



Strategic interaction in political competition: Evidence from spatial effects across Chinese cities[☆]



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ABSTRACT

Promotion of local leaders in China is decided by their upper-level governments which evaluate their performance based largely on local economic growth. Such a promotion scheme leads to tournament competition among local government leaders of the same level. We test the hypothesis of tournament competition by studying the spatial effects across Chinese prefectural-level cities. Employing spatial econometrics tools, we document a strong spatial effect for city-level total investment which fuels short-term economic growth. This spatial effect is shown to occur only for cities within the same province, but not for neighboring cities located in different provinces. We also find that within the same province, the spatial effect mainly exists for cities with similar economic ranking but not for cities that are geographically proximate. The spatial effect tends to diminish for city leaders who are close to the end of their political careers. These findings suggest that the spatial effect for investment is driven by strategic interactions among political rivals in tournament competition. We rule out alternative factors, such as economic spillovers and tax competition, as the key drivers of the observed spatial effect.

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1. Introduction

The phenomenal economic growth in China has spawned a large literature that studies the Chinese economy from various perspectives. One distinguished branch of research links this economic growth to tournament competition among local government leaders (Zhou, 2009; Xu, 2011). A key hypothesis from this perspective is that, in order to maximize their chances of political promotion,

local government leaders compete against one another in spurring total investment and boosting the growth of the local economy. This GDP-based political competition significantly contributes to the investment-driven high growth of the Chinese economy as a whole.

The theoretical grounding of tournament competition is well summarized in Xu (2011) as possessing two key components – political centralization and economic regional decentralization. With political centralization, higher level officials in the hierarchical political system maintain personnel control over their lower level counterparts, so that the former are able to promote the latter based on their performance.¹ On the other hand, regional economic decentralization gives local leaders abundant space for maneuver to promote economic growth. Due to economic decentralization, local

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¹ China's local governments have four hierarchical levels: province, prefectural city, county, and township.

leaders can seek to leverage local investment by using a number of different instruments. Examples include directly influencing the investment decisions of state-owned enterprises, allocating land and loans from local state-owned banks, using Local Financing Platforms to finance various investments,² and providing pro-business policies and services (e.g. offering tax reductions and subsidies and speeding up the administrative approval of large projects) to attract FDI and investment from other regions in China. [Bardhan and Mookherjee \(2006\)](#) assert that China is the only country in the world where local governments have played a leading role in economic growth.³

The goal of our study is to present evidence that local leaders in China indeed engage in tournament competition by strategically leveraging investment. An analysis of such strategic behavior sheds light on at least two prominent features of the Chinese economy. The first is China's much debated high investment rate. According to the National Bureau of Statistics of China, the ratio of total investment over GDP was as high as 48% in 2012. At the city level, our data show that total investment as a percent of GDP has been increasing steadily since 2000, reaching 47% in 2005, the last year in our sample. Our study highlights the important role of local governments in China's investment-driven economy. The high government-led investment could be a source of large misallocation of capital and loanable fund in China ([Hsieh and Klenow, 2009](#); [Song et al., 2011](#)). The second feature is the political business cycle of investment in China — the fluctuations in gross capital formation closely correlate with the timing of Party congresses held every five years, as documented in [Li \(2012\)](#). Given the fact that Party congresses at both national and local levels often reshuffle government officials, our study demonstrates a deeper link between the political incentives of local leaders and investment fluctuations in China.⁴ Despite its importance, to the best of our knowledge, few empirical studies have touched on the strategic behavior of Chinese local leaders in investment, and we aim to fill this gap in the literature.

We study prefectural-level city total investment, and identify three clear patterns of spatial correlation. The first is a border effect. We find a strong spatial correlation among cities within the same province, but little correlation for cities that are geographically proximate but belong to different provinces. The second pattern is a GDP ranking effect. Within the same province, the spatial effect mainly exists among cities with similar rankings of per capita GDP, but not among geographical neighbors. The third is an age-of-leader effect. We find that spatial effect is much weaker among leaders who are near their mandatory retirement age.

