Dear CPW participants,

Thanks for reading my paper. This is a draft of my prospectus. I am eager to hear your comments and suggestions on the following issues:

i I used subjective evaluation of courts as the DV, what else could potentially be good measures of quality of legal institutions (or the rule of law in general)?

ii Although there are some ”stars” on the regression coefficients, but I am not 100% sure the mechanism I propose here is correct. What other observational implications should I deduce from my theory? What alternative explanations should I pursue?

iii Where should I go from here? What left unexplained? What should I focus on during fieldwork (I plan to add one section talking about fieldwork plan after the workshop)?

Thanks and hope to see you on Friday!

Yuhua
When Do Authoritarian Rulers Tie Their Hands? Mobile Capital, Fiscal Dependency, and Political Climbers

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Abstract
When do authoritarian rulers eschew arbitrary rule and instead adhere to the rule of law? This paper seeks to address this puzzle in the Chinese context. Drawn theoretical insights from North and Weingast (1989), this paper proposes a simple theory to explain the variation of quality of courts at the sub-national level in China. I argue that due to specific incentives facing local Chinese Communist Party officials, local officials are more likely to adhere to rule of law and strengthen local legal systems the more they are dependent upon mobile capital. The rationale is that if capital is mobile and if a locality’s main revenue source depends on local economy, that locality’s officials will enforce the rule of law to keep mobile assets holders from moving. Based on a data set compiled from survey data and government yearbooks, this paper then tests this theory empirically. An implication is that rule of law may not be the result of external imposition (Acemoglu et al. 2001), but may actually develop from the internal incentive structure
1 Introduction

After the disastrous Cultural Revolution, China resumed its state building process in the late 1970s, in which institutionalization of the formal legal system is a crucial component. Today China has a nationwide court system including over 3,000 basic courts and almost 200,000 judges (Cohen 2005). The Chinese Communist Party (CCP) is mobilizing a mass campaign for the rule of law.

Although there is a strong national initiative, the development of the rule of law is quite uneven across the country. Why do we see such a large variation in an authoritarian regime where political leaders are believed to disfavor rule of law and local political institutions are roughly identical across the country? Existing literature provides limited insights for understanding judicial politics in authoritarian regimes (Ginsberg and Moustafa 2008; Helmke 2002), and studies of Chinese law fall short of explaining local variation and suggesting causal stories (Diamant, Lubman, and O’Brien 2005; Peerenboom 2002). This paper is an attempt to fill this gap by explaining the variation of adherence to rule of law at the sub-national level in China.

I assume that local state agents in China have strong incentive to stimulate economic growth. To achieve this goal, they need cooperation of economic actors. The bargaining power of economic actors hinges on the mobility of their assets: the more mobile their assets are, the higher bargaining power they hold. The bargaining power of the state depends on the government’s fiscal conditions: if the government is dependent on local economy for revenues, officials have lower bargaining power; if the government is fiscally autonomous vis-à-vis the local economy, local officials have higher bargaining power. Therefore, local officials have strong incentive to adhere to rule of law and strengthen formal legal institutions when economic players hold mobile assets and the government is dependent on local economy for revenues. Fiscal dependency is a condition for capital mobility to have an impact on legal institutions. If the government is fiscally
autonomous, even when economic actors hold mobile assets, local officials have no inclination to strengthen legal institutions to court investors. I test this theory quantitatively using a data set compiled from survey data and government released yearbooks.

This article has six sections. The next section posits a puzzle and proposes a simple theory to address the puzzle. The subsequent section generates one testable hypothesis, introduces the data set, and proposes ways to measure key variables. The fourth section carries out empirical tests using a cross-sectional data set on Chinese courts. The fifth section tests two rival explanations: a social capital explanation and a guanxi explanation. The final section then concludes.

2 A Puzzle and A Theory

This research is motivated by one puzzle: When do authoritarian rulers, relying on completely controlled and hierarchically organized political systems, tie their hands and tolerate independent courts?

Complete control of political organizations is an effective means of autocratic rule. As Friedrich and Brzezinski (1965) in a seminal work of dictatorship point out, dictatorships are often featured with "A single mass party led typically by one man, the 'dictator.' ..., such a party being hierarchically, oligarchically organized, and typically either superior to, or completely intertwined with the bureaucratic government organization". In this view, independent judicial organizations are impossible to exist in an hierarchically and oligarchically organized autocratic system. As Moustafa and Ginsberg (2008) contend, there is "a long-standing presumption among many political scientists that courts in authoritarian regimes serve as mere pawns of their rulers, and that they therefore lack any independent influence in political life." (1) Seminal works on property rights also claim that rule of law is only compatible with democracy (North and Thomas 1973; North 1990). The rationale behind this line of thinking is that democracy is an effective
tool to keep political leaders accountable and prevent them from predating.

However, empirical studies on the correlation between democracy and the rule of law are inconclusive. While some scholars have indeed found democracies are more likely to protect property rights (Leblang 1996; Rigobon and Rodrik 2004), others find no relationship. Barro (2000) argues that the rule of law and protection of property rights occur in both democracies and dictatorships. As Table 1 illustrates, some countries score highly in a rule of law index but poorly on an electoral rights (democracy) index.

