

State Capacity v.s. Rights of “Man on the Spot”

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Introduction

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 - ▶ One cannot understand China's tremendous success without understanding its central planning experience

Introduction

- ▶ From China's transition, to central planning, to the revolutions, to the late Qing Dynasty
 - ▶ China's transition from central planning to a market economy has so far been a remarkable success
 - ▶ One cannot understand China's tremendous success without understanding its central planning experience
 - ▶ Likewise, one cannot understand central planning without understanding revolutions that led to the communist party to power
 - ▶ But to understand revolutions, one needs to go further back to the late Qing dynasty

Introduction

- ▶ Offer a simple framework to picture this episode of history as a logical development in responses to challenges confronting China at various points of history
- ▶ My framework begins with what institutions are
 - ▶ Discussion limited to formal institutions
 - ▶ Define what state capacity refers to
- ▶ Followed by a brief sketch of the history

Introduction

- ▶ The key messages are the following
 - ▶ Evolving from weak state capacity (“man on the spot” were nevertheless able to flourish, but on to a limited extent) to strong state capacity (strengthening certain public goods provision, but stifle incentives and initiatives of “man on the spot”)
 - ▶ Decentralization seen as expanding rights to “man on the spot”, but gradually led to new challenges of increasingly aggravated externalities (both intra-right and extra-right)
 - ▶ Unable to develop strong while at the same time responsible and disciplined (accountable) state capacity
 - ▶ Outlooks

What (Formal) Institutions Are

- ▶ North (1990): “rules of the game”
- ▶ Greif (1998): “equilibrium rules of the game”
- ▶ Aoki (2001): “self-sustained system of shared beliefs of how the game is played”
- ▶ This author:
 - ▶ Institutions are human construct, even though not all such constructs are effective in equilibrium
 - ▶ Thus, need a concept pertaining to real-world discussion
 - ▶ Inspired by Aoki (2001), built on Hayek (1945), Coase (1937), Grossman and Hart (1986, 1990), and Hurwicz (2007)

(Formal) Institutions as Structure of Rights

- ▶ Rights (or obligations) shape people's set of choices
- ▶ While obligations are merely the opposite of rights

(Formal) Institutions as Structure of Rights

- ▶ Individuals, players, and rights
 - ▶ Individuals \neq players: a single individual can be multiple players
 - ▶ Player is a capacity: includes citizen in particular
 - ▶ Rights are associated with a set of players vis-a-vis a set of players
 - ▶ When the two sets are the different, the latter set holds an obligation to the first
 - ▶ Individuals are allocated to (or alienated from) players through rights

(Formal) Institutions as Structure of Rights

- ▶ Right of a set of players vis-a-vis another set of players is a set of allowable choices of decision/actions to be taken with respect to a set of resources (human and physical), a set of rights, and a set of players by the second set of players at the order of the first set of players
- ▶ Institution is an allocation of rights across players (capacities)

(Formal) Institutions as Structure of Rights

- ▶ Rights are allowable decisions/actions with respect to *objects*, including human and physical resources, as well as rights and players
 - ▶ Right is limited if a set of objects is small, even though the set of allowable actions is huge
 - ▶ Rights expand only with richness
- ▶ Decisions/actions can have rich contents

(Formal) Institutions as Structure of Rights

- ▶ Rights are state-contingent
 - ▶ State-contingencies may not be fully specified
 - ▶ Hence include having rights if “other than the following state-contingencies”: residual rights
- ▶ State-contingencies include the dimension of time, and hence rights are temporal

(Formal) Institutions as Structure of Rights

- ▶ Examples of rights

History Matters

- ▶ Institutional outcome is a structure of rights realized in heterogeneous individuals
- ▶ No institutional outcome is well defined without history
- ▶ Institution maps history to future, as people as different players exercise their rights
 - ▶ Their decisions be guided by their preferences, informal institutions, and their beliefs
 - ▶ These decisions change the identity of individuals as well as (human and physical) resources associated with all players and hence all the rights.

