister of DOO of Fujian the following year. In June 2009, Yu became the Party secretary of Xiamen.

It is not clear if there was a faction power struggle between He Lifeng and Yu Weiguo. What public records show is that Yu Weiguo and He Lifeng shared no overlapping working experiences. When Yu came to Xiamen from Beijing, He Lifeng was transferred to a neighboring city as a rotated top political leader. While He Lifeng was transferred back to Xiamen, Yu had been promoted to the head of provincial DOO. The only overlapping period of these two top leaders was two and half years when they were both provincial Party Standing Committee members between 2006 and 2009.

Tirole (1994, p. 7) introduced the theory of career concerns that argues that civil servants and politicians “are concerned by the effect of their current performance not so much on their monetary reward, but rather on their reputation or image in view of future promotion.” Performance measurement for local officials in China comes from the Cadre Evaluation System (CES), which is the major instrument that the central government has used to manage its cadre corps. Economic growth measured by numbers of GDP growth rate has been one of major criteria to determine whether a particular local leader should be promoted to a higher rank (Li and Zhuo 2005). Another two important factors that determine local officials’ prospect of promotion are personal characteristics mainly age and education, and personal connections with their superiors in charge of promotion.

Table 5.3 The Policy Making and Policy Changes of Gulangyu B&B Industry in Xiamen



He Lifeng administration (2005.05—2009.05)

- 1) Talk in a tourism industry development conference in April 2006
- 2) A note to GSMC indicating that GSMC should take “some real actions” to promote the development of B&B industry in Gulangyu in February 2007.
- 3) A visiting tour, a statement that sets a clear goal of achieving 3000 B&B beds in Gulangyu by the end of 2008, and a “major project work leading group” meeting in May 2008.

- 4) A special meeting of the city Party Committee discussing the development of B&B industry in Gulangyu in November 2008.
- 5) The promulgation of “Xiamen Gulangyu B&B Management Regulations (Trial)” in December 2008.

#### Yu Weiguo administration (2009.06—2013.05)

1. Permission from GSMC in addition to “six-license” process of B&B hostel in May 2010.
- 2-1. CPC standing committee’s enquiry on “improve Gulangyu’s tourism environment”
- 2-2. Established “Gulangyu Scenic Improvement Work Leading Group” charged by GSMC
3. Established “Gulangyu Applying World Cultural Heritage Work Leading Group” and the former Mayor was in charge of the group.
4. An informal administrative order that temporarily suspended the application of B&B hostel in Gulangyu issued by GSMC
5. Open the application
6. Re-closed the process
7. Re-opened the process
8. An informal administrative order using the form of a meeting memo signed by several government agencies issued to terminate the application
9. “Gulangyu Applying for World Cultural Heritage Improvement Projects—A Specific Plan for Gulangyu B&B Industry” issued by GSMC

*Source:* Compiled by author.

Unlike He Lifeng, Yu was a typical *mishu* cadre<sup>34</sup> sent-down from the central organization of the CCP who lacked local government experiences. Although he worked in Xiamen for ten years, Yu was truly a transferred official. More importantly, compared to native leader He Lifeng, Yu had personal tie with higher rank officials both at the center and provincial DOO who were in charge of promotion. While He Lifeng had to respond to “support” constituency’s interests in order to secure his position, Yu just needed to build up an impressive image in the view of party officials for future promotion. By “support” constituency, it doesn’t mean specific constituencies within the electorate. Rather, it means the social and commercial elite, not the political elite. In the context of China, this means urban district level officials or local businesspersons.

