

# Governance and Economic Growth

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China and India highlight the profound importance for economic growth and poverty reduction of allowing private firms to compete in markets from which they previously were barred and of providing the complementary government services, such as infrastructure, that promote economic productivity. Earlier chapters in this volume have made that clear. This chapter identifies a second lesson that has received less attention: the experience of these two large, but strikingly different, countries underlines the importance of the governance environment for growth and development. In addition, although the political underpinnings of secure governance apparently are very different across the two countries, they share an important characteristic: checks and balances at the top levels of government.

One common definition of governance focuses on outcomes—the extent to which governments enact and implement policies in the interests of all citizens. Another definition focuses on the extent to which governments have incentives to adopt and enforce policies in the interests of all citizens, based on the political institutions and dynamics that determine governance outcomes. One set of governance indicators covering the period 1996 through 2004—that of the World Bank (Kaufmann, Kraay, and Mastruzzi 2005)—embraces both definitions. The indicators *voice and accountability* and *political instability and violence* are related more closely to the political conditions that determine governance outcomes. India scores significantly higher than China on the voice measure and significantly lower on the political stability measure, both scores reflecting the existence of competitive elections in India.<sup>1</sup>

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1. For example, India is above the 50th percentile and China is below the 25th percentile of all countries on the voice measure.

The governance indicators also include four outcome measures: (1) government effectiveness, (2) regulatory quality, (3) the rule of law, and (4) control of corruption. These outcomes affect development in numerous ways. This chapter addresses their effects on the security of property rights, which is a key driver of economic growth and most often is represented by variables such as government effectiveness, the rule of law, and corruption control. China has ranked consistently higher than India with regard to government effectiveness and, in 2004, with respect to corruption control, but consistently lower than India with respect to the rule of law. Despite the significant differences between China and India with respect to voice, however, none of these outcome differences is statistically significant.

Two puzzles occupy the analysis here. First, what has enabled the Giants to grow rapidly despite the presence of quite average governance outcomes? Fast growth, and extraordinary growth in China, has been accompanied by strictly average governance indicators (right around the 50th percentile, according to the World Bank governance indicators). Poor countries might infer from these experiences that countries can fall considerably short of achieving good governance and still grow rapidly. The analysis below indicates that this conclusion is incorrect. Governance outcomes in China and India, although only average overall, were better than average when compared with those of other poor countries. The difference had a material effect on the Giants' growth, relative to other such economies. Moreover, China and India have benefited from large markets and an abundance of low-cost labor that attracted investment despite merely average governance outcomes. Countries with smaller markets are likely to require significantly more aggressive measures to improve their policy and governance environment to achieve similar growth. Finally, growth in both countries did not occur until meaningful improvements in governance occurred in the late 1970s and early 1980s.

The second puzzle addressed here is why China and India exhibit similar governance outcomes but entirely distinct political institutions and forms of competition? Poor countries might infer from this that political institutions are irrelevant for good governance. The evidence presented below suggests that this inference also is incorrect. At the same time as the two countries pursued policy changes that are widely and correctly credited with triggering growth, they experienced broadly similar political changes, particularly the introduction of greater political checks and balances on the top leadership. These political checks, though comprising vastly different formal institutions, limited the discretion of leaders and laid the groundwork for improved governance.

## Fast Growth and Average Governance: Governance Still Matters

Growth took off in both China and India in the early 1980s. In China, per capita growth was approximately 8.0 percent a year in the 1980s, twice that of the 1970s. India's growth accelerated by a similar margin, rising from close to zero in the 1970s to 3.5 percent in the 1980s. India grew approximately twice as fast as the median country, and China grew approximately *five* times faster than the median country. On the surface, it is difficult to discern the role of governance in these growth explosions. It is not possible to use the World Bank governance indicators to examine country-level governance and growth because they go back only to 1996. Instead, we can employ a widely used and closely related index of governance outcomes from Political Risk Services' *International Country Risk Guide* (ICRG) to compare China and India with other countries (see Knack and Keefer 1995).