State Capacity v.s. Rights to “Man on the Spot”

- ▶ For my discussion, players in an economy may be classified into two sets: the state (the collective of government offices) and “man on the spot”
 - ▶ There is no political party outside the state
- ▶ State capacity is the structure of rights in association with a collective of government offices
- ▶ This talk focuses on the following rights
 - ▶ Rights for public goods provision
 - ▶ Rights to determine (explain, enforce) rights

State Capacity v.s. Rights to “Man on the Spot”

- ▶ There is a conflict between state capacity and rights of “man on the spot”
 - ▶ Strong state capacity is associated with the state commanding more resources, a larger spectrum of rights and actions, and *highly capable, if not also virtuous, people assuming corresponding offices* (in equilibrium)
 - ▶ Whether more resources/rights, and more capable people, to the state or to “man on the spot” depends on the challenges the country confronts

The Collapse of Qing

- ▶ Some regimes collapse even with strong state capacity, some regimes with weak state capacity are able to survive nonetheless
- ▶ Qing collapsed because of its weak state capacity that was unable to address challenges at the time
- ▶ What were the key challenges?
 - ▶ Repeated transgressions on sovereignty, with much more advanced technologies, in a vicious seemingly unstoppable fashion

The Collapse of Qing

- ▶ In what sense did the state capacity of Qing become weak confronting these challenges?
 - ▶ Among others, two intrinsic disadvantages in Qing's rise: ethnicity and population
 - ▶ Commitment to eight bannermen and terror to overcome these two intrinsic disadvantages (Fairbank and Goldman 2006)
 - ▶ Result: “strong” state capacity when conquering Ming, but weak state capacity during peace (Ma 2011, Sng 2014, Sng and Moriguchi 2014)

The Collapse of Qing

- ▶ In what sense did the state capacity of Qing become weak confronting these challenges?
 - ▶ Supplementing weak state capacity was the the rise of local gentry power, under the suspicion of the bannermen
 - ▶ “Man on the spot” somewhat flourished (Brandt, Ma, Rawski (2014)), only to further weaken Qing’s state capacity (Fairbank and Goldman 2006)
 - ▶ Rights for political leadership appointment appointment narrowly based, inevitably breeding incompetent leadership, which in Qing’s case, resorted to an appeasement strategy that badly backfired

Revolutions

- ▶ Dealing with new challenges
 - ▶ Arguably, the only answer to deal with repeated transgression with much more advanced technologies lies in China's "comparative advantage" in warfare: population
 - ▶ Thus came the need to reach to the populace, mostly in vast rural areas of China, mobilize and organize them to facilitate the functions of the state
- ▶ The period of revolutions signified how different factions raced to this particular goal, some more successful than others, with the Communist emerging as the eventual winner

Revolutions

- ▶ Warlords and the Republic
 - ▶ The collapse of Qing came relatively peacefully
 - ▶ Result: almost no power consolidation during the collapse, further weakening, if not disintegrating, the state capacity
 - ▶ Amidst chaos arose regional warlords, each with own self-proclaimed rights to rights and to personnel

Revolutions

- ▶ Warlords and the Republic
 - ▶ Even after the KMT was able to reign in these warlords, compromises had to be made, oftentimes by allowing warlords to maintain their local stakes
 - ▶ Result: turned the KMT into a collection of local factions with no real central control on the one hand, and unable to make real attempt to reach rural people on the other
 - ▶ Ironically, areas where sovereignty was overtaken by foreign transgression saw considerable growth and spearheaded China's economic development in China

Revolutions

- ▶ The rise of the Communists
 - ▶ The brutal ending of the short honeymoon between the KMT and the Communists drove the latter to seek haven in countryside, where the state capacity of the new, KMT-led, Republic was the weakest
 - ▶ The Communists began state capacity building there to finance defensive warfare against the KMT, introducing social reforms on land and women among others that reallocated and redefined rights in those areas
 - ▶ Constantly threatened by the KMT, the Communist also established much tighter control on personnel (as compared to KMT), even at the grassroots level

Revolutions

- ▶ The rise of the Communists
 - ▶ The prolonged Japanese invasion offered another opportunity for the Communists to cultivate state capacity at the countryside behind the enemy line.
 - ▶ As a result, after the war, the Communists, by mobilizing rural populace, were able to swiftly defeat the much better armed, and yet fiscally stranded (as a result of combatting against the Japanese invasion) KMT
 - ▶ The defeats on battleground sent the KMT regime into a downward fiscal spiral.