Due to the term limits and rotation system, Yu faced short-time pressure to show his ability for local governance in only 2 to 3 years so as to impress both his superiors and the local public to win promotion. One of the best strategies for him to demonstrate his

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<sup>34</sup> “*Mishu* cluster” is an important faction in the power struggle of Chinese politics. It refers to as Graeme Smith argues that “working as a sent-down cadre enhances their prospects of promotion” (Smith 2010).

ability was to pursue “achievement projects” for an instant success.<sup>35</sup> In addition, as the succeeding transferred top leader, Yu needed to differentiate himself from the previous native Party secretary through his unique “achievement projects.” Yu concentrated his efforts on building the new city image—to make Gulanyu one of the World Cultural Heritages.<sup>36</sup>

The dual administrative system of Gulanyu offered an opportunity for the new leader to introduce his “achievement project” and to intervene in the affairs of an ever-growing local tourism industry. In May 2010, the second year of Yu’s tenure, the process of the six-license application of a B&B hostel added one more step—the permission from GSMC. Since GSMC is a subordinate agency of Xiamen government and the Party committee determines major affairs of the city, the Party secretary Yu gained final say over the direction of Gulanyu tourism industry development, specifically B&B development.

In January 2010, Yu acquired another top position in the City People’s Congress (CPC) standing committee in addition to the Party secretary position, which is not normal practice in local political structure. Yu chose to show his local governance innovation by introducing the CPC standing committee’s enquiry on local government with regards to specific topics. The first enquiry of Xiamen’s history was held on November 29, 2010 and the topic was about how to “improve Gulanyu’s tourism environment.” In order to follow up the issues raised in the enquiry, Xiamen government delegated to GSMC who

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<sup>35</sup> Short-time horizon in each locality causes short-term behavior of local officials eager for instant success. This is why many local officials are fanatic in “achievement projects” to demonstrate their ability to impress their superiors and the public. Achievement projects mainly refer to constructing fancy skyscraper, new airports, or city image with the money squeezed from public goods spending.

<sup>36</sup> Heritage tourism as a new way to promote local economy discussed by scholars, see Qin et. alt 2011.

coordinated with nine relevant government agencies to establish the “Gulangyu Scenic Improvement Work Leading Group.”<sup>37</sup>

In December 2010, Xiamen government held the 119th executive meeting and decided to establish “Gulangyu Applying World Cultural Heritage Work Leading Group”, and the former Mayor was in charge of the group. The GSMC was responsible for the daily work of the applications and for coordinating government agencies in order to submit the application in 2013. Shortly after the establishment of the leading group, the GSMC issued an informal administrative order that temporarily suspended the application of B&B hostels in Gulangyu in the name of improving Gulangyu’s tourism environment and World Cultural Heritage application. Without knowing the reasons, the suspension of applications was lifted in July 2011 after a few months of rejection. But the suspension began again in November. Two or three months later, the suspension was lifted again and finally in July 2012, an informal administrative order in the form of a meeting memo signed by several government agencies was issued to terminate all the application to this point. This revolving door of local administrative orders resulted in almost 200 B&B hostels with a partial license or without any license doing business.

In May 2013, the GSMC issued “Gulangyu Applying for World Cultural Heritage Improvement Projects—A Specific Plan for Gulangyu B&B Industry” (the Plan),” which aims to shut down at least half the number of B&B hostels on the island. The promulgation of the Plan as the turning point of policy making about the B&B industry in Gulangyu seriously threatens the property rights of private investors. In late 2013, many B&B hostel owners were detained for 5 to 15 days by Siming district police station and

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<sup>37</sup> Jiang Shengyang and Feng Shijie “To Make Effective Supervision: on Xiamen City People’s Congress Standing Committee Three Topic Enquiries.” *China Daily* 04-13-2011.

fined severely by different local government agencies. One month before the promulgation of the Plan, Yu gave a talk to the GSMC, which praised the achievement of GSMC on the job of Gulangyu improvement and encouraged them to work harder in order to “better protect and governance Gulangyu.”<sup>38</sup>

#### **5.4 Conclusion**

Local officials’ role in local industry policymaking is not a rational response to the problem; it is not simply strategic actions in response to faction power struggles; and it is not muddling through decision-making in bureaucratic politics. Performance evaluation systems associated with the prospect of promotion have motivated local political leaders to pursue policy initiatives. However, different types of local political leaders conditioned to resources and constraints determine the policy choices that local officials can make in order to satisfy goals. While native leaders with fewer resources and greater constraints are more likely to respond to “support” constituency’s interests, rotated officials, especially transferred officials from the center, are more likely to build impressive images or short-term “achievement projects” at the price of local public good.