These countries are typically run by dictators who promote property rights and a reliable legal system. Examples of such dictators include Augusto Pinochet in Chile (1973-1990), Lee Kuan Yew in Singapore (1959-1990), and Shah Mohammed Reze Pahlavi in Iran (1941-1979). Barro therefore concludes that, ”the electoral rights index has no predictive content for the rule of law index.” (p.46) So why are authoritarian leaders, equipped with guns and tanks, induced to build a clean and independent judicial system?
Table 1: Countries with High Rule of Law Relative to Electoral Rights in 1998

<table>
<thead>
<tr>
<th>Country</th>
<th>Rule of Law Index</th>
<th>Electoral Rights Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bahrain</td>
<td>0.83</td>
<td>0.00</td>
</tr>
<tr>
<td>Cameroon</td>
<td>0.50</td>
<td>0.00</td>
</tr>
<tr>
<td>China</td>
<td>0.83</td>
<td>0.00</td>
</tr>
<tr>
<td>Egypt</td>
<td>0.67</td>
<td>0.17</td>
</tr>
<tr>
<td>Gambia</td>
<td>0.83</td>
<td>0.00</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>0.83</td>
<td>0.33</td>
</tr>
<tr>
<td>Iran</td>
<td>0.83</td>
<td>0.17</td>
</tr>
<tr>
<td>Kuwait</td>
<td>0.83</td>
<td>0.33</td>
</tr>
<tr>
<td>Malaysia</td>
<td>0.83</td>
<td>0.33</td>
</tr>
<tr>
<td>Morocco</td>
<td>1.00</td>
<td>0.33</td>
</tr>
<tr>
<td>Myanmar (Burma)</td>
<td>0.50</td>
<td>0.00</td>
</tr>
<tr>
<td>Oman</td>
<td>0.83</td>
<td>0.17</td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td>0.83</td>
<td>0.00</td>
</tr>
<tr>
<td>Singapore</td>
<td>1.00</td>
<td>0.33</td>
</tr>
<tr>
<td>Syria</td>
<td>0.83</td>
<td>0.00</td>
</tr>
<tr>
<td>Tanzania</td>
<td>0.83</td>
<td>0.33</td>
</tr>
<tr>
<td>Tunisia</td>
<td>0.83</td>
<td>0.17</td>
</tr>
<tr>
<td>United Arab Emirates</td>
<td>0.67</td>
<td>0.17</td>
</tr>
<tr>
<td>Yugoslavia</td>
<td>0.83</td>
<td>0.17</td>
</tr>
</tbody>
</table>

Source: Barro (2000: 37)

This research sets out to explaining this puzzle in the context of sub-national China. A within-country comparative research has several advantages. First of all, a within-country study can control for domestic institutional factors and focus on political economic influences. In this way, a researcher can simplify the theoretical model and concentrate on variables of interest. In addition, existing measures of rule of law and corruption (such as Transparency International), particularly on authoritarian regimes, are often biased and thus not reliable for inference. A within-country research can tease out different components of the rule of law and obtain finer-grained measures. Lastly, a within-nation comparative study can examine the spillover effects of property rights protecting institutions while cross-country research often suffers from low degrees of freedom.
I assume, in this research, that local officials in China are promotion-opportunity maximizers, that is, they are "political climbers" who are willing to do anything to increase their chances of getting a promotion. Getting a promotion in the bureaucratic hierarchy in China means a higher wage, a bigger house, a more comfortable car, a better health care package, a more luxurious lifestyle, and, above all, access to greater rents.

Like its Soviet counterpart, the Communist Party of China uses a nomenklatura system to regulate authority over Party and state "main leading cadres" and other important individuals (Lieberthal 2003). The Russian term nomenklatura generally refers to the lists of offices controlled by the various Party committees (Manion 1985: 212). In this nomenklatura system, the appointment, promotion, transfer and removal of leading cadres are based, in principle at least, on their qualifications and performance as assessed regularly in the cadre evaluation system (Manion 1985; Burns 1994; Huang 1995; Whiting 2000).

Whiting (2004) provides the most detailed accounts of the cadre evaluation systems to date. A sample of the cadre evaluation form is drawn from Jiading County, Shanghai. The first set of indicators in the local version of the cadre evaluation forms assigns highest priority to increases in the gross value of industrial output and industrial profits. The second set of indicators focuses on state procurement of agricultural and agricultural subsidiary products and the marketing of pork; it assigns highest priority to the sale of grain to the state. The third set of indicators covers party building. The fourth set addresses education and includes both the completion rate for compulsory education and an indicator of investment in education. The fifth performance indicator is the family-planning compliance rate. The final indicator is public order. In each locale, performance on these criteria was used to determine the bonuses of state cadres and the total salaries of collective cadres. In addition, local leaders’ tenure in office and opportunities for advancement were to some extent determined by their performance as well. Generally speaking, local cadres need to undertake three challenging, yet often
conflicting, tasks to maximize their "grades" in this GDP-centered evaluation form: (1) Promoting local economic growth; (2) Securing and expanding revenue sources; and (3) Maintaining social order.

How can they maximize their grades? Township and Village Enterprises (TVEs) and Foreign Direct Investment (FDI) are seen as major driving forces of China’s economic growth in the 80s and 90s¹. In order to attract FDI and promote economic growth, local governments are expected to deliver and maintain consistent policies and put in place a legal environment in which contracts can be enforced and property rights established (Zheng 2007).

An effective legal system is also conducive to maintaining social stability. As Diamant, Lubman, and O’Brien (2005) observe, "Today, we are witnessing an outpouring of grievances from, among others, people who lost money in the stock market, pensioners, veterans, unemployed laborers, disgruntled peasants, and unhappy couples. Yet, only a small proportion of these complaints spread to other sectors, lead to violence, or threaten the existence of the regime." (6) The formal legal institutions have played a notable role in channeling social discontent into moderated forums (Gallagher 2005, 2006; O’Brien and Li 2005).