That index is the sum of *bureaucratic quality*, *rule of law*, and *corruption*, which correspond to the World Bank governance indicators of government effectiveness, the rule of law, and control of corruption. The maximum score on the index is 18. At the beginning of the 1980s, the governance index calculated from ICRG was 9.0 for India and 9.3 for the world as a whole. At the beginning of the 1990s, the index stood at 9.6 for the world, at 10.0 for China, and at 7.1 for India.

Microeconomic evidence from China reinforces the conclusion that growth has proceeded despite a merely average governance environment. Cai, Fang, and Xu (2005) found that firms make large payments to government officials (allocated to the budget item "entertainment and traveling costs" in company accounts) to offset bureaucratic burdens and the threat of opportunistic behavior by governments. Political intervention is a concern for firm managers and it affects business decisions. Nee and Opper (2006) analyzed a survey of 72 firms listed on the Shanghai Stock Exchange, asking about involvement either by government agencies or officials of the Communist Party of China (CPC) in 63 different firm decisions, ranging from finance and investment to personnel and external relationships. On average, firms reported some involvement in all of these decisions. They also presented evidence that the power of government bureaucrats and party authorities over firm decisions is associated negatively with firm return on assets and equity.

At the same time, good relations with the government are essential to credit access. Using data from the World Bank's 2003 investment climate survey

of China, Nee and Opper (2006) found a striking reliance on the government's administrative assistance in the loan process. More than 40 percent of state-owned enterprises, collectively owned firms, private firms, and individually owned firms that received government assistance also had a bank loan; only 15 percent of those that did not report assistance had a loan. Similarly, 32 percent of private firms with chief executive officers who held official positions in the CPC received credit, compared with 17 percent of the firms lacking this status.

Similar evidence is not available to document the effects of specific governance lapses on firm behavior in India, although it is clear that access to basic economic inputs often is unrelated to market forces. For example, firm access to credit from state-owned banks, which control the lion's share of credit in India, seems largely unrelated to firm profitability or to changes in firm profitability (Banerjee, Cole, and Duflo 2003).<sup>2</sup>

Although Chinese and Indian governance outcomes were only average, their experience gives other poor nations three reasons to redouble efforts to improve governance outcomes. First, China and India achieved better governance outcomes than did most other poor countries. On a scale running from zero to 18, actual governance levels in China and India exceeded those of countries with similar incomes per capita by roughly 3 and 2 points in 1985 and 1990, respectively.<sup>3</sup>

Second, as is well known, governance outcomes matter for growth. Reiterating this amply documented conclusion, table 7.1 offers the results of regressions that examine the correlates of per capita economic growth (in constant local currency) over the period 1980–2004 in a cross-section of countries.<sup>4</sup> In columns 1 and 4 of table 7.1, beginning of period income per capita, gover-

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2. Although credit rationing is clearly significant in India, Mengistae, Xu, and Yeung (2006) found that Chinese firms are actually more responsive to credit access than Indian firms. Using World Bank investment climate data, they found in both countries that firms in cities exhibiting better average firm access to a bank credit line (overdraft protection) are more productive and exhibit faster growth in employment and manufacturing value added. The effect, however, is much stronger for Chinese firms.

3. Based on simple regressions of governance indicators on income per capita and country dummies.

4. The log of initial income yields similar results, as does the use of exchange rate-weighted initial income rather than purchasing power parity-adjusted initial income. These differences are 1.5 standard deviations in excess of the average lower-income country.