These main findings reflect three key features of China's performance-based promotion system. First, the promotion of prefectural-level city leaders is decided by the provincial government, which means that only city leaders in the same province are political rivals for promotion and they do not compete with city leaders from other provinces. Second, in order to level the playing field, a relative performance evaluation is conducted among political peers in prefectural-level cities with similar economic potential. In other words, geographical neighbors, even within the same province, are not proper rivals. Finally, due to the mandatory retirement age, local leaders face a finite horizon planning problem. Since the chance

of promotion is almost zero when they are near the age limit, they have little incentive to engage in tournament competition.

Concerns might arise that spatial correlation of investment observed in our data might be caused by factors other than tournament competition, such as an economic spillover effect. To address these concerns, we argue that the alternative explanations are not consistent with all the observed patterns, especially the age-of-leader effect. Nevertheless, additional tests are conducted to further rule out this alternative explanation. In summary, the combined results strongly support the view that the documented spatial effect of total investment is a result of strategic behavior of local government leaders in tournament competition.

It is worthwhile to compare the tournament competition among local leaders in China with Western style yardstick competition as studied in [Besley and Case \(1995\)](#) and the ensuing literature. In both cases, competition involves assessment of relative performance, but in very different ways. The assessment of relative performance in yardstick competition is done by voters, reflecting the bottom-up power structure in a democratic society; while the tournament competition in China is based on a top-down power structure in which a higher-level authority picks a winner from a set of political contestants.⁵ The difference in power structure also relates to constraints that the contestants face. China's local leaders have a larger capacity to influence the local economy and react strategically to their political rivals than their counterparts in a democratic regime, because the latter have limited discretion in their investment behavior due to checks and balance from the legislature. Another difference is the assumed information structure. Yardstick competition assumes that voters are poorly-informed about the ability or efforts of the incumbent politicians, so they have to rely on the policies and outcomes of neighboring states or cities as benchmarks. On the other hand, tournament competition assumes that the higher-level authorities have sufficient information about the economic performance of their subordinates, which is a realistic assumption given the hierarchical system in China. A perhaps more important difference is that, in tournament competition, only the performance of contestants within the tournament (cities in the same province in our case) and not the performance of neighbors outside the tournament (e.g. cities sharing a common border but from different provinces) will be compared. This is one of the main sources of evidence for the strategic behavior of local leaders in China.

Our paper is closely related to three strands of literature. The first strand of literature discusses the link between promotion of a local government official (cadre) and the economic performance of the city under his/her administration, examples include [Li and Zhou \(2005\)](#), [Chen et al. \(2005\)](#), [Xu \(2011\)](#), and [Choi \(2012\)](#). Along this line of research, three papers are closely related to the interpretation of our empirical findings. First, [Maskin et al. \(2000\)](#) document a significantly positive correlation between the change in rank in provincial GDP growth and the change in political status of provincial leaders during 1976–1986. Thus local leaders are likely to engage in regional tournament competition in which relative performance is critical. Second, [Wu et al. \(2013\)](#) show evidence that city spending on transportation infrastructure correlates strongly with real GDP growth and that a higher GDP growth rate is related to better odds of promotion for local leaders. But higher city-level environmental investment is uncorrelated with odds of promotion. The third paper is [Zheng et al. \(2014\)](#) which shows that environmental performance positively affects a city leader's probability of being promoted, but the marginal effect is of a much lower scale compared to that of GDP growth. These empirical observations are complementary to our

² Local Financing Platforms refer to government-backed investment companies through which provincial, prefectural and county governments raise funds for the construction of roads, airports, bridges, power plants and other projects. These investment companies typically use land or government assets as collateral to leverage bank loans.

³ A number of papers specifically study the effects of economic decentralization in China. Examples include [Zhang and Zou \(1998\)](#), [Lin and Liu \(2000\)](#), [Feltenstein and Iwata \(2005\)](#); [Jin et al. \(2005\)](#), and [Zhang \(2006\)](#).

⁴ Such political business cycle stems from a very different institutional background than the one studied in [Hibbs \(1977\)](#) and the ensuing research.

⁵ For Chinese villages that have undergone transitions to democracy, [Agostini et al. \(2010\)](#) find evidence of yardstick competition similar to that in a mature democracy but at a lower magnitude.

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