Although it is generally believed that the rule of law is the key to economic growth and attracting investment either through protecting property rights (North and Thomas 1973; Acemoglu et al. 2001) or through increasing policy stability (Henisz 2000; Feng 2001), another school of scholars, however, argue that government’s obsession with attracting foreign investments will bring lax regulations. Such claims are based on competitive pressures: The mobility of MNCs, coupled with a desire to create jobs, produces incentives for governments to engage in cross-national "races to the bottom" (Drezner 2001). In addition, the experience of East Asian NICs further casts doubt on the assumed relationship between the rule of law and economic growth (Campos 2001; Rock

and Bonnett 2004). Yet empirical studies do not lend support to the "racing to the bottom" argument (Wheeler 2001; Prakash and Potoski 2006; Mosley and Uno 2007), and the East Asian paradox only exits at the national level, once data is disaggregated at the sub-national level, the positive link between the rule of law and economic growth still remains (Zheng 2007; Huang 2008).

While the cadre evaluation system provides the incentive structure of local officials in China, it alone cannot explain why some local leaders, similarly obsessed with GDP growth, do not promote the rule of law. It also cannot explain, in this authoritarian system, why local "dictators" do not simply act predatorily and employ means of violence to force enterprises into production. The next step is to build on the objective function of local officials and extend the model to take into account the environmental constraints local cadres face.

Wintrobe (2000) points out that dictators cannot solely rule by use of political repression, they also need people’s loyalty, and the common way to create loyalty is to stimulate economic growth. Economic stagnancy destabilizes dictatorships (Przeworski et al. 2000). It hurts dictators either through reducing the amount of private goods allocated to their winning coalitions (Bueno de Mesquita et al. 2003) or through empowering their opponents and making opponents easier to coordinate (Acemoglu et al. 2005). In the Chinese case, economic stagnancy may ruin local leaders’ political career by failing them on the cadre evaluation system. Therefore, in order to stimulate economic growth and remain in power, dictators need cooperation. As Holmes (2003) contends, "the principle reason why people with power voluntarily agree to render their own behavior predictable is that even the most powerful people need cooperation to attain their ends." (30)

To obtain the goal of stimulating economic growth, dictators especially need the cooperation of economic actors: entrepreneurs, merchants, foreign investors, bankers, etc. However, the bargaining power of economic actors varies. Economic actors’ power
comes from the credible threat to withdraw urgently needed cooperation. Government power also varies; it relies on government’s fiscal dependency on the economy. This dynamic is vividly illustrated by the story of the Glorious Revolution. In 17th century England, the Crown needed money to wage their wars abroad. However, the rise of wool producers, merchants, and financial intermediaries who controlled assets that were very difficult for the state to tax significantly increased the bargaining power of the Parliament where these property holders were represented. In order to make a credible commitment to the Parliament that the Crown would pay back the debt, the Crown had to grant the Parliament veto powers which constrained the Crown’s discretionary behavior in the future\(^2\) (North and Weingast 1989; Weingast 1997).

I argue that Chinese local officials’ incentive to improve formal legal institutions comes from their desire for fulfilling fiscal requirements and their need to make mobile assets holders happy. In order to get a promotion, local officials are required to stimulate economic growth and keep fiscal balance. To achieve these two goals, they need the cooperation from local economic actors. This need is more emergent when local capital is mobile and the government is under severe fiscal constraints. When local capital is mobile, local state agents have strong incentive to strengthen formal local institutions to enforce contracts and protect property rights. This incentive is stronger when the local government is fiscally dependent on local economy. When the government is fiscally autonomous (for example, the government can obtain large amount of fiscal transfers from the central government), this incentive to please mobile capital is weak. The next section will derive a testable hypothesis and propose ways to measure the key variables in the theory.

\(^2\)Clark, Golder, and Golder (2008) formalized this story into a game theoretical model that they called the ”Exit, Voice, and Loyalty” game. But the results of this paper are slightly different from the outcome of their game: While they find both capital mobility and fiscal dependency are necessary but insufficient conditions for good governance, this paper’s results do not corroborate this.
3 One Testable Hypothesis, The Data, and Measurement

In this section, I derive one testable hypothesis, introduce the dataset, and propose potential ways to measure key variables in the model. Three key variables wait to be measured: quality of courts, capital mobility, and government’s dependency on local economy. The unit of analysis is county, county level districts, or county level cities.

3.1 One Testable Hypothesis

Based on theoretical discussions in the preceding section, one hypothesis is generated:

_Hypothesis: Capital mobility has a positive and conditional effect on the quality of local courts. As local capital mobility increases, the quality of local courts increases, ceteris paribus. This connection exists or is stronger when the local government is fiscally dependent on local economy. When the local government is fiscally autonomous, the statistical relationship between capital mobility and quality of courts is weak or nonexistent._

3.2 The Data

The data used in this paper is drawn from a survey of the Institutionalization of Legal Reforms in China 2003, conducted by the Research Center of Contemporary China at Peking University. This survey interviewed a national probability sample of 7,714 respondents (i.e., completed interviews) on a wide range of items related to their attitudes and behavior in dispute resolution.