Local political officials formulate sometimes contradictory or conflicting local economic policies, although not just because of bureaucratic politics decision-making. Instead, these conflicting economic policies come from strategic calculations according to each local leader’s attributes and resources. In the case of Gulangyu B&B industry policy making in Xiamen, the policy changes of the B&B industry have not served to regulate the market but to promote local leader’s achievement project, which has created room for predatory activities on local private property rights. The same local state being

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<sup>38</sup> “The Party secretary Yu Weiguo’s important note to Gulangyu Management Committee’s work on April 4<sup>th</sup>, 2013”



developmental or predatory was a result of the change from native to transferred key local political leader. Understanding the variations of property rights, therefore, requires a close examination of local political leaders.

## CHAPTER 6

### CONCLUSION

This research hopes to contribute some new perspective to current studies on property rights in China. A lot of existing literature has systematically studied the causes of economic growth. This study takes a different approach, which, instead of directly looking for the causes of economic growth, tries to answer why private investors invest in the face of the commitment problem and why some local officials actively protected property rights more than others. To answer these questions, I provide a game-theoretic model to study the political economy of property rights in China, that is, a bargaining game between a firm and a local political official. This political-economics explanation sheds light on the variation in the protection of private property rights for private firms across China rather than regional variations of economic performance.

#### **6.1 The Summary of the Study**

In this study, I argue that property rights protection results from a bargaining game between a local political actor and a private investor under the incentive structure of the Cadre Evaluation System (CES) designed by the central government. As the personnel control system literature shows, official promotion is mainly determined by officials' political and economic performance in local jurisdiction, their age, and degree of education, and informal personal connections with their superiors. As the competition has been getting more severe, the evaluation criteria, such as performance, age and

education degree, have been set higher and higher. Several criteria of local economic performance are actually out of control of the local political leaders. Young and well-educated local officials are more preferred for further promotion. In addition, age limits to retirement and the rotation system shortened many officials' political career. These factors make local officials' promotion harder.

At the same time, compared to political actors in democratic regime, there are two more distinct features of career patterns for political actors within the Chinese power hierarchy: 1) almost permanent tenure as long as they have secured an office; 2) almost no job option outside the political career when you are in the system. All of the aforementioned constraints place more weight on local political actors' calculation with regards to their strategies to achieve their goals in terms of property rights protection.

Under the current institutional arrangements, private firms are on their own to resist local officials' predatory activities. However, resources and constraints as results of firms' characteristics have impact on private firms' post-bargaining power in the bargaining relationship with local officials. Only certain firm-specific characteristics can greatly enhance private investors' bargaining power, which makes private firms in better position to protect their investment.

There are three players in the local economy, Government is the principal, the local political official serves as the supervisor, and the Private entrepreneur is the agent. In the context of China, political actors are local political leaders, economic actors are indigenous private entrepreneurs, and government includes central and local. I detach political actors from government because the goals of government are not always

identical with political actors and hence I reconsider the role of local political leaders on economic development in general and property rights protection in particular.

The goal of government both central and local is tax revenue. The primary and foremost concern of local political leaders is to stay in office and being promoted to a higher rank. But the ultimate goal of local officials is to acquire more wealth and secure their possessions. In other words, the pursuit of political power is the means to achieve the end (wealth acquisition). For the indigenous private entrepreneur, what he/she wants is not only to maximize profit but also to secure their property rights.

As the discussion of the CES shows in chapter 2, local political actors face political imperatives and policy tasks set from upper-level governments. These tasks include promoting economic and fiscal revenue growth, boosting local employment, and providing public goods and services. Local officials are evaluated based on how well they accomplish these policy tasks. But they are constrained by the lack of fiscal resources as a result of the fiscal reform in early 1990s (Tao and Yang 2008; Yang 2006). Therefore, local officials turned their hands toward the private sector. The model assumes that local officials are potential predators and private firms are their prey. The predator and prey interact strategically in the context in which the central government evaluates the local officials on the basis of the cadre performance evaluation system.