**Table 7.1 Correlates of Growth, 1980–2004**

Dependent variable <sup>a</sup>	India			China		
	(1)	(2)	(3)	(4)	(5)	(6)
China (1 = yes, 0 = no)				0.050 (8.10)	0.049 (7.44)	0.007 (0.37)
India (1 = yes, 0 = no)	0.018 (4.79)	0.018 (4.59)	-0.029 (2.61)			
Income per capita (beginning of period; 1,000s of constant, PPP-adjusted dollars)	-0.0023 (6.40)	-0.002 (4.80)		-0.0002 (6.33)	-0.0002 (4.62)	
Population (beginning of period, 100 millions)			0.008 (5.22)			0.006 (3.05)
Total income (beginning of period trillions of constant, PPP-adjusted dollars)			-0.005 (2.82)			-0.004 (2.29)
Governance index (beginning of period)	0.0016 (3.31)		0.001 (1.89)	0.0016 (3.34)		0.001 (1.81)
Percent of population 14 years and under (beginning of period)	-0.0016 (3.57)	-0.002 (4.62)	-0.0005 (1.22)	-0.0015 (3.46)	-0.0019 (4.51)	-0.0005 (1.29)
Percent of population rural (beginning of period)	0.00005 (0.56)	0.00005 (0.50)	0.0002 (1.68)	0.00005 (0.53)	0.00004 (0.47)	0.0002 (1.68)
Gross secondary school enrollment (beginning of period)	0.00015 (0.23)	0.00015 (1.18)	0.0002 (1.27)	0.0002 (1.33)	0.0002 (1.31)	0.0002 (1.22)
1980s (1 = yes, 0 = 1990–2004)	-0.006 (1.82)	-0.006 (1.70)	-0.008 (2.24)	-0.006 (1.74)	-0.005 (1.62)	-0.008 (2.28)
Number of countries	193 (112)	193 (112)	193 (112)	193 (112)	193 (112)	193 (112)
R <sup>2</sup>	0.35	0.32	0.27	0.36	0.33	0.26

Sources: World Bank 2005b, *World Development Indicators*; *International Country Risk Guide*.

Note: PPP = purchasing power parity. The *t*-statistics appear in parentheses. Ordinary least-squares with robust standard errors (clustered). The governance index is the sum of Political Risk Service's *International Country Risk Guide* corruption, bureaucratic quality, and rule of law indicators. Constant not reported. A positive coefficient on the India or China variables indicates that growth is faster than predicted by the other control variables; a negative sign indicates that it is slower than predicted.

a. Per capita income growth, constant local currency, periods 1980–89 and 1990–2004.

nance, and population 14 years of age and under exhibit a large and significant association with growth.

These regressions explain about half of India's growth—the “India” coefficient indicates that 1.8 percent of India's yearly per capita growth is unexplained; and they explain less than half of China's actual annual growth (8.7 percent)—the “China” coefficient indicates that China's actual yearly per capita income growth was 5 percent faster than can be explained by its income per capita, demographic, governance, and other characteristics. We do not expect the Giants' extraordinary growth to be explained by country characteristics, such as governance, in which the two countries are merely average. Consistent with this, whether we take governance into account (in regressions 1 and 3) or not (in regressions 2 and 5), the fraction of Chinese and Indian growth that is unexplained remains the same.<sup>5</sup> Making comparisons with other poor countries rather than with all countries, however, we can infer from table 7.1 that Chinese governance outcomes relative to those of other poor countries enabled it to grow approximately 0.75 percent a year faster than those other countries over the period 1980–2004.

Third, China and India enjoy extraordinary potential market size that other poor countries cannot replicate and that offsets the entrepreneurial risks in weak governance environments. Holding the policy environment constant, we would expect foreign investment to gravitate to countries where the prospects of future growth are highest. Fan et al. (2006) compared foreign direct investment (FDI) received by China with that received by the rest of the world. They conclude that the burst of FDI into China in the 1990s was driven essentially by high expected growth (as represented by high past growth)—that is, by the enormous opportunities in the Chinese market that largely were opened to foreign investors by policy measures undertaken in the late 1980s and early 1990s. FDI into China is perhaps 80 percent greater than into comparator countries because of the expected rates of return. This effect dominates the (also large) influence of the institutional environment, which suppresses FDI in China by approximately 30 percent.<sup>6</sup>

Columns 3 and 6 in table 7.1 also shed light on this question. These regressions disaggregate two measures of market size, total income and total popula-

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5. The governance variable is missing for China for the 1980s.

