
Comment

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The paper puts forward a provocative thesis. The proposition is that informal arrangements between bureaucrats and the private sector, so-called “special deals,” have allowed the Chinese bureaucracy to overcome poor formal institutions, and these special deals are an important driver of the country’s growth miracle. The argument is that Chinese local governments have well-developed administrative capacity and use it to provide these deals to favored firms to allow socially beneficial business transactions to go forward and spur economic development. The paper proposes that local political officials behave as if they have high-powered incentives to assist favored private firms because they are in competition with other local governments to attract businesses and show economic growth. Of course, many economists have argued that special deals or side payments can be a second-best solution for bureaucratic gridlock. For example, Fisman (2001) and McMillan and Woodruff (2002) have suggested that deals can “grease the wheels” in a system with high regulatory burdens, and De Soto (1989) famously emphasized the importance of the informal economy for growth in countries with overbearing regulation. The novel hypothesis put forward in the current paper is that special deals are the reason for growth, not a second-best solution.

Although the paper does not provide evidence on the causal nature of special deals for economic growth in China, of course, China is not the only country that promotes bureaucratic influence in economic decisions. The literature in other countries has typically found that a reliance on these special deals is a detriment to growth. Overall the cross-country evidence suggests that more corrupt countries also grow more slowly (Mauro 1995; Rodrik, Subramanian, and Trebbi 2004). These cross-country correlations are supported by micro studies, which show that reliance on these deals leads to distortions in resource allocation. In France, for example, a country that promotes national champion firms, a number of papers have

shown that politically connected firms grow more slowly and have lower productivity (Kramarz and Thesmar 2013). In fact, the banking reform in the mid-1980s, which led to a reduction in government-directed credit to connected firms, reduced growth of connected firms but promoted the entry of more efficient new firms and overall improved net job creation and productivity (Bertrand, Schoar, and Thesmar 2007). Similarly, studies in other countries (La Porta, Lopez-de-Silanes, and Zamarripa 2003; Rajan and Zingales 2004; Khwaja and Mian 2005) have shown that subsidized loans go to connected firms that have low productivity. A growing set of experimental studies points to severe misallocation of resources from corruption. For example, professional and other licenses to ensure minimum skill level (such as driver's licenses) are awarded to unqualified people (Bertrand et al. 2007); perceived corruption leads to underprovision of public goods (Olken 2007, 2009) or distortion in talent allocation (Ferraz, Finan, and Moreira 2012).

Against the backdrop of the large literature on corruption, we have to ask if special deals in China are truly special. In other words, did the Chinese Communist Party figure out a way to set up its bureaucracy to solve the old problem of misalignment of incentives? In an interview with the *Financial Times*, Bhagwati (2014) suggests that the Communist Party has an advantage over a messy democracy because Chinese politicians have longer horizons and do not need to face reelection threats. As a result, they may see themselves as the residual claimants on the country's growth and are not distracted by short-term voting cycles. This is an intriguing idea and deserves serious consideration in light of China's unique development experience. Of course, in the spirit of Shleifer and Vishny (1993), one might ask why the central government did not design better rules from the start so that special deals would not be needed to fix problems of formal institutions if the party is trying to maximize the long-run welfare of the country. But one cannot dismiss out of hand that a complicated political economy between the legislature and the bureaucracy might make it difficult to change laws and regulations even if the bureaucracy has the best interest of the country at heart.

At its core, bureaucratic corruption is like a principal-agent problem, where bureaucrats trade off their career concerns and status in their government position against the income from corruption and the likelihood of being caught. The former is often long term and uncertain whereas the payoffs from special deals are often much more immediate and certain. Thus, the challenge is how to design incentives for bureaucrats to mitigate these corrupt impulses or even turn them into a force for beneficial

decision-making as proposed in the current paper. A number of possible solutions have been proposed, notably going back to Weber (1922) who suggested creating a culture of elite bureaucrats, basically sidestepping the central problem and hoping for better humans. More recently, Becker and Stigler (1974) argue that providing efficiency wages for officials and monitoring their actions would be optimal. Di Tella and Weinschelbaum (2008) point out when agents are poor it is easier to monitor their bribetaking via consumption because any large and unusual consumption patterns would not be explained by their legitimate income. But at the same time, incentives to engage in special deals are higher for poorer bureaucrats who have less to lose. Similarly, papers by Holmstrom (1982); Maskin, Qian, and Xu (2000); and Xiong (2018) stress the career tournaments of bureaucrats.