The PSUs of the sample were counties and county level units (urban districts). There are 102 PSUs in total, across all 31 provinces and provincial level units of the country, and from the coastline areas to the remote western regions. They vary in great deal in terms of level of economic prosperity and fiscal condition. I compiled a unique cross-sectional data set using the survey data and data collected from various sources ranging from yearbooks to government websites\(^3\). All variables in the data set are measured in

\(^3\)Data sources include University of Michigan’s China Data Center [http://chinadataonline.org/](http://chinadataonline.org/).
3.3 Measuring Quality of Courts

This paper uses respondents' subjective evaluation of basic courts to measure the quality of courts. I use basic courts as focus of this study because they are the first ladder in the Chinese legal system that the majority of the litigants need to go through. Most legal cases in China are dealt with daily by over 3,000 basic courts all over the country. While people might feel the Supreme Court is far away, they probably would feel that the basic court located at the center of their county is very familiar and, therefore, are well-informed of basic courts.

Since very few respondents (9% in civil disputes, 7% in economic disputes, and 7% in administrative disputes) had ever encountered a dispute of any kind, the survey questionnaire includes three vignettes tapping respectively three types of disputes (Table 2) to solicit respondents' evaluation of local courts.
Table 2: Three Vignettes Tapping Three Types of Disputes

**Civil dispute**

Since you have not had such experiences, let’s use a hypothetical case to understand your views. The labor contractor of a construction site has been embezzling the workers’ wages, and the workers were denied their demands for payment numerous times. If you are one of the workers, what would you do? Would you take action to settle the dispute, or would you not do anything?

**Economic dispute**

Since you have not had such experiences, let’s use a hypothetical case to understand your views. To help a township business through some financial difficulties, a township government borrows 100,000 yuan from villager Wang Lin. The agreement lays down that this amount should be repaid in two years. But two years go by, and the amount has still not been repaid. If you are Wang Lin, what will you do? Would you take action to settle the dispute, or would you not do anything?

**Administrative dispute**

Since you have not had such experiences, let’s use a hypothetical case to understand your views. Zhang Jie is an individual industrial household with a license to set up his stall. But the relevant authority found his stall detrimental to aesthetic of the city, and thus confiscated his goods and fined him. If you were Zhang Jie, what would you do? Would you take action to settle the dispute, or would you not do anything?

Most respondents (76% in civil dispute, 78% in economic dispute, and 60% in administrative dispute) chose to take actions if they confronted with any of these three situations. They are then offered up to three options to settle the dispute: mediation, administrative arbitration, and legal litigation. As far as this research is concerned, only a minority (35% civil, 30% economic, and 28% administrative) chose to go to court.

The dependent variable is constructed using answers given by respondents who did not choose to go to court. The survey asked these respondents why they chose not to go to court, and they could choose up to 11 reasons. To our interests, two quantities

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5 The options include: 1. Fees were too high; 2. In this locality, we don’t have the practice of going to court; 3. Too heartless to go to court; 4. Courts are corrupt; 5. Was not aware that one could go to court.
are calculated: the proportions of respondents in each county who chose "Courts are corrupt" ($P_c$) and "Courts side with the government" ($P_g$). A variable "corrupt" is constructed by adding up proportions of respondents who chose "Courts are corrupt" in three types of disputes and then normalizing to 1:

$$corrupt = \frac{P_{c*civil\text{dispute}} + P_{c*economic\text{dispute}} + P_{c*administrative\text{dispute}}}{3} \times 100\%$$

Since "Courts side with the government" was only asked in administrative dispute, a variable "interdependent" equals to $P_g$:

$$interdependent = P_g$$

Theoretically, "corrupt" and "interdependent" should be highly correlated, since they both tap the (lack of) fairness of courts. Factor analysis shows that there is one underlying factor that has factor loadings of 0.79 for both "corrupt" and "interdependent". Therefore, a composite measure "goodcourt" is constructed by taking the negative sum of "corrupt" and "interdependent":

$$goodcourt = -(corrupt + interdependent)$$

There is an advantage of using survey data to measure judicial corruption and independence: since respondents were firstly put in the context of three hypothetical cases the sensitivity of these questions are much toned down, and thus the validity of the questions are enhanced.

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6. The data is weighted by taking into account sampling design effects.
3.4 Measuring Capital Mobility

FDI is not a perfect measure of mobile capital, since in some places state-owned enterprises and private enterprises are as mobile as foreign enterprises. However, FDI is the only measure that is available at the county level. Two variables are collected from government released reports: "Foreign capital actually used in 2003" ($FDI_1$) and "Contractual foreign investment in 2003" ($FDI_2$). As expected, these two variables are significantly correlated (factor loadings 0.70 for both). A composite measure of "mobilecapital" is constructed in the following way:

$$\text{mobilecapital} = \left( \frac{FDI_1 + FDI_2}{GDP} \right) \times 100\%$$

This composite measure is more comprehensive than either of the two individual measures because it captures both the amount of mobile capital already existed and potential mobile capital gained in the future.

3.5 Measuring Fiscal Autonomy

The degree of dependency on local economy is much determined by local governments’ fiscal conditions. After China’s 1994 tax reform, to decrease regional imbalance, the national government and every provincial government provide "regular fiscal transfer" (T) to city governments and county governments in order for them to provide basic public goods. If a large proportion of fiscal revenues comes from higher governments, the county is considered to be autonomous. A variable "autonomy" is constructed in the following way:

$$\text{autonomy} = \frac{T}{\text{OverallFiscalIncome}} \times 100\%$$
3.6 Overview of Variables

All variables in the data set are measured at the county level in 2003. Table 3 shows basic statistics of these variables.