6. Huang (forthcoming) will argue that Chinese policy has been much friendlier to FDI than to domestic investment. This finding reinforces the essential point: foreign investors have flocked to China because high expected rates of return offset a governance regime in which property and contractual rights were moderately insecure.

tion. Country income captures two offsetting effects: the market is smaller in countries with low total incomes, thereby deterring investment, but poorer countries have lower wages and greater potential for catching up, thereby raising growth rates. Total population is an indicator of both the size of the market for a key input—labor—and the potential size of the market if per capita incomes grow—that is, the size of the option value of a current investment in the country. From columns 3 and 6 in table 7.1, we see that every increase of 100 million people in the total population is associated with a 0.6–0.8 percent increase in the annual growth of per capita income, consistent with the advantages of larger potential markets for products and larger labor markets. Every trillion-dollar *decline* in total income is associated with a 0.4–0.5 percent increase in annual growth.

These regressions offer indirect evidence that market size offsets weak governance. First, the governance coefficient drops by a third after controlling for market size. Second, Chinese growth is explained almost entirely in column 6: when policy reforms allowed the market to be exploited, potential rates of return dwarfed governance risks. In India, on the other hand, where policy reforms were less dramatic, more directly accounting for market size *reverses* the sign of the India coefficient. Rather than growing 1.8 percent faster than expected in columns 1 and 2, Indian growth was 2.9 percent *slower* than its market size would have predicted.<sup>7</sup>

One might argue that the market advantages of China and India are overstated here. Markets in both countries are splintered by uneven transportation networks and protective trade barriers set up by regions within these countries. But such barriers exist as well in small countries and often are worse.<sup>8</sup>

In addition, investors in China and India may have sought out these countries primarily for their export-based production facilities. Exports as a share of gross domestic product (GDP) rose from approximately 10 percent in 1980

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7. Earlier “miracle” countries with weak governance environments, such as the Republic of Korea in the 1960s or Indonesia, relied much less on large markets to offset governance disadvantages, in contrast to the general experience summarized in table 7.1 These countries also were more likely to solve the governance–investment problem by relying for investment on a small number of families with close ties to the regime and/or military. Ultimately, in most cases, these institutional arrangements were unstable; in some cases, institutional changes eventually extended a secure governance environment to a larger fraction of citizens.

8. Although much smaller than its two giant neighbors, Nepal confronts worse transportation constraints because of its geography, and, like Chinese and Indian locales, Nepali towns have been known to apply such internal trade barriers as octroi taxes on goods passing through them.

to approximately 20 percent in 2000 of GDP in China, and from 6 percent to 12 percent in India. Over that period, however, per capita incomes nearly quintupled in China and more than doubled in India. Thus, although household consumption remained at approximately 50 percent of GDP in China and dropped from 74 percent to 65 percent in India, much economic growth went to satisfy the growth in domestic consumption. At the same time, even exporters have several reasons to care about domestic market size. These reasons range from any agglomeration economies that are more likely to exist in larger markets to more liquid labor markets (any single new entrant is unlikely to increase wages). Kochhar et al. (2006) have attributed Indian success to the virtues of experimentation and learning by doing; the number of experiments that an economy can conduct also rises with the size of the economy.

The evidence here strongly supports the conclusion that poor countries cannot afford to use Chinese and Indian growth experiences as reasons to downplay governance: on average, governance outcomes matter for growth; Chinese and Indian governance outcomes in any case were better than those of other poor countries; and merely matching the average governance outcomes in China and India likely will not be enough because most poor countries cannot offer the potential returns of large markets.

The next section of this chapter uses historical evidence from China and India to reach this same conclusion in another way: China and India began to grow rapidly after they had improved the governance environment significantly, even if only to average levels. It also uses the Giants to help identify the conditions that countries with and without competitive elections must meet to produce good governance outcomes.

## **Beneath the Cross-country Data: Political Economy and Governance Outcomes**

Because growth erupted in China and India in the 1980s, we would like to know what happened to governance throughout the 1970s. There are unfortunately few data to track governance outcomes from the 1970s onward, but we can trace the evolution of Giants' political characteristics that, like voice and accountability in the World Bank governance indicators, shape the incentives of governments to pursue good governance outcomes.