Revolutions

- ▶ The rise of the Communists
 - ▶ The defeat of the much better armed KMT set a prelude to the country's newly established ability to address the aforementioned century-old challenge
 - ▶ Shortly after coming to power, the Communists put its state capacity in mobilizing the populace to fight a warfare against much more advanced military technologies to test
 - ▶ Peace finally arrived at the horizon

Rapid Industrialization under Strong State Capacity

- ▶ Central planning with regional diversification
 - ▶ Yet, peace continued to be under threat, especially in the shadow of foreign blockade, rapid industrialization was called for (Cai, Li, and Lin 2003)
 - ▶ The aspiration for rapid industrialization led to central planning: many rights were withdrawn from “man on the spot” to the state; state capacity seemed to be highly strengthened as a result, reaching deep into every corner of the Chinese society
 - ▶ Meanwhile, to manage risks of any warfare against Western powers, the economy was organized with different regions remaining somewhat self-sufficient, paving the way for China’s reforms in the future (Qian and Xu 1993)

Rapid Industrialization under Strong State Capacity

- ▶ Mixed results of central planning
 - ▶ With rights to “man on the spot” (such as rights to move and rights to birth) minimized, their incentives and initiatives diminished too, with a vengeance (Erickson 1991)
 - ▶ Meanwhile, the era of central planning brought China a healthier and better educated people; capital-intensive heavy industry was developed and nuclear deterrence capability was established

Rapid Industrialization under Strong State Capacity

- ▶ Mixed results brought differences in views with the state
- ▶ To resolve these conflicting views while maintaining the seemingly ultra-strong state capacity, the Communist leadership reduced itself to a one (strong) man show
 - ▶ Policy debates turned into witch-hunt: repeated political movements heightened at the cultural revolution
 - ▶ The vengeance of yes men: great leap forward turned into one of the largest famines

Turning point

- ▶ 1970's saw a change in the world political landscape: the United States and China turned friendly, and the Soviet became to show signs of weakness.
- ▶ With its own nuclear deterrence capability in place and a border conflict showcasing its strong state capacity, this change of the international political landscape finally brought China to a new horizon of sustained peace
- ▶ China became ready to address the incentives and initiatives of “man on the spot”, as Mao's passing and Deng's return to power created an opportunity for practicality to dominate ideology dogma

Decentralizing Rights to “Man on the Spot” while Leveraging the Strong State Capacity

- ▶ Reforms began with “man on the spot” stepping outside the boundary of their rights at the countryside
 - ▶ The household responsibility system
 - ▶ Endorsed by the practical administration *ex post* and the practice spread to other villages around China
- ▶ The explosion of farmers’ incentives compelled other rural reforms
 - ▶ Dual track price reform (price reform with grand-fathering clause) for agricultural products (Lau, Qian and Roland 2000)
 - ▶ Emergence of township-village enterprises, assisted by the central planning legacy (Che and Qian 1998)

Decentralizing Rights to “Man on the Spot” while Leveraging the Strong State Capacity

- ▶ The success of rural reforms propelled further reforms elsewhere through learning
 - ▶ Urban state sector reform through contractual arrangement (Groves, Hong, McMillan, and Naughton 1994)
 - ▶ Dual track price reform for industrial products
 - ▶ Reform in government sector through contractual arrangement
- ▶ Opening to the world in dual track fashion
 - ▶ Special economic zones

Decentralizing Rights to “Man on the Spot” while Leveraging the Strong State Capacity

- ▶ However, reforms in dual track fashion created ample rent seeking opportunities, causing public concerns that eventually led to the June 4th incident
- ▶ Economic slowdown ensued after the incident, amidst a new round of foreign blockade against the incident.
- ▶ To bring the economy back on track, Deng visited the South
- ▶ Heeling after Deng’s call, regional governments expanded many of their state-owned firms

Decentralizing Rights to “Man on the Spot” while Leveraging the Strong State Capacity

- ▶ The spur of state owned firms was short-lived, however
 - ▶ Soon, the rise of non-state firms including township-village enterprises brought fierce competition against these state firms, reducing them to loss-making burdens for these regional governments
 - ▶ By mid 1990s, a large scale of privatization under the name of “grabbing the large and letting go the small” was ready.

Decentralizing Rights to “Man on the Spot” while Leveraging the Strong State Capacity

- ▶ Since the onset of economic transformation till the mid 1990s, much of China’s reform was carried out with the following features
 - ▶ Bottom up, relying upon local initiatives,
 - ▶ Dual track fashion (Lau, Qian and Roland 2000), and
 - ▶ Gradual (McMillan and Naughton 1992)

Decentralizing Rights to “Man on the Spot” while Leveraging the Strong State Capacity

- ▶ “Bottom up” in this particular context implies reform initiatives “stepped out of bound” , threatened to cause confusions on the economic institution, i.e., the structure of rights; likewise dual track required enforcement of the old way
- ▶ However, two key characteristics of the Chinese institutions helped making “bottom up” and “dual track” work
 - ▶ Regional subeconomies being largely self-sufficient (Qian and Xu 1993)
 - ▶ An ability to sanction *ex post*, put a break when things went awry, while at the same time keeping the rest of the activities and rights to be carried out the same way as before (Blanchard and Shleifer 2000)