<table>
<thead>
<tr>
<th>Variable</th>
<th>Mean</th>
<th>Std. Dev.</th>
<th>Min.</th>
<th>Max.</th>
<th>N</th>
</tr>
</thead>
<tbody>
<tr>
<td>goodcourt</td>
<td>-0.136</td>
<td>0.132</td>
<td>-0.636</td>
<td>0</td>
<td>102</td>
</tr>
<tr>
<td>mobilecapital</td>
<td>0.068</td>
<td>0.207</td>
<td>0</td>
<td>1.88</td>
<td>101</td>
</tr>
<tr>
<td>autonomy</td>
<td>0.045</td>
<td>0.066</td>
<td>0</td>
<td>0.394</td>
<td>102</td>
</tr>
</tbody>
</table>

Figure 1 graphs "goodcourt" against county GDP per capita. It is interesting to see that there is a "upper triangular" pattern, which implies level of economic development is a sufficient but unnecessary condition for good courts.

Figure 1: Quality of Local Courts Across Chinese Counties
4 Analysis and Results

Using the data set I compiled, this section tests the theory empirically. The observations are 102 randomly sampled Chinese counties. Based on the hypothesis, an econometric model is specified as follows:

$$goodcourt = \beta_1 + \beta_2mobilecapital + \beta_3autonomy + \beta_4mobilecapital \times autonomy + X\beta + \epsilon$$  \hspace{1cm} (1)

where $\beta_2$ is expected to be positive since it is the marginal effect of "mobilecapital" when a county government is completely dependent on local economy fiscally (autonomy=0). $\beta_3$ is expected to be negative: it is the marginal effect of fiscal autonomy when assets are completely fixed (mobilecapital=0). $\beta_4$ is expected to be negative, because as "autonomy" increases, the marginal effect of "mobilecapital" should decrease as the theory implies. $X$ is a vector of control variables, including proportion of third industry ("third") in GDP and GDP per capita ("pcgdp"). By holding these variables constant, we can examine the role played by capital mobility at the same level of economic development and in similar industry structures.

Prior to estimating the model, I carried out diagnosis using Cook’s methods (Cook 1977) to identify highly influential cases (please see the graph in the Appendix). Three observations are highly influential and therefore dropped in the following analysis. In addition, Cameron and Trivedi’s decomposition of IM-test rejects the null hypothesis of homoskedasticity ($\chi^2 = 31.60, p < .05$), thus, robust standard errors are estimated in the regression analysis.

Table 3 shows regression estimates of Model I and an alternative model without the interaction term. In Model I, mobile capital has a positive effect and the effect is distinguishable from zero when autonomy equals zero. The interaction term is close to being significant, though we cannot tell the standard error of the marginal effect of capital mobility at this point. Magnitude of third industry, surprisingly, has a negative sign but fails to pass any conventional level of significance. Level of economic development, on
the other hand, has a positive impact on quality of courts, which is intuitive. Model II excludes the interaction term, and capital mobility still has a positive sign. I then graph the marginal effect of "mobilecapital" conditional on "autonomy" based on the results of Model I, Figure 2 shows the results.
<table>
<thead>
<tr>
<th>Variable</th>
<th>Coefficient (Robust Std. Err.)</th>
<th>Coefficient (Robust Std. Err.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>mobilecapital</td>
<td>0.078*** (0.023)</td>
<td>0.094*** (0.026)</td>
</tr>
<tr>
<td>autonomy</td>
<td>−0.170 (0.149)</td>
<td>−0.241 (0.152)</td>
</tr>
<tr>
<td>mobilecapital × autonomy</td>
<td>4.819 (3.026)</td>
<td>-</td>
</tr>
<tr>
<td>third</td>
<td>−0.178 (0.116)</td>
<td>−0.186 (0.117)</td>
</tr>
<tr>
<td>pcgdp</td>
<td>0.000* (0.000)</td>
<td>0.000** (0.000)</td>
</tr>
<tr>
<td>Intercept</td>
<td>−0.100** (0.046)</td>
<td>−0.096** (0.045)</td>
</tr>
</tbody>
</table>

| N                      | 93                            | 93                            |
| R²                     | 0.106                         | 0.95                          |
| F                      | 3.56***                       | 4.34***                       |

*p < .1, **p < .05, ***p < .01
As shown in Figure 2, the marginal effect of capital mobility is significantly positive when a government is dependent on local economy (when "autonomy" is within the range of [0.00, 0.07] and there are 76 counties in this range). Interestingly, this effect is indistinguishable from zero when the county government is fiscally autonomous. This result supports the theory.

Several tests are conducted to test the robustness of the model\textsuperscript{7}. First of all, I tried using unweighted data. It slightly changes the distribution of the dependent variable but doesn’t alter the results. Secondly, I used "corrupt" and "interdependent" as dependent variables respectively, and a model with "corrupt" as the dependent variable shows the same results. But the model with "interdependent" does not reveal any significant results, probably it is because "Interdependent" was only asked once in the questionnaire, and there are too many zeros in the variable. In addition, I also tried using "foreign

\textsuperscript{7}Results are available upon request.
investment actually used” and “contractual foreign investment” separately as explanatory variables, they both have significant effects as expected. Lastly, I added one more control variable to the model: government spending on legal institutions. I expect the effect of this variable to be positive: the more a government spends on legal institutions, the better quality legal institutions should have. But regression results do not show any significant effect\(^8\), and adding this variable does not alter the previous results.