The starting point is the puzzle that the voice and accountability indicators for China and India are dramatically different, but their governance outcomes

are not. This finding is surprising. One might expect competition for the electoral support of a fully enfranchised citizenry to generate greater interest among political leaders in broad social welfare, including the pursuit of good governance outcomes. An influential literature argues precisely this: elections prevent elites from expropriating non-elites, thereby encouraging non-elite investment and growth (as in Acemoglu and Robinson 2006). In fact, governance scores in countries with competitive elections differ little, on average, from those in countries without.

In 1995, for example, the governance score of countries in the 50th governance percentile of all countries with competitive elections was nearly the same as the score in the 50th percentile of countries without competitive elections (11.0 versus 10.7 out of 18).<sup>9</sup> On the one hand, having competitive elections is not enough to ensure improved governance outcomes; on the other hand, in countries lacking competitive elections, leaders may have incentives to create institutions that strengthen the governance environment. Most measures of voice and democracy do not take these nuances into account. The cases of India and China highlight the obstacles and opportunities in both types of countries to improve governance outcomes.

The challenge in generating good governance outcomes can be framed as a question: what fraction of the population feels secure from the threat of opportunistic behavior by government? The discussion in this chapter points to a number of political characteristics of countries that influence the answer to this question. Political checks and balances are one key characteristic. Non-elected leaders can enlarge this fraction to the extent that they can build large parties with internal institutions, including internal political checks and balances on leader discretion, which make party members more secure from threats of arbitrary treatment by the leader. This was the Chinese solution to its governance problems. Political checks and balances in democracies also can expand the coverage of the good governance umbrella by expanding the range of social interests with the authority to veto arbitrary government initiatives. Although India increasingly has benefited from political checks and balances since 1977, and particularly since 1989, events of the early 1970s dismantled both external and internal checks and balances on the governing leadership of the Congress Party. In both countries, political checks and bal-

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9. Countries are categorized as having competitive elections when they score the maximum (7) on both the executive and legislative indexes of electoral competitiveness from the Database of Political Institutions (Beck et al. 2001).

ances were weak in the 1970s, a decade of slow growth, and strengthened during the 1980s and 1990s, periods of faster growth.

Even in countries with competitive elections and checks and balances, political market imperfections can weaken political incentives to pursue good governance outcomes (see Keefer and Khemani 2005). For example, when citizens are not well informed about the connection between political decisions on particular issues and their own welfare, as is often the case with governance reforms, politicians are unlikely to compete on those policy dimensions. Lack of education and of access to information, time lags, and a noisy economic environment full of shocks all can contribute to information problems. Another political market imperfection exists when parties cannot make political promises that are broadly credible to all citizens. Parties resort to appeals to those groups of citizens to whom they *can* make credible promises—but when those groups are narrow, incentives to improve governance for all citizens dwindle (Keefer and Vlaicu 2005). Again, isolated and poor populations are less likely to know of the relationship between political actions and the governance environment, or to appreciate the importance of the country's governance environment for their own personal well-being. Similarly, in countries riven by social tension, the costs of making credible political promises to all citizens dwarf those of making promises targeted to individual groups. Each political competitor belongs to one of the groups and therefore is mistrusted by all the others.

Political market imperfections explain why political decision making in India is more likely to focus on subsidies and macroeconomic policy than on better-quality social services, better governance outcomes, and the regulatory environment for business: the political contribution to citizen welfare is harder for citizens to discern in these latter cases, allowing elected officials to be more sensitive to the pleadings of special interests opposed to reform.

## Political Change and Governance in India

Most explanations of Indian growth focus on the major policy reforms of 1991. Average annual per capita growth in India, however, was about the same in the 1980s as in the 1990s (approximately 3.5 percent), compared with less than 1 percent in the 1970s.<sup>10</sup> Rodrik and Subramanian (2005) found no

10. Income is measured in constant local currency. Volatility also dropped significantly; the standard deviation of annual growth in the 1970s was more than twice the standard deviation in the 1980s and 1990s. Volatility in the 1970s is another sign of weak democratic in-

evidence of significant policy changes in the early 1980s to explain growth in that decade. Kohli (2006) has argued that there were modest policy reforms, but their importance was to signal a shift away from a redistributive development model to one friendlier to incumbent private business interests. This section points to a complementary explanation of faster growth in the 1980s. In the 1970s, both the policy and governance environments steadily deteriorated. This deterioration began to reverse just prior to the onset of growth in the 1980s.