I model the relationship as a bargaining game with conflicting goals. Under the incentive structure of the CES, a firm has strong bargaining power at the time of entry because local officials are eager to attract investment and understand that the firm has other options. However, once the firm has made sector-specific investment, its bargaining power diminishes. Only certain firm-specific characteristics can empower private

investors' bargaining power, which constrains local officials' predatory behaviors towards private investment. In this way, firms with strong post-entry bargaining power enjoy a high level of credible commitment from the local government as local officials are under the pressures of performance-based evaluation by his/her superiors. But weak firms are vulnerable to the local officials' predatory activities, and therefore need to rely on their social networks or bribery to overcome the commitment problem. In particular, all else being equal, the availability of an exit option greatly enhances the private firms' post-entry bargaining power vis-à-vis local political actors. This hypothesis has been tested statistically in Chapter 3. Also, in Chapter 3, the media reports on government-related property rights expropriation cases, further supporting the hypotheses.

Another equilibrium that emerges from the interaction between local political supervisors and economic agents is the symbiotic relationship between less favorable local political officials and private entrepreneurs, which creates conditions similar to the secure property rights at the local level. Individual local official will calculate their resources and weakness in order to make their choices under the CES. If they are near age limits to retirement or less educated, and above all, have no personal tie with their superiors, they will have nearly zero chance to be promoted to a higher rank in the bureaucratic hierarchy and thus tend to pursue economic interests rather than political. More importantly, these local officials who are relatively disadvantageous in the power structure realize that their political survival needs support of local economic actors, and actively cultivate ties with them. They provide property rights at a local level as returns for political-economic alliance. This symbiotic relationship between less favorable local political actors and private entrepreneurs provides a condition similar to property rights,

which fostered the private sector and paved the way for long-term economic growth in certain localities.

I argue that under the current institutions of CES and the cadre rotation system, the attributes of local political leaders affect their behaviors with regards to private investment. Local political leaders tend to protect private property rights when a symbiotic relationship between local officials and private entrepreneurs is feasible. All else being equal, native local political leaders have lower transaction costs, face more social constraints, and gain extra benefits in establishing symbiotic relationship with local private entrepreneurs and, therefore tend to protect private property rights more than those rotated ones. Chapter 4 provides systematic empirical evidence from Guangdong province both cross-sectionally and over time to tests this hypothesis by investigating the characteristics of 263 prefecture-level local political leaders between 1992 and 2008, and find that native political leaders promoted substantially higher levels of private investment—the proxy for the protection of private property rights. The results are robust to various alternative specifications, including models that account for heterogeneous regional characteristics, initial economic conditions, and socioeconomic factors. Chapter 5 further provides a detailed case study on local industry policymaking in Xiamen, which also supports this hypothesis.

To be true, the protection of property rights afforded by this relationship is fleeting and localized, but in a country where credible property rights institutions are weak, this mechanism has been effective in fostering the private sector in some localities at some times. More importantly, this study fills a void in the literature of political economy under authoritarian governments. It points to the unique authoritarian political

arrangement in China, where the central government is growth-oriented, and local officials enjoy a great deal of discretionary power. The model demonstrates that the protection of private property rights is not exogenously imposed by the central government but derives from the interactions between local officials and private firms.

## **6.2 Prospects of Further Research**

Two main challenges for the empirical studies in this research are measurement and data quality. For the challenge of measurement, I have used private investment in fixed assets as an indicator to measure the security of property rights. This is a better proxy than GDP measurement since this kind of investment bears considerable risks with only promises of future revenue whereas GDP growth may not require the commitment to protect private property rights as long as the local leaders could gain economic resources for higher authorities or state-owned financial institutions. I also used the proportion of private investment on total investment as another way to measure the level of property rights protection.

For property rights expropriations, I used arbitrary fess and fines collected by local government as an indicator to measure the level of indirect taking of property rights since these activities are common practices by local officials with regards to private firms. I also used media reports on government-related outright taking property rights cases to measure the level of property rights protection.

Data quality is a common concern to any study on contemporary China. I tested the hypothesis of the model using various sources of data: biographies of local political leaders, statistical yearbooks, media reports, government reports, interview notes, and other fieldwork notes. Empirical results I tested in this research are consistent with the

theoretical prediction. All the findings suggest firms with high level of FSAs enjoy better property rights protection and having native local political leaders promoted substantially higher levels of private investment-the proxy of property rights protection.

