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Size and dynastic decline: The principal-agent problem in late imperial China, 1700–1850

Tuan-Hwee Sng

Department of Economics, National University of Singapore, AS2 Level 6, 1 Arts Link, 117570, Singapore

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Abstract

This paper argues that China's size was one reason behind its relative decline in the nineteenth century. A ruler governing a large country faces severe agency problems. Given his monitoring difficulties, his agents have strong incentives to extort the taxpayers. This forces him to keep taxes low to prevent revolts. Economic expansion could aggravate corruption and cause further fiscal weakening. To support the model's predictions, I show that the Chinese state taxed and administered sparingly, especially in regions far from Beijing. Furthermore, its fiscal capacity contracted steadily during the prosperous eighteenth century, sowing the seeds for the nineteenth-century crises.

Keywords: Economic history; Political economy; China; Taxation; Public goods; Institutions and growth
JEL classification: N15; N45; O43

1. Introduction

Why was China unable to seize the opportunities presented by the Industrial Revolution to modernize its economy in the nineteenth century? Traditionally, many blame its autocratic regime. Going back to Montesquieu, prominent scholars have argued that China's growth was hampered by an autocratic, managerial, and interventionist state, whose power to collect taxes, confiscate materials, and conscript labor was virtually unlimited. The Chinese state's tendency to suppress private enterprise stifled initiative. Economic stagnation became inevitable thereafter (Wittfogel, 1957; Balazs, 1964).

This argument, however, faces theoretical challenges, for the Chinese emperor was a stable dictator.[1] As Mancur Olson taught us, a stable dictator understands that excessive exaction in the short run reduces future tax revenues and increases political instability (Olson, 1993). Such a dictator will therefore demonstrate self-restraint when he expropriates.[2]

The argument is also inconsistent with the findings of Chinese historians in recent decades. While Kenneth Pomeranz's claim in *The Great Divergence* that the

E-mail address: tsng@nus.edu.sg.

[1] According to the Naito Hypothesis, the Chinese emperor became more secure from the Song dynasty (960–1279) onward. Usurpation became rare after the introduction of examinations to select officials (Miyakawa, 1955).

[2] As Rosenthal and Wong (2011) put it, the Chinese rulers "were well aware that social stability translated into political longevity."

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levels of development in the Lower Yangzi delta and England were comparable in the eighteenth century is a subject of debate, his book has fostered an emerging consensus that the eighteenth-century Chinese economy was more developed than previously thought.[3] Commercialization, facilitated by the monetization of taxes and the inflow of silver from Japan and the New World, linked the lives of ordinary people to the world outside their villages (Li, 1998; Wu and Xu, 2000). There is strong evidence suggesting that market integration was high in China before 1800 (Shiue and Keller, 2007).

Importantly, these empirical findings have created a new set of questions. If all was well and good with China in the eighteenth century, why did its fortunes reverse in the nineteenth century? Was China's relative economic decline in the nineteenth century a consequence of historical contingency, or were structural factors at work?

This paper argues that part of the answer can be found in China's size. The vast size of the Chinese empire created a severe principal-agent problem and constrained how the country was governed. In particular, taxes had to be kept low due to the emperor's weak oversight of his agents and the need to keep corruption in check.[4] The Chinese state's fiscal weaknesses were long masked by its huge tax base. However, economic and demographic expansion in the eighteenth century exacerbated the problems of administrative control. This put a further squeeze on the nation's finances and left China ill-prepared for the challenges of the nineteenth century.

Reprising the earlier work of Kiser and Tong (1992), I argue that the state in late imperial China (c. 1650–1850) [5] can best be understood in light of a large (and stable) dictatorship where excessive exploitation comes not from the ruler, but from his agents who have shorter decision horizons and less encompassing interests than the "benevolent" ruler himself. While the ruler is motivated not to overtax the population to preempt rebellion, his agents have private incentives to expropriate rent from the taxpayers. If the ruler is unable to keep corruption in check, he will have to keep the tax rate low and his bureaucracy small to mitigate this "tyranny at the bottom" effect.

Size plays a crucial role in the hypothesis as it shapes the ruler's ability to monitor his agents and the agents' incentives for rent seeking. Specifically, size carries two dimensions in the hypothesis: geographic and economic. Geographic size matters because the costs of transmitting information over distance matter, especially in the premodern world. Moreover, a geographically large polity usually comes with regional diversity that makes collecting useful information more costly. Regional differences in climate, crops, per capita income, and other socioeconomic conditions often imply that local agents must have some flexibility in implementing central government decrees. Yet that very flexibility also makes it harder for the ruler to determine whether an agent who pursues a different path is doing so for private gain or in response to local conditions. Finally, when political power is highly centralized, monitoring and sanctioning would inevitably involve the ruler. All else equal, the larger his domain, the higher the risk that his attention may be spread too thin.

The effect of economic size on state finances is more ambiguous. Economic expansion enlarges the tax base, but it also increases the rent-seeking incentives of state agents. This puts pressure on the ruler to lower his rate of extraction to ensure that taxpayers are exploited in a sustainable manner. This paper constructs a simple model to show that if the principal-agent problem is sufficiently severe, the negative effect of economic expansion (a lower tax rate) could eventually overwhelm its positive effect (a bigger tax base) so that economic expansion actually hurts the ruler and weakens his ability to maintain stability and order.

The issue of size is particularly relevant to China, given that for the last two millennia, the landmass between the Great Wall and the South China Sea was more often than not under the rule of a single central authority. China's vast size implies that obtaining timely and accurate information has always been a challenge to its ruler. In 1853, when the Taiping rebels captured Wuchang, a major city about 1200 km from Beijing, the news took eight days to reach the capital (Xie, 2002). Mao highlighted the challenges that size posed to centralized control when he told Nixon during the latter's visit to China, "I have not been able to change [China]. I have only been able to change a few places in the vicinity of Beijing" (Kissinger, 1998, 60).

[3] Pomeranz (2000). See also Wong (1997).

[4] It is now widely accepted that in early modern Europe, absolutist states such as France and Spain actually taxed less than England and the Netherlands due to institutional fragmentation (Hoffman and Rosenthal, 1997; Epstein, 2000; Dincecco, 2011). However, this explanation does not apply to late imperial China as China had overcome jurisdictional fragmentation quite early. From the tenth century onward, a nonhereditary bureaucracy replaced the aristocracy. Passing civil service examinations became the main avenue to joining the political elite. Accordingly, the elite became averse to challenging the authority of the emperor (Miyakawa, 1955).

[5] Late imperial China usually refers to China during the Ming (1368–1644) and Qing (1644–1912) dynasties. This paper focuses on the Qing dynasty before 1850.