The policy deterioration of the 1970s is well known. It was sparked by the election of 1967, in which the Congress Party's share of seats in the Parliament dropped by 19 percent, to a majority of 54 percent. As electoral weakness reduced the costs of defecting, the party began to splinter. Indira Gandhi chose to consolidate support within the interventionist wing of the party by dramatically increasing the state's role in economic activity. The government nationalized the major banks and steadily increased the profile of state-owned enterprises. Shanker and Nayak (1983) estimated that state-owned companies' gross value added in 1968–69 rose from 15 percent of the combined value added of government companies and of nongovernment, nonfinancial medium- and large-size public and private limited companies to 26 percent in 1977–78. The "License Raj" also expanded dramatically. In 1970, all large enterprises were required to register with the new Ministry of Company Affairs and could not expand without approvals from a range of ministries and, in problematic cases, from the prime minister herself. In 1976—marking at least eight successive years of growing restrictions on entrepreneurial activity—amendments to the Industrial Disputes Act obliged firms with 300 or more workers to seek government approval before laying off workers (Frankel 2005).

Weakened governance during the 1970s is less often discussed, although some of the policy changes themselves were clear evidence of it. The License Raj was not applied transparently and bank owners were not fully compensated for the losses they suffered from nationalization. Furthermore, the political drivers of good governance outcomes in India weakened in the 1970s. Events of that decade reduced both external political checks and balances and internal party checks and balances on Congress Party leaders.

Prior to 1967, competing interests had significant influence over internal Congress Party decision making; these interests limited the discretion any

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stitutions, as Quinn and Woolley (2001) showed that democracies exhibit less volatile growth more generally.

one of them could exercise. Leaders of the Congress Party ranged from the anti-industrial Mahatma Gandhi wing of the party, to the pro-industrial but socialist wing represented by Jawaharlal Nehru, to militants prepared to take up arms in pursuit of redistributionist aims. Less ideological leaders—those who managed the Congress' well-developed clientelist network that was key to voter mobilization—also were prominent. Frankel (2005) described this network in the following terms:

In general, national political parties did not recruit from among the poor peasantry. Instead, they accommodated themselves to the existing power structures as the easiest way to win votes. . . . [T]he major beneficiaries of [adult suffrage] were the most prosperous sections of the dominant landowning castes, individuals who could exploit a wide network of traditional caste, kinship, and economic ties (of dependent sharecroppers and laborers) to organize a large personal following (p. 20).

The interests of these landowning castes therefore were amply represented in Congress and could veto policy change. In 1946, the most powerful man in the Congress Party was Sardar Vallabhai Patel, Mahatma Gandhi's chief lieutenant, who was responsible for building up the local party. He frequently prevailed in conflicts with Nehru (for example, by blocking socialist candidates for Congress Party leadership [Frankel 2005]), and only when Patel died was Nehru able to push forward in promoting state-led industrialization (Nayar 1990).

In November 1969, the Congress Party attracted fewer than half of the votes cast (43.7 percent), dropping below 50 percent for the first time ever. Gandhi's opponents left the party, weakening internal party checks and balances.<sup>11</sup> Shortly thereafter, Gandhi took key functions of government out of the control of cabinet ministers and put them under her direct control. In 1970, she transferred 60 of the 100 sections of the home ministry (and 7 of 14 joint secretaries) to the cabinet secretariat, bringing under her personal oversight the major administrative, policy, and intelligence services of the national government (Frankel 2005).