In the Chinese context, the problem of lower-level officials is how to keep them focused on the long term. This means that the benefits from being promoted or staying in the job have to be stronger than the benefits of diversion in the interim, which means that the center or the politburo has to have vast resources to provide such incentives. Similarly, there has to be the belief throughout the bureaucratic hierarchy that evaluation is fair and people get promoted based on performance, not on connections or political whims. If local officials feared that those who work on promoting long-run growth will not be rewarded in the end, it would undermine their willingness to abstain from extracting short-term rents. Finally, these local politicians must have a very strong belief in the efficacy of the tools they have at their disposal to promote growth.

A set of recent papers documents that the alignment of incentives along the hierarchy chain of the Chinese bureaucracy might not be as meritocratic as one might hope for the political tournament story to work. Persson and Zhuravskaya (2016) show some of the limitations to the idea that career concerns of local politicians are uniformly focused on the common goal. The authors show that local politicians use government resources to cater to demands of low-level provincial elites, who helped them rise to power. This suggests that local incentives create competing allegiances. In addition, Goh, Ru, and Zou (2019) show that personal connections to high-ranking officials reduce the punishment of lower-level officials in the case of corruption. Even in the wake of the anti-corruption program in China, connections to high-ranking politicians make local officials less likely to be investigated and receive lighter sentences. In contrast, the investigations of Central Committee members lead to more investigations of their connected city officials. This type of evidence suggests

that local officials should worry that the career concerns are not stacked as clearly toward providing efficient economic outcomes. But, instead, many players are willing to further their own goals.

On a more macro level, the recent paper by Ru (2018) tracks the impact of a large set of special deals on the local economy. Local mayors in China are selected and promoted every 5 years in line with the Communist Party Congress. Those mayors who show significant growth during their time in office can be promoted to higher positions or larger cities. The paper looks at the type of deals mayors facilitate when they come into office. The paper supports the idea that there are career concerns for mayors, but it also shows that many of the projects or deals that the local governments undertake have mixed results on growth at best. Projects that support infrastructure building do indeed help to spur growth of private firms and state-owned enterprises (SOEs). However, projects and credit lines that support the expansion of SOEs, which is a large fraction of special deals, lead to significant crowding out of efficient private firms.

Finally, Lin et al. (2016) provide evidence from the effect of the anti-corruption campaign on the Chinese stock market. The paper uses the anti-corruption campaign as an event study in the Chinese public markets. On December 4, 2012, Xi Jinping announced a new "Eight-point Policy" to stop government officials and top executives in SOEs from demanding or accepting extravagant perks. Chinese market index increased significantly (15% over a 30-day window) after the announcement of the Eight-point Policy. Again, this evidence suggests that at least stock market participants do not see the ability to engage in special deals as a benefit to publicly traded firms.

In sum, my reading of the existing literature suggests that there is no evidence that special deals and corruption were a positive factor for growth in China. But it is remarkable nevertheless that the Chinese government managed to restrain corruption to a level that allowed for significant growth over the last 2 decades despite the massive opportunities to extract rents. Learning from the Chinese example of how it managed to set up institutions that contain corruption to allow rapid economic development to occur can be a powerful laboratory. And framing the analysis in this way seems more in line with a large prior literature on corruption. Going forward, it will be interesting to see if this system can provide sustained economic growth. Governance by one-party rule might be easier when an economy is closed and poor. Detection of excess consumption and spending by bureaucrats might have been easier in these early years, and shipping profits from corruption overseas was also more difficult. At

the same time, the economic policies that were needed to create growth might be less ambiguous, for example, building roads and allowing some private enterprise. It might be less adept in a middle-income country where there is more uncertainty about which economic policies will foster innovation and inclusive growth.

Endnote

Author email address: Schoar (aschoar@mit.edu). For acknowledgments, sources of research support, and disclosure of the author's material financial relationships, if any, please see <https://www.nber.org/chapters/c14235.ack>.

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