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Political institutions, entrenchments, and the sustainability of economic development – A lesson from rural finance☆

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ABSTRACT

This paper provides insights on the sustainability of economic development from a historical and political economy perspective. We demonstrate that China's rural financial policy in the 1980s was quite liberal in employing market mechanisms, supporting entrepreneurship, and encouraging competition. These policies were abandoned in the early 1990s and replaced by ubiquitous government interferences that shifted resource and policy priorities to benefit political incumbents. A large panel of survey data confirms that rural household access to finance decreased dramatically in the 1990s and that the statistical significance of economic entrepreneurial factors in determining credit allocation also fell. Further empirical analyses show that market economic conditions are not sufficient to explain these changes and the evidence is consistent with a political entrenchment motive during the political regime after the turmoil in the year 1989. Given the connection between entrenchment and underdevelopment, our findings raise the concern that China's political institutions' insufficient limits on the government could be a challenge for China to sustain its economic success.

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1. Introduction

Can China preserve its economic success? The sustainability issue is important for both China and the world. The World Bank recommends six strategies, including structural foundations for a market economy, innovation, and green energy, to build China into a "modern, harmonious, and creative high income society".[1] Achieving these goals, however, largely depends on the direction of China's reform in the coming years. As many countries' experiences show and the literature argues, liberalization reforms are often resisted by the vested interest group.[2] In fact, Morck, Wolfenzon, and Yeung (2005) empirically show that interest groups in control of an economy seek institutional development or policies that preserve their economic entrenchment, which in turn undermines economic growth.

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[1] "China 2030", The World Bank, Development Research Center of the State Council, The People's Republic of China.

[2] The other resistance forces discussed in the report are a group that may be hurt in the short-term and a group who equates remaining distortions as the results of early reform.

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Given that the Chinese government has demonstrated an impressive capability of mobilizing, organizing, and managing resources and human capital to achieve its development goals over the past 30 years, one may argue that this strong government will continue to clear any obstacles to future success. Indeed, hegemony has undeniably played a critical role in China's remarkable economic success to date. However, given the nature of history, we are unable to compare the present to unobservable alternative paths.

Addressing the sustainability question goes way beyond what one academic paper could cover. This paper attempts to provide some insights into the sustainability issue by reflecting on one specific perspective: how China's economic policies over the past 30 years have instituted market mechanisms. Showcased by micro-level evidence, we argue that the weak limitations on government may turn out to be a significant challenge for China's future economic development. The political institution in China with little constraints on the government allow for convenient implementation of entrenchment strategies, through the government's control of production resources, such as capital and land and by imposing financing rations, access restrictions, differential pricing, and entry barriers.[3]

We chose rural financing as our context for illustrating government policy choices for two reasons. First, access to finance is an ideal barrier to competition (Rajan & Zingales, 2003). Second, rural sector was important as majority of the Chinese population and much of the private sector resided in rural areas in the early 1990s. Using a unique panel of fixed-site household survey dataset from 1986–1991 and 1995–2002, together with historical bank performance statistics and documents, we identify a significant—but seldom externally recognized—illiberalization process in China's rural financial policy, beginning in the early 1990s. We show that rather than simply not having launched liberal financial reforms (Lardy, 1998), China actually reversed those that had emerged in the 1980s.

The changes can be characterized along three dimensions: market mechanism, competition, and credit rations. In the 1980s, the policies encouraged floating interest rates, the loan decisions were made based on economic variables, and the credit allocation operated in a similar way as microfinancing in developing countries and/or venture capital in developed countries—to fund entrepreneurship. However, in the 1990s, strict regulations were introduced to curb high margin interest rates in private sector lending and to mandate collateral on all loan decisions. Likewise, whereas the first regime in the 1980s encouraged competition from informal financial institutions and kept entry barriers low by permitting and formalizing non-state financial institutions, the second policy regime of the 1990s outlawed non-state-owned financial institutions. In particular, while the banks actively financed and assisted entrepreneurs in the 1980s, credit allocation was explicitly rationed against rural entrepreneurs in the 1990s. Consequently, there was a dramatic reduction in credit flows to the private sector.

According to the fixed-site rural household survey data, 13% of rural households reported receiving formal loans in a given year between 1986 and 1991, but this figure fell to 4% in the period from 1995 to 2002. The difference is even larger when informal loans are included in the calculations. Moreover, the economic determinants of credit allocation became less significant in the 1990s, while political factors became increasingly important. It should be noted that the household sector was in fact the main private component of the economy in the early years of Chinese reforms and therefore in this paper, we treat credit flows to the household sector as functionally equivalent to credit flows to the private sector.[4]

We examine various potential explanations for the changes. First, the period of tightening rural finance (1990s) coincided with a massive out-migration of rural labor to coastal areas and the demise of TVEs. This trend requires a careful examination of the causal relation between financial closure (hence suppression of entrepreneurship) and labor migration (hence demise of TVEs). The demand-side causes include a possible correction of inefficient investment in rural areas during the first period or a decline in the profitability of rural entrepreneurial activities in the second period. On the supply side, there might be competition from foreign direct investment and crowding-out by informal financing or rising finance costs. Lastly, political regime changes after 1989 may have brought about policy changes that favor political incumbents.

We test the plausibility of each of these hypotheses using data on bank performance, labor migration, and profitability of rural entrepreneurship activities. Our results surprisingly indicate that none of these economic factors sufficiently explain the reversal in rural finance. However, there is evidence consistent with the political entrenchment hypothesis: In the 1980s, credit allocation was determined by economic factors; in the 1990s, credit allocation was significantly related to only the political status of the borrowers. Aside from the empirical results, the government policy and bank documents we reviewed explicitly encourage favoritism to political incumbents.

Admittedly, pinning down a causal story using conditional means in a time series pattern in the absence of an experiment is problematic. We alleviate the identification concern by examining the cross-sectional implications of the above hypotheses. First, we use cross-region comparison to show that the reversal in the 1990s was deeper in regions that were better developed in the 1980s. Second, we use the Lagrangian approach to identify the lead–lag effect in credit allocation and loan performance. Third, we

[3] For example, private firms are explicitly excluded from financial, natural resource, telecommunication industries, etc. These restrictions not only discourage competition, but also facilitate profiting from arbitrage between non-market resource inputs and market pricing of outputs. Using capital as an example: state-owned firms have priority access to bank credit at fixed low interest rates, while the products are sold at market prices – transferring welfare from depositors and consumers to state-owned firms. Using land as another example: the government can confiscate land but sell to real estate developers and consumers through “market” mechanisms – transferring welfare from farmers and consumers to government units and real estate developers. These phenomena, which emerged during the 1990s, are called the “new double-track pricing system” *viz* the “old double-track pricing system” of the late 1970s and 1980s that facilitated the development of a private sector to replace the planned economy.

[4] Semantically, it is fair to say that the only private part of a centrally planned economy is the household sector. That is, in a classic planned economy, the corporate sector—in the form of state-owned enterprises (SOEs)—is completely owned by the state and non-government organizations are banned and therefore nonexistent.

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