The split in the party need not have led to a reduction in political checks on the exercise of executive discretion if it had forced the Congress (I) Party to govern in coalition, replacing intraparty with external checks; if it had strengthened the electoral challenge to Gandhi's party; or if she had allowed intraparty

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11. She formed the Congress (R) Party (later I, for Indira); senior Congress officials formed the Congress (O) (Organization) Party.

checks in Congress (I) to gain strength. None of these possibilities happened. External constraints dissipated in the 1971 elections, when the refashioned Congress (I) Party increased its parliamentary majority to 68 percent.

Internally, crisis made it difficult to construct intraparty agreements that were essential to developing internal political checks and balances. In addition to foreign policy crises of the 1970s, India was struck by monsoon failure and food shortages, an economic crisis starting in 1973 triggered by the quadrupling of oil prices, and inflation exceeding 23 percent over the period 1973–74 (Frankel 2005, p. 647; Brass 1990, p. 40). Large and sometimes violent public demonstrations accompanied these shocks. Massive student-led demonstrations in Gujarat and Bihar led the government to send 40,000 troops to Bihar. Activists and demonstrators eventually earned the support of Jayaprakash Narayan, widely respected for his proximity to Mahatma Gandhi and his advocacy of the poor; and after evolving into the “J.P. Movement,” the activism became an India-wide movement to challenge Indira Gandhi’s government within and outside the parliament (Frankel 2005). In 1974, 700,000 railway workers went on strike—half of the sector’s workforce; the strike ended 20 days later, after the government had arrested most of the union leaders and 20,000 of the workers (Frankel 2005, p. 530). In 1975, the first post-Independence assassination of a cabinet minister occurred in the bomb explosion that killed railway minister L. N. Mishra (Frankel 2005).

Faced with a foreshortened political horizon and the high costs of retaining support even inside the Congress Party, in 1975 Indira Gandhi declared an emergency, definitively relaxing both external and internal party constraints on her authority. Thousands of local-level party workers were detained, and her principal opponents were arrested (Brass 1990). She postponed parliamentary elections scheduled for 1976, thereby weakening legislative checks on executive authority (Brass 1990, p. 42). She also arranged for the late-1976 passage of the 42nd Amendment to the Constitution, which made the cabinet’s advice binding on the president and removed the president as a constraint on prime ministerial discretion.

The 42nd Amendment also undercut judicial oversight of the executive. This oversight had been vigorous. For example, the Supreme Court rejected almost immediately the 1969 bank nationalization and government efforts to abolish the privy purses and privileges of ex-princely rulers. Precipitating the declaration of emergency, in June 1975 the High Court of Allahabad found Prime Minister Gandhi guilty of illegal electoral manipulation and ordered her to vacate her seat. The 42nd Amendment gave primacy to Directive Prin-

ciples over Fundamental Rights. Directive Principles were constitutional goals related to the pursuit of social justice, and whose pursuit was subject to substantial executive discretion. This undercut much of the constitutional basis of judicial review. For example, the Court had used Fundamental Rights to justify the defense of property rights in the case of bank nationalization and princely privileges (Frankel 2005).

In sum, the 1970s witnessed not only significant policy deterioration with respect to private sector activity, but also deterioration in the governance environment—bank nationalization and a reduction in the checks and balances operating on the executive. It is not surprising that growth was slow in the 1970s, nor that even a gradual flattening and reversal of the hostile investment trend of policy and governance was associated with the resumption of growth in the 1980s.

### ***Governance and Policy Reforms at the End of the 1970s***

These negative trends came to a halt and began to reverse direction in 1977, when Prime Minister Gandhi called for new elections. These elections brought the Janata coalition into government in a major defeat for the Congress Party. This government implemented modest policy reforms that signaled the end of policy deterioration: coverage under the open general licensing list was expanded; access to credit and foreign exchange was liberalized; delicensing, and measures that expanded the range of products that could be produced under any given license were undertaken; and price controls were relaxed somewhat (see Kohli 2006; Kochhar et al. 2006). Also, the Communist Party decided to abandon the alliance with Congress that it had maintained since 1969, further evidence for entrepreneurs of the shift away from ever-deeper government intervention in the economy (Frankel 2005).