As for testing the local political leaders' hypothesis, while my evidence focuses on Guangdong province, the symbiotic logic can apply to other provinces as well. Further study can be conducted by using a nationwide private investment dataset to test this hypothesis.

Based on this research, it is worthy to explore the repeated game between local political actors and private investors. For one-shot game, local political actors and private investors found themselves in a prisoners' dilemma game. However, in an infinitely repeated version of the game, both players may choose to play, for example, a trigger strategy and therefore the "common interest" may be realized. The study also can explore the conditions under which both the local political actor and the private entrepreneur will cooperate with each other.

Moreover, there is a need, both intellectual and practical, to further explore the sources that affect these political-economic dynamics and how these interactions at the micro-level lead to institutional change at the macro-level. One of the sources that may affect local political-economic dynamics is the impact of varying forms of formal and informal institutions in fostering collective bargaining. In the project involving business associations, I have tried to explore the effects of business associations on the bargaining relationship between private firms and local officials. Contrary to the existing studies, which generally consider business associations as state corporatist instruments, my in-depth comparative case study shows the structure of business associations and the type of



association leaders in the bargaining game with local political leaders determining the effectiveness of the organization in terms of defending members' interests and providing public goods such as property rights protection.

Another source that may also affect local political-economic dynamics is in the form of corruption. Corruption is often treated as detrimental to economic development (Shleifer and Vishny 1993). Yet, some argue for efficiency-enhancing corruption, the effects of which may be positive (Leff 1964; Huntington 1968; Li and Wu 2010). Other studies further distinguish among different types of corruption (Shleifer and Vishny 1993; Sun 2004; Wedeman 1997; Manion 2012). Many studies focus on the coexistence of rapid growth and rising corruption in China (Li and Wu 2010; Wademan 2012). The further study will explore how corruption, in the form of the mutually beneficial exchange between the local official and the private investor, becomes a source of property rights protection, and sees how it works in the local political-economic dynamics in China.

Finally, further research projects can go in a different direction that will focus on the interplay between political institutions and political connections to explain the huge regional disparities in China's rapid economic development. It will examine empirically how the interplay of promotion incentives and political connections of local political leaders affect investment patterns.

In this research project, it will demonstrate that the huge regional disparities in economic growth and investment variations can partly be explained by the interplay of promotion incentives and political connections of local political leaders. Guided by a simple career concerns model with option of with and without political connections, it

will show that strategic actions and purposeful choices by local political leaders are key to understanding the regional disparities in economic growth and investment patterns. The logic is that local political leaders seek investment when they have strong incentives to promote growth, as economic growth is one major measure to judge their job performance and their job performance will influence their promotion results. However, political connection networks will determine what kind of investment local political leaders are looking for. Those who have political connections with the higher authorities will have an advantage for attracting the allocation of government support such as huge government projects, whereas those who do not have connections tend to promote local private sector in their jurisdictions. As a result, the regions with connected political leaders have relatively higher growth rate but lower level of private entrepreneurship activities.

Using political connections as explanatory variable, it will explore the characteristics of local officials to test the hypothesis and will collect data on top political leaders in 333 prefecture municipalities in China between 1992 and 2008.<sup>39</sup> A mayor or the party secretary is defined as connected if at least one of his past colleagues, classmates, or natives is the provincial party secretary or governor.

In order to test the hypothesis, three dependent variables are identified: capital construction and collective-owned investment in fixed assets, the annual GDP growth rate, and private investment in fixed assets in 333 municipal-level cities in China from 1992 to 2008. The annual GDP growth rate is to measure the overall economic performance; the construction and collective-owned investment in fixed assets measure

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<sup>39</sup> I start from 1992 because this is the division year of private enterprise as the introduction of the Company law paved the way to the rapid private investment. More importantly, this is the year to which the detailed biographical data of political leaders and private investment in fixed assets can be traced back.

the allocation of government support; and the private investment in fixed assets is an indicator to measure the development of private economy. A host of control variables, mainly including initial economic conditions and geographical variables, are also involved in my model. I expect the empirical test will support my hypotheses.

