



THE WILLIAM DAVIDSON INSTITUTE
AT THE UNIVERSITY OF MICHIGAN BUSINESS SCHOOL

*Changing Incentives
of the Chinese Bureaucracy*

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Working Paper Number 130
January 1998

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Changing Incentives of the Chinese Bureaucracy

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January 1998

Abstract

It has been increasingly recognized that the Chinese government's newly acquired enthusiasm for economic development is a major factor explaining the relative success of China's transition from socialism. This paper argues that the changed behavior of the Chinese government is an outcome of a series of reforms of the bureaucracy. The bureaucracy was transformed from inside through a massive mandatory retirement program and a drive for administrative/fiscal decentralization. It was also changed from outside since many bureaucrats can quit government positions and join businesses. China's unique approach to reform bureaucracy without explicit political liberalization is predetermined by its initial conditions of transition.

Key Words: Reform of the Bureaucracy, Bureaucratic Behavior, Government in Transition.

JEL Classification Codes: H10, H70, P26, P30, P51, P16, P52.

¹ I would like to thank Yasheng Huang, Ramon Myers, Yingyi Qian, Andrei Shleifer, and Wenfang Tang for helpful discussions and detailed comments on earlier versions of the paper. A National Fellowship of the Hoover Institution is gratefully acknowledged. All errors and mis-information are my own

A striking difference among economies in transition from socialism is in government attitudes toward economic development. In China, the government functions as a “helping hand” for economic development, promoting economic growth; in Russia, the government is like a “grabbing hand,” suffocating economic development (Timothy Frye and Andrei Shleifer, 1997). Indeed, after years of transition, it has been increasingly recognized that a proper transformation of the role of government, rather than mechanical implementations of standard reform packages, is a critical determinant of the success of transition.

The Chinese case of transforming government behavior is dramatic and defies conventional explanations. Forty years ago, the same authoritarian regime under the control of the same Communist Party was waging a massive campaign under the name of the Great Leap Forward, resulting in the loss of tens of millions of lives. Thirty-two years ago, the same regime was launching the so-called Cultural Revolution, denouncing any traces of economic incentives. Meanwhile, influential theories of the political economy of the former socialist systems emphasize that unless the one-party (Communist Party) monopoly is abolished, reforms are doomed to fail (Janos Kornai, 1992). These theories cannot explain the Chinese experience, where political liberalization toward representative democracy and the rule of law has been limited and the one-party monopoly still exists.

This paper argues that, despite the lack of political liberalization, China has benefited from a major transformation of its bureaucratic system. This transformation, which started years before formal economic reforms, consists of a mandatory retirement program that replaced the revolutionary veterans, a drive for administrative and fiscal decentralization, and granting permissions allowing bureaucrats to quit bureaucracy and join businesses. The implementation of these reforms was facilitated by a buy-out program for the incumbent government officials. As a result of the transformation, Chinese bureaucrats now face incentives to support economic reform and to promote economic development.

1. Reforms within the Bureaucracy

The first reform, which dealt with the way bureaucrats are promoted and retire, was initiated by Deng Xiaoping in 1980, years before any discussions of reforming the economic system. The proclaimed purpose of Deng's reform was to "abolish the de facto life time tenure system of government officials" and to "modernize the contingent of government officials" (Deng Xiaoping, 1983). The reform's crucial measure was to introduce a set of strict retirement age for government officials, and thus by implication, a massive mandatory retirement program (Hong Yong Lee, 1991, and Kenneth Lieberthal, 1995). On a less restrictive basis, an education requirement was also introduced at each level of government positions (see Table 1 for a summary of the reform).

(Insert Table 1 here)

The massive mandatory retirement program was facilitated by a one-time buy-out strategy, with the out-going officials being partially compensated both economically and politically (Susanto Basu and David Li, 1996). This is similar in style to the Russian privatization program, in which stakeholders such as managers were offered discounted shares. The buy-out program was a special arrangement for revolutionary veterans who were the first and biggest potential opponents of this the reform. In fact, a special name was coined for such kind of retirement, i.e., *lixiu*, meaning literally leaving the post and resting. After *lixiu*, retired officials continued to enjoy all their former political privileges, such as reading government circulars of the same confidentiality level. Some served as special counselors for their successors. As economic compensations, they could keep using their official cars with chauffeurs and security guards. In addition, officials under *lixiu* received an extra month of wages each year and extra housing that their children and grandchildren were entitled to enjoy after their death. Finally, for the most senior officials, there were implicit and informal

arrangements whereby their children were allowed to enter politics in senior positions, the origin of the so-called princeling party in China.

There have been two major consequences of the reform. The first and direct consequence is that many younger and more educated bureaucrats have replaced the older revolutionary veterans. The new and young officials were generally more supportive of reforms, more adaptable, and more pragmatic. Being better educated in almost all cases, they were also generally more competent than their predecessors. In short, the massive retirement program has radically changed the human capital of the Chinese bureaucracy. In fact, by 1988, 90 percent of the officials above the county level had been newly appointed after 1982. In contrast, in Russia, Andrei Shleifer (1997) reports that the local leaders are largely the very same people who were there before the reform began.