There is a possible endogeneity problem with the model estimated: capital mobility might be endogenous to quality of courts. It might be argued that mobile assets holders would take into account quality of local legal systems when they choose location of investment. There is a historical fact that rules out this possibility. During the Culture Revolution, the whole legal systems, including legislatures and courts at various levels, are completely abolished. So at the beginning of the reform era, quality of local courts were equally poor. Initial attractions for investors are mainly proximity to raw products and markets, cheap labor costs, and favorable policies. That’s why the five Special Economic Zones (SEZs)\(^9\) and the fourteen ”Coastal Open Cities” (COCs)\(^10\) are concentrated in coastal areas that are close to Hongkong, Macau, and Taiwan. Quality of legal systems carry little weight in the selection of these hot spots of investment. And also, China’s FDI inflow started in mid-1980s, but development of the formal legal institutions mainly happened in the 1990s. As Clark, Murrell, and Whiting (2008) argue, China experienced very rapid growth throughout its reform period, but it was only in the 1990s that legal developments began to catch up with changes in the way that the economy was functioning and in the roles that economic agents were dening for themselves. Indeed, ’The Development of Law during the Era of Economic Reform’ contains more evidence for the proposition that economic change spurred legal change than for

\(^8\)This is probably because the variable combines spending on public securities, prosecutions, courts, and legal bureaus and does not reflect directly priorities given to courts.

\(^9\)The first four SEZs established in 1980 are Shenzhen, Zhuhai, Shantou, and Xiamen. Hainan province was added to this list in 1988.

\(^10\)COCs were established in 1994 and include Dalian, Qinhuangdao, Tianjin, Yantai, Qingdao, Weihai, Lianyungang, Nantong, Shanghai, Ningbo, Wenzhou, Guangzhou, Zhanjiang, and Beihai
the opposite relation.” (399)

However, this is an empirical question instead of a theoretical one. To verify this proposition empirically, I carry out Hausman test to test the endogeneity of capital mobility. I use two instrumental variables. One (distance) is the distance to the nearest Special Economic Zones or Coastal Open Cities. The distance is calculated using Google Map’s ”get direction” function. It gives the distance in kilometers from the observations to their nearest SEZs or COCs. For example, the closest SEZ or COC to Shenze county in Hebei province is Tianjin city and the distance is 284 km. The rationale of using ”distance” as an instrument is that China’s opening up is very much policy-oriented: the first few open areas were deliberately selected by the national government and were given special tax and tariff policies. These open areas, such as Guangdong and Shanghai, later played significant roles in stimulating FDI inflows and economic development in neighboring areas. So the closer to these open zones inland areas are, the more likely they would attract investors. The second instrumental variable (migrate population) is measured by a county’s migrate population as percentage of the whole population. The data was drawn from the fifth census carried out by China’s Bureau of Statistics in 2000. The census measures the number of people who migrated into this area from other counties in the same province and people who migrated from other provinces. The variable ”migrant population” is measured by the percentage of migrant population. The rationale of using it is that China’s development in FDI is labor-intensive. So the more free labor an area is endowed with, the more likely it would attract investors. These two variables constitute strong instruments because we do not have theoretical and empirical reasons to believe that they directly cause quality of courts.

Durbin-Wu-Hausman $\chi^2$ test cannot reject the null hypothesis that capital mobility is exogenous to quality of courts ($\chi^2_{(1)} = 0.138, p = 0.71$). I therefore do not use 2SLS method to estimate the model, since the cure can be worse than the disease in small

11These two variables have significant effects on capital mobility in regression analysis and explain 10 percent of the variation of capital mobility
5 Alternative Explanations

Is this political economic explanation performing stronger than other explanations? In this section I will test two alternative explanations: a social capital explanation and a "guanxi" explanation.

5.1 A Social Capital Explanation?

Since Putnam (1993)’s seminal work on institutional performance in Italy, social capital has been considered a prominent factor in determining the performance of institutions. In Lily Tsai (2007)’s application of social capital theory in China, she successfully explained the variation of public goods provision of Chinese villages. In Tsai’s story of local government performance, formal institutions (e.g. democratic elections in villages) have merely limited impact on local officials’ behavior; instead, Tsai (2007) argues that, "in political systems with weak formal institutions of accountability, localities with encompassing and embedding solidary groups are likely to have better local governmental provision of public goods than localities without these groups, all other things begin equal.” (120) And Tsai considers village temples being qualified as "encompassing and embedding solidary groups” whereas "village church institutions are associated with dangerous connections to foreign actors and the undermining of state authority.” (123) Therefore, she hypothesizes that village temples should have positive impact on public goods provisions whereas village church institutions should have no or negative effect on public goods provision.

One weakness with Tsai’s theory of institutional performance is, while she was suc-

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12IV estimators are biased, and their finite-sample properties are often problematic. Most of the justication for the use of IV is asymptotic, performance in small samples may be poor (Please see a discussion in Cameron and Trivedi 2005:103-109).
cessful at explaining performance of the lowest level of government\textsuperscript{13}, the generality of the theory to higher levels of government is in question. This flaw is especially troublesome in China because county governments are the major public goods providers. According to a World Bank report in 2001, county and township governments paid for 70 percent of budgetary expenditures for education and about 55 percent of budgetary expenditures for public health (World Bank 2001). As far as rule of law is concerned, the lowest level of formal legal institutions, including basic courts and local legislatures, are also located at the county level.