Decentralizing Rights to “Man on the Spot” while Leveraging the Strong State Capacity

- ▶ Such an ability rested on the strong state capacity the country inherited from the central planning era, without any “on-the-book” political liberalization that is to decentralize political rights to “man on the spot”
- ▶ Even though political rights were not decentralized to “man on the spot”, political reform did take place within the state, reshuffling rights inside the party
 - ▶ Mandatory retirement
 - ▶ Term limits

Decentralizing Rights to “Man on the Spot” while Leveraging the Strong State Capacity

- ▶ Measures above helped reassure collective leadership within the state (Che 2008) and created upward career opportunities to help motivate local cadres (Li and Zhou 2005)

Decentralizing Rights to “Man on the Spot” while Leveraging the Strong State Capacity

- ▶ A few key developments between mid 1990s and early 2000 are to be noted
 - ▶ Tax reform
 - ▶ Large scale of privatization of regional governments controlled state firms
 - ▶ Entry to WTO
 - ▶ Asian financial crisis

Decentralizing Rights to “Man on the Spot” while Leveraging the Strong State Capacity

- ▶ The tax reform came because, despite a strong state capacity overall, the fiscal share of the central government in GDP gradually declined after 15 years of reform, thanks to the fiscal contractual arrangements between itself and local governments that were designed to offer local governments incentives and encourage their initiatives
- ▶ This, together with large scale of privatization and China’s entry to WTO, enormously expanded rights to “man on the spot”, the central government’s rights over resources, leaving local governments stranded in the middle, with limited resources for their administrative duties

Decentralizing Rights to “Man on the Spot” while Leveraging the Strong State Capacity

- ▶ For some local governments, this awkward situation was mitigated with the advent of Asian Financial Crisis
 - ▶ To counter the decline in aggregate demand caused by Asian Financial Crisis, the central government began to liberalize housing market starting from late 1990s
 - ▶ The ensuing housing market boom provided local governments an opportunity to make up their losses in revenues with land sale, to which they have rights to administer
- ▶ For local governments where demand for new housing was weak, they would resort to collecting illicit fees (and hence became predatory) to get by

Decentralizing Rights to “Man on the Spot” while Leveraging the Strong State Capacity

- ▶ Such a regional disparity coincided the regional disparity in economic development as well as the regional disparity in local government quality due to the nature of the Communist personnel hierarchy
 - ▶ Result: excessive agglomeration to backfire later

Decentralizing Rights to “Man on the Spot” while Leveraging the Strong State Capacity

- ▶ The double edged-swords of WTO
 - ▶ Access to WTO committed China to further embracing market competition; but it also induced the nation to create state-owned national champions to head off competition;
 - ▶ It turned China into the world factory, while at the same time changed the landscape of world economy, forcing the rest of the world, especially developed countries to make adjustments; and part of the adjustments may have come in the form of Global Financial Crisis in late 2000, which has lingered on even today.

Decentralizing Rights to “Man on the Spot” while Leveraging the Strong State Capacity

- ▶ To once again manage the aggregate demand brought about by these financial crises, the state leveraged on remaining state firms, in particular its national champions, with a large amount of credit that “man on the spot” found difficult to attain.
 - ▶ Result: expansion of state capacity at the expense of “man on the spot”, inviting many outcries (Brandt and Zhu 2000)
 - ▶ Thus the recent leverage of the state capacity seems to have been applied in a wrong direction
- ▶ Compounding such a distortion is the distortion in migration/agglomeration, that forced the manufacturing cost in China to rise sharply, before the country truly gets rich, much due to congestion and related pollution

Challenges: Hazy but Present

- ▶ Decentralizing rights to “man on the spot” inevitably increases the incidences of intra-right externality, and perhaps those of extra-right externality as well
 - ▶ Dirty air, dirty food, ... and dirty officials, despite unprecedented phenomenal growth for the last three decades
- ▶ To provide remedies, the state needs to either step in itself or to allow “man on the spot” to form certain coalitions
- ▶ But even if “man on the spot” can form coalitions to address some of these issues, the state is needed for enforcement

Challenges: Hazy but Present

- ▶ Either way, the state is needed, and needs to be honest
 - ▶ To keep the state honest is to keep players who hold the right against each other within the state honest
- ▶ An infinite regress problem (Hurwicz)?
- ▶ Only finite if there exist a few good men that can rise to the top