The second consequence of the reform is that the average duration of a bureaucrat's tenure in a government position has been reduced, partly due to the increased turnover rates of bureaucrats. Compared with the old bureaucracy, the reformed one with rather strict age and education requirements generates more vacancies per unit of time, providing the young and educated with more upward mobility. In addition, the central government seems to have increased the frequency of shuffling provincial/ministerial officials by transferring provincial governors/ministers from one province/ministry to another. Yasheng Huang (1997) argues that this is due to the central governments' fear of local entrenchment due to the decentralization program, which I discuss below. Both effects reduce the duration of bureaucratic tenure in a given position.

Undoubtedly, the changed human capital composition of the Chinese bureaucracy vastly helped the implementation of the economic reform. This has been proved to be a critical factor for the success of reform in many transition economies. In both China and Russia, it has been found that replacing the old management is a critical factor explaining an enterprise's efficiency

improvement (Theodore Groves, Yongmiao Hong, John McMillan, and Barry Naughton, 1995 and Nicholas Barberis, Maxim Boycko, Andrei Shleifer, and Natalia Tsukanova, 1996). Using a large-scale survey, Wenfang Tang and William Parish (1998, chapter 7) find that the young and educated officials in China are significantly more supportive of reform than the old and uneducated.

The second reform within the bureaucratic structure is an extensive administrative and fiscal decentralization. During the early 1980s, a so-called fiscal-contract system was introduced for provincial governments in China, in which, each province was responsible for collecting tax revenues in its region and was entitled to retain a high proportion of the marginal tax revenue (Jean Oi, 1992 and Yingyi Qian and Barry Weingast, 1996). Administrative decentralization was also implemented, shifting formal authorities from the central government to lower-level governments, including the authority to appoint subordinate government officials (Yasheng Huang, 1996) and the rights to supervise state-owned enterprises (SOEs). Many provinces, in turn, implemented similar reforms with their subordinate cities or counties.

The extensive administrative and fiscal decentralization has had far-reaching implications for both the Chinese bureaucracy and the Chinese economy. Perhaps the most dramatic has been a massive entry of new business entities, which are either partially owned or supported enthusiastically by various governments, whose motivation for doing so comes from increasing tax revenues and, often times, enlarging local employment (Chun Chang and Yijiang Wang, 1994 and Jiahua Che and Yingyi Qian, 1997). These newly established businesses are organizationally completely different from SOEs. Typically, the manager is one of the founding entrepreneurs who have contributed their own financial as well as human capital. Often, one of the founding entrepreneurs is a former government official, a phenomenon discussed below. Most important, the manager shares substantial residual control rights with the sponsoring government (David Li, 1996). In effect, such new businesses constitute coalitions between the bureaucrats, who contribute bureaucratic connections, and entrepreneurs, who provide business

vision and managerial skills. Both parties are indispensable for the success of new businesses in the half-reformed Chinese economy.²

The massive entry of semi-private businesses has had substantial impact on the incentive and behavior of Chinese bureaucrats. First, bureaucrats are now beginning to act like businessmen. Jean Oi (1992) calls this local corporatism. Also, since bureaucrats now benefit from the new businesses through better official cars, bigger budgets, and better office facilities, their interest is no longer solely in pleasing their bureaucratic superior. More important, they become de facto shareholders rather than short-termist bribe-takers. This new behavior reduces the prospect for local officials to adopt irrational decisions from the top to maximize their political goods, a bureaucratic pattern associated with the Great Leap Forward.

Second, through their involvement in these businesses, bureaucrats are beginning to become pro-reform in principle, having incentives to lobby higher level agencies for reduced regulations on behalf of local entrepreneurs. However, one negative effect of bureaucrats sponsoring businesses is that it increases their appetite for bureaucratic power. In the Chinese context, the economic and bureaucratic competition among regions seems to have kept this tendency in check.

2. Changes from outside the Bureaucracy

A veritable bureaucratic revolution has taken place in China since the mid-1980s when bureaucrats were allowed to quit their government positions in order to join the business community, a phenomenon that later became to be known as *xiaohai*, i.e., “leaping into the sea” or “jumping into the ocean”. Starting in the mid-1980s, many government agencies began establishing business entities and bureaucrats became managers of these businesses. Gradually,

² Although most studies have focuses on those new businesses established by local governments, in fact, many central government agencies have also established their own business ventures.

such businesses are gaining independence from the founding government agencies; meanwhile, many relatively independent and semi-private enterprises are being established. In addition, there were substantial efforts to downsize government agencies during the 1980s, generating a large surplus of government officials. Therefore, by the early 1990s, *xiahai* was in full swing.

It is not difficult to explain the economics of *xiahai*. Joining the business world, the former bureaucrats obtain much higher economic payoff as well as personal freedom, despite being exposed to more economic uncertainty. On the other hand, there is high demand for those bureaucrats, since, in the half-reformed economy, many non-state enterprises need their knowledge and skills to deal with the remaining government regulations.