The governance environment improved as well. Formal, institutional checks and balances were restored. The Janata government repealed the 42nd Amendment and passed the 44th Amendment, largely restoring the pre-emergency constitution and the predominance of Fundamental Rights. The Supreme Court reestablished its right to review the consistency of laws with the Fundamental Rights of the constitution in the *Minerva Mills* case in May 1980 (Frankel 2005).

None of this is to say that India in the 1980s was a model of coalition government and institutionalized decision making. The Janata government, which lasted only until 1981, used all the formal and informal instruments at its dis-

posal in attempting to remove state governors who had come to office under the Congress era. In the 1984 elections, following religious riots and the assassination of Indira Gandhi, the Congress Party won more than 70 percent of the seats in the national legislature. In his role as the new prime minister, Rajiv Gandhi was able to govern unchecked by the presence of coalition partners.

Nevertheless, the 1980s differed from the period following the 1971 elections for one significant reason: the 1977 elections proved that the Congress Party could be removed from office, thus establishing for the first time that electoral accountability was firmly entrenched in India. These elections were the first to demonstrate that no government in India was safe from poor performance and that multiparty competition was resilient in the face of such extra-institutional intrusions as mass demonstrations and declarations of emergency.<sup>12</sup> Even enjoying large parliamentary majorities, therefore, the governments of the 1980s confronted an electoral check on their actions that had not existed previously.

One final piece of evidence supports this conclusion. Business Environment Risk Intelligence (BERI) is an analysis and forecasting service that reported information on 45 countries in the late 1970s, among them India but not China. One of the dimensions of governance that BERI tracked was the quality of contract enforcement. This variable rose (that is, improved) from 1.15 to 1.93 (on a 4.0-point scale) from 1979 to 1980. This rise was not the product of a change in methodology or a secular improvement, for the median of the whole sample of countries (45) dropped slightly (2.43 to 2.30).

### ***Governance and Policy Reforms in the 1990s***

In 1991, the minority Congress government, led by Narashimha Rao, moved strongly to free economic activity from restraints established in the 1970s. The initial impetus behind the reforms was crisis: foreign lending on which India had relied in the 1980s dried up, debt service rose to 21 percent of current account receipts, and interest payments grew to 20 percent of government expenditures. The Rao government, however, issued executive orders that went well beyond the narrow fiscal sources of crisis, cutting back the number of industries reserved for the public sector; removing private sector compulsory licensing for starting or expanding enterprises; devaluing the ru-

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12. The 1967 election sometimes is taken as a watershed that ended Congress hegemony. However, although the Congress Party received only 41 percent of the popular vote, its closest challenger, the Bharatiya Jana Sang, received merely 9 percent.

pee; allowing for current account convertibility; removing quantitative import quotas and reducing tariffs; lifting restrictions on foreign investment; and allowing foreign financial institutions to make portfolio investments in India's two stock markets.

These reforms were sufficient to sustain the growth rates of the 1980s without incurring the fiscal and trade disequilibria of policies of the 1980s—but not more. One reason is that substantial policy distortions remained. Subsidies remained large; state-owned enterprises were burdensome; bad loans in the banking sector were significant; and regulatory rigidity in the labor market was extreme. Reforms in these areas all required the agreement of the Lok Sabha, the lower house of India's Parliament, and they were not undertaken (Kohli 2006). The World Bank's Doing Business indicators monitor aspects of countries' legal and regulatory environments that directly affect the costs of entrepreneurial activity. By 2004, India's employment rigidity and cost of enforcing contracts were still significantly worse than those of other countries, even controlling for income per capita. India's percentile rank among all countries with respect to regulatory quality, as assessed by the World Bank governance indicators, fell from 44th to 27th from 1996 to 2004.

Governance outcomes appear to have improved during the 1990s, although the data are somewhat ambiguous. The *International Country Risk Guide* reports that India's increase in rule of law, one of the three measures used earlier to compile the 18-point governance indicator, was 3.0 or less until 1992 and 4.0 (out of 6.0) from 1994 onward. Bureaucratic quality subsequently increased from 4.0 in 1996 to 5.0 (out of 6.0). Corruption, however, changed little in the 