In addition, the dynamics of everyday life in Chinese localities further cast doubt on Tsai’s theory in the sense that the causal mechanism that works in Tsai’s story might not work in higher levels of government. In Tsai’s words, the mechanism that links village temples and public goods provision is moral standing: ”solidary groups make the awarding of moral standing possible, first, by establishing a set of shared moral and ethical standards, and, second, by providing opportunities for members to demonstrate their adherence to these standards publicly.” (113) While ”the awarding of moral standing” has strong power in villages where village officials interact with villagers daily, it is hard to extend this power to higher levels of administration where government officials rarely interact with the masses on a daily basis in China.

Based on the two reasons reviewed above, I propose that 1) existence of solidary groups has no effect on performance of courts at the county level, and 2) adding variables measuring solidary groups will not change the original results. Validation of these two propositions will not make Tsai’s theory less plausible though, since she used different dependent variables; it will only prove the ”political economic model” more robust.

Ideally I should use Tsai’s data to test these two propositions, but the unit of analysis in her study is village and there are no questions tapping rule of law in her survey. Therefore I add two variables measuring existence of solidary groups to my county-level

\textsuperscript{13}Constitutionally village committees are not a level of formal government in China but they carry heavy burdens of implementing government policies.
data set: temple and church. The survey on the Institutionalization of Legal Reforms in China does not have direct measure of religious groups, so I use respondents’ religious activities as a proxy for existence of religious groups. "Temple" is a dichotomous variable with value 1 if both of the following conditions are met: 1) There is at least one Buddhist resided in the county and 2) The Buddhist(s) should attend some religious activities each year. My rationale of using this proxy is that if there is a Buddhist in the county and she attends some religious activities I can infer that there probably is a temple located in that county. As a result, "temple" equals 0 when 1) there is no Buddhist in the county or 2) There is at least one Buddhist but she never attend religious activities. The variable "church" is constructed in the same way. "Church" equals 1 when both of the following conditions are met: 1) There is at least one Protestant or one Catholic resided in the county and 2) She attends some religious activities each year.

Table 4 shows estimation of the model with the two "solidary groups" variables. As is shown, first of all, both "temple" and "church" do not have any significant effect of the quality of courts. Secondly, adding the two variables do not change the original results. Overall speaking, the "political economic model" survives a test versus the "social capital" explanation.

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14 Tsai’s original measures are also indirect. She uses two indicators to measure village temple groups: the existence of a formal temple manager; and the percentage of households that have participated in village temple reconstruction projects by donating money, labor, or materials since the beginning of the reform. Two similar measures are used for village church groups: the existence of a state-approved Protestant minister or Catholic priest who organizes church services and activities; and the existence of a church that has been renovated or rebuilt in the reform period.

15 The marginal effect of capital mobility is significant at a similar range. Graph is available upon request.
Table 4: OLS Estimation of Solidarity Group Explanations
(DV=goodcourt)

<table>
<thead>
<tr>
<th>Variable</th>
<th>Model III</th>
<th>Model IV</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Coefficient</td>
<td>Coefficient</td>
</tr>
<tr>
<td></td>
<td>(Robust Std. Err.)</td>
<td>(Robust Std. Err.)</td>
</tr>
<tr>
<td>mobilecapital</td>
<td>0.084***</td>
<td>0.098***</td>
</tr>
<tr>
<td></td>
<td>(0.025)</td>
<td>(0.027)</td>
</tr>
<tr>
<td>autonomy</td>
<td>0.177</td>
<td>0.238</td>
</tr>
<tr>
<td></td>
<td>(0.155)</td>
<td>(0.160)</td>
</tr>
<tr>
<td>mobile×autonomy</td>
<td>4.321</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td>(3.032)</td>
<td></td>
</tr>
<tr>
<td>third</td>
<td>-0.164</td>
<td>-0.167</td>
</tr>
<tr>
<td></td>
<td>(0.124)</td>
<td>(0.124)</td>
</tr>
<tr>
<td>pcgdp</td>
<td>0.000**</td>
<td>0.000**</td>
</tr>
<tr>
<td></td>
<td>(0.000)</td>
<td>(0.000)</td>
</tr>
<tr>
<td>church</td>
<td>-0.026</td>
<td>-0.027</td>
</tr>
<tr>
<td></td>
<td>(0.026)</td>
<td>(0.026)</td>
</tr>
<tr>
<td>temple</td>
<td>-0.010</td>
<td>-0.015</td>
</tr>
<tr>
<td></td>
<td>(0.024)</td>
<td>(0.024)</td>
</tr>
<tr>
<td>Intercept</td>
<td>-0.092*</td>
<td>-0.088*</td>
</tr>
<tr>
<td></td>
<td>(0.049)</td>
<td>(0.049)</td>
</tr>
</tbody>
</table>

N 93 93
R² 0.120 0.111
F 2.824** 3.80***

*p < .1, **p < .05, ***p < .01

5.2 A guanxi Explanation?

Is formal legal protection a unique means to protect property rights and attract investors? Students of Chinese political economy have long been arguing that business and the state has strong patron-client ties through which private firms are protected (Wank 1999). Oi (1992) has argued that the impressive growth of collective rural industrial output between 1978 and 1988 is in large measure a result of local government entrepreneurship.
Fiscal reform has assigned local governments property rights over increased income and has created strong incentives for local officials to pursue local economic development. In the process local governments have taken on many characteristics of a business corporation, with officials acting as the equivalent of a board of directors. This merger of state and economy characterizes a new institutional development that Oi labels local state corporatism. Wank (1999), in a more blunt way, argues that, "Much exchange conducted by private companies is embedded in clientelist ties with various administrative, policing, distributive, and manufacturing organs of the local state. These ties are symbiotic transactions of commercial wealth for political power." (68) The "developmental state" literature has also noted the importance of administrative protection of business in East Asian economies (Evans 1995, Johnson 1999, Woo-Cumings 1999, Kohli 2004). Meanwhile these scholars have also observed massive corruption in "transactions of commercial wealth for political power" that Kang (2004) terms "crony capitalism".

Under the pressure to stimulate economic growth, have Chinese local state agents relied on "guanxi" (informal ties) to protect mobile asset holders? If this guanxi story had some explanatory power, we would expect to observe more government corruption in places where economic actors hold mobile capital and less government corruption in places with fixed assets.

To measure government corruption I again use survey data. A variable "govcorruption" is constructed in the same way that legal corruption is measured. Respondents were asked whether they would choose to go to the government if they confronted with three types of disputes. And for those who chose no, we asked why. One of the reasons given in the questionnaire is "Government is corrupt." The variable "govcorruption" is constructed by adding up proportions of respondents who chose "Government is corrupt" in three types of disputes and then normalizing to 1:

\[
govcorruption = \frac{P_{gov\_civildispute} + P_{gov\_economicdispute} + P_{gov\_administrativedispute}}{3} \times 100\%
\]
Table 5 shows estimates of the model with "govcorruption" as the dependent variable\(^{16}\). If the alternative explanation is plausible, we would expect the effect of capital mobility on government corruption is significantly positive, all else being equal. However, empirical results do not corroborate this proposition. The effect of capital mobility on government corruption is significant but negative in Model V, which suggests that capital mobility decreases government corruption. And interestingly, the interaction term in Model V is not significant, which implies that the effect of capital mobility does not condition on government’s fiscal constraints. This is different from previous estimation with quality of courts. Overall speaking, competition for mobile capital has not made Chinese local governments more corrupt but cleaner.

\(^{16}\)One outlier (Beilin county) is dropped before the estimation.
### Table 5: OLS Estimation of the *guanxi* Explanation (DV=govcorruption)

<table>
<thead>
<tr>
<th>Variable</th>
<th>Coefficient (Robust Std. Err.)</th>
<th>Coefficient (Robust Std. Err.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>mobilecapital</td>
<td>-0.293* (0.167)</td>
<td>-0.193 (0.205)</td>
</tr>
<tr>
<td>autonomy</td>
<td>-0.389** (0.180)</td>
<td>-0.313* (0.168)</td>
</tr>
<tr>
<td>mobilecapital×autonomy</td>
<td>5.433 (6.187)</td>
<td>-</td>
</tr>
<tr>
<td>third</td>
<td>0.171** (0.082)</td>
<td>0.168* (0.085)</td>
</tr>
<tr>
<td>pcgdp</td>
<td>0.000 (0.000)</td>
<td>0.000 (0.000)</td>
</tr>
<tr>
<td>Intercept</td>
<td>0.152*** (0.041)</td>
<td>0.154*** (0.041)</td>
</tr>
</tbody>
</table>

| N                         | 92                              | 92                              |
| R²                        | 0.072                           | 0.064                           |
| F                         | 3.07**                          | 2.41*                           |

*p < .1, **p < .05, ***p < .01

In conclusion, the political economic explanation performs better than the social capital explanation and the "*guanxi*" explanation. The tests further add robustness to the model.

### 6 Conclusion

Drawn theoretical inspiration from North and Weingast (1989), this paper builds a simple theory to explain the variation of rule of law at the sub-national level in China. I argue that due to specific incentives facing local Chinese Communist Party officials, those officials and their local court systems are more likely to adhere to rule of law the more they are dependent upon mobile capital. The assumption is that if capital is mobile
and if a locality’s main revenue source depends on local economy, that locality’s officials will enforce the rule of law and strengthen the legal systems to keep mobile assets holders from moving. This research has important theoretical and practical significance.

Studies of authoritarianism are surging lately (Wintrobe 2000; Acemoglu et al. 2005; Magaloni 2006; Brownlee 2007; Tsai 2007; Gandhi 2008; Landry 2008), and the resilience of Chinese authoritarianism is still puzzling (Nathan 2003). This research sheds light on studies of authoritarian resilience through looking at an important mechanism dictators utilize to channel social discontent: law. It is noted that law has become a tool (rule by law) employed by dictators to consolidate their rule (Ginsberg and Moustafa 2008), this research argues that rational dictators as well have to constrain themselves within the legal framework to seek cooperation. In addition, previous studies often assume that democracy is a necessary condition for rule of law (North 1981, 1990), yet this is not corroborated by empirical evidences (Barro 2000). This study provides both theoretical and empirical bases to point out that dictators might also be fond of rule of law. Rule of law may not be the result of external imposition (Acemoglu et al. 2001), but may actually develop from the internal incentive structure.

There is also a recent resurgence of social science interest in Chinese law, especially people’s legal behavior and legal attitudes (e.g. Diamant, Lubman and O’Brien 2005; Gallagher 2006; Michelson 2007). Legal scholars have been focused on China’s legal institutions (Lubman 1999; Peerenboom 2002), their analyses are good at descriptions but often fall short of causal analysis. This research fills this gap by bridging institutional analysis and behavioral studies and offers a micro-foundation for the development of rule of law in China.
References


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Appendix

Figure 3: Diagnostic Statistics