This project is built upon unresolved performance versus connections debates in the literature on the political economy of development and sheds light on this issue by examining the interplay of promotion incentives and political connections on economic development in China. Also, this research is one of the first attempts to address the politics of investment-driven growth in the context of huge regional disparities in economic development. Finally, in discussing the role of local officials on economic growth, scholars often focus on provincial leaders, county and township level officials; mine is to study behaviors of intermediate level political leaders.

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## APPENDIX A – ABOUT THE SURVEY DATA

The Survey on Privately Owned Enterprises in China used in this study was jointly conducted in 2012 by the All-China Federation of Industry and Commerce (ACFIC), the State Administration of Industry and Commerce (SAIC), the United Front Work Department (UFWD), and the Institute of Chinese Private Economy at the Chinese Academy of Social Sciences (CASS). It is the most recent survey among a series of similar ones conducted by the same team every two years since the 1990s. We obtained the survey data from the University Services Center at the Chinese University of Hong Kong. A detailed description of the survey is available on the center's website ([www.usc.cuhk.edu.hk/DCS31-16.aspx](http://www.usc.cuhk.edu.hk/DCS31-16.aspx)). According to the description, the survey pooled across two samples, one sample (653 firms) obtained from the fixed observation points of the ACFIC and the other (4,094 firms) randomly selected from the population of all private firms as of 2011. For the random sample, a proportionate stratified sampling method was employed on the strata of the thirty-one provincial units in China. In total, the survey collected data on 4,747 firms.

I admit the weaknesses of the survey. First, it is not a purely representative sample because a portion of it comes from the ACFIC's fixed observation points. But the good this is that the proportion of the fixed observations dropped significantly in the 2012

survey from almost 40% to 13.76%. Second, because the ACFIC was a major organizer, the sampling seems skewed toward ACFIC members. Finally, the survey included a nontrivial portion of missing values in most financial indicators, decreasing the sample size available for empirical analysis. Despite these weaknesses, the survey has been extensively used by many scholars and produced fruitful findings.



## **APPENDIX B – ABOUT THE MDEIA REPORTS OF GOVERNMENT-RELATED PROPERTY RIGHTS EXPROPRIATION CASES**

I acknowledge the limitations of our cases. First, the media exposure cases are not exhaustive since we are unable to include all property rights expropriation cases. It is likely that most of the government appropriation cases may not be made public. On the one hand, the private owners may, for instance, have a chance to negotiate with local governments regarding their property, so they will not expose their story in order to save the local officials' face. On the other hand, large firms or those owners who have good connections with the media may have better chances to reveal their experiences. In addition, all the 279 cases we documented are related to direct expropriation. In practice, the indirect expropriation cases are perhaps far more common than the ones shown here (Nee and Oppen 2012).

Second, sometimes, it is difficult to distinguish between entrepreneurial crimes and government-related property rights appropriation involving private entrepreneurs because criminal charges are a common tool local governments use to prey on private firms. The number of criminal cases filed against private entrepreneurs rose sharply against the backdrop of the steady improvement of the legal status of private businesses. According to the report published by the Chinese Entrepreneurial Crime Prevention Research Centre at Beijing Normal University, 483 out of 599 entrepreneurial crimes in 2013 were committed or allegedly committed by private entrepreneurs. This is a significant increase from 2009 when private entrepreneurs committed merely 49 out of 84 entrepreneurial

crimes (Ren 2014). The most common charges brought against private entrepreneurs were illegally absorbing public savings, fraudulent fundraising, misappropriation of funds, and tax evasions.

In some cases, private entrepreneurs were sentenced to prison for entrepreneurial crimes while still retaining their control over the firms and properties as shown in the “Huang Guangyu case.” In other cases, local governments confiscated private firms and properties in the name of cracking down on organized crimes in which private entrepreneurs were allegedly doing business with crime syndicates as demonstrated in the so-called “Chongqing model.” For our study, we include only the cases in which firms or properties were confiscated by the government for whatever crimes they committed or allegedly committed.