Since 1992, *xiahai* has been an immensely popular phenomenon among Chinese government official. In a survey conducted around 1992, Ruying Chen (1993) reports that 30 percent of surveyed officials were thinking about “leaping.” In another survey of local government officials in 1995 (State Commission of System Reform, 1996), close to 20 percent were planning to *xiahai*. Of those, 35 percent were looking for joint-venture enterprises, 21 percent for private enterprises, and 15 percent for SOEs. Tang and Parish (1998, chapter 7) find in their large survey that 99 percent of those officials who planned to quit the bureaucracy wanted to join businesses.

A much more difficult and interesting issue is how to evaluate the impact of *xiahai* on the Chinese bureaucracy. Few systematic analyses exist. A common view, based on experiences of market economies, regards *xiahai* as detrimental to economic growth because it creates an environment where the government and the business are not separated. As a result, government-business collusion arises and corruption prevails. Moreover, anticipating *xiahai*, according to this view, incumbent bureaucrats may have incentives to increase the complexity of economic regulations so as to increase their future value in the business world.

Contrary to this common analysis, *xiaohai* seems to have had a fundamentally positive impact on China's reform process, pushing for dynamic changes in the Chinese bureaucracy in two important ways. First, *xiaohai* changes the *ex ante* behavior of bureaucrats before leaving the government by making them more interested in local economic growth, especially in the growth of the non government controlled sector, i.e., the non-state sector. Since a more prosperous non-state sector generates more opportunities for the incumbent bureaucrats when leaving their government positions. Moreover, the *ex ante* behavior is also affected through a reputation effect. That is, an incumbent bureaucrat must establish a pro-business and pro-reform reputation to find a good position in the local business community after leaving the government. The best way to enhance this reputation is to promote growth and reform and to nurture personal rapport with local entrepreneurs by helping their businesses thrive. In the Chinese business community, personal relations, reputation, and trust (*guanxi*, in general) are very important. Therefore, a renowned anti-reformist bureaucrat will find it impossible to find a good position in the local business community after leaving his government position.

Second, *xiaohai* also transforms the *ex post* behavior of the bureaucrats who quit the bureaucracy. After leaving the government, most bureaucrats joined new businesses rather than traditional state enterprises. Therefore, the former bureaucrats now find that many of the bureaucratic regulations that they helped maintain in the bureaucracy are obstacles to their business interests. They are in the position to help get around and lobby for reductions in these bureaucratic regulations. Having the bureaucratic knowledge and skills, they are more effective lobbyists for reforms of these regulations than those outsiders of the bureaucracy. This seems to be a rather effective mechanism of reducing Chinese bureaucratic institutions during reform.

Finally, it is interesting to note that *xiaohai* seems to be a phenomenon unique to China, at least in its impact on the bureaucracy. In Russia, according to Shleifer (1997), with the exception of Moscow, politicians are not accepted by the private sector. When the private sector grows, they lose power. They are much closer to the formerly state enterprises, many of which

are subsidy-seekers. In Poland, local politicians seem to be mostly concerned with getting re-elected, rather than joining private businesses after leaving their government positions.

3. Concluding Remarks

The paper argues that the Chinese government's newly acquired spirit for economic development during the reform era is a result of a major transformation of the Chinese bureaucracy, rather than an outcome of political liberalization. Of course, the analysis does not imply that political liberalization is not necessary or unhelpful for economic reform. As many have rightly argued, political liberalization has its own intrinsic value and may be the outcome of an increased per capita income.

Using the Northian framework (Douglass North, 1990), the transformation has changed the formal and informal rules within the bureaucracy, i.e. the bureaucratic institutions. The reformed bureaucratic institutions have induced changes in incentives and behavior of the bureaucrats and this, in turn, has facilitated reforms of the economic institutions, which have spurred economic growth.

China's unusual experience of reforming the bureaucracy without explicitly liberalizing the political system may not be generalizable to other transition countries, since it has been shaped by initial conditions. A particularly intriguing and under-studied initial condition is the legacy of the Cultural Revolution, which ex post not only boosted Deng Xiaoping's credibility and authority as a reformer but, more importantly, also left China with a weakened bureaucracy for easier bureaucratic reforms.

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Table 1: The Reform of the Bureaucracy: February 1982—September 1984

	Mandatory	Average Age		College Degree (%)		Average Tenure (Years)	
	Retirement Age	Before	After	Before	After	Pre-1993	Post-1993
						(Governor/Party Secretary)	
Provincial Governors	65	62	55	20	43	6.43/6.23	3.84/4.05
Ministers	65	64	58	37	52	6.56	4.44
City Mayors Or Department Chiefs	60	58	50	14	44	---	---
County Sheriffs Or Division Chiefs	55	---	<45	11	45	---	---

Notes: By 1988, 90 percent of government officials above the county level were newly appointed after 1982. 60 percent of those government officials had college degrees. This was a result of retiring 3.4 million revolutionary veterans.

Source: Chronicles of Contemporary Chinese Politics (Beijing: The People's Publisher, 1996) and Huang (1997) (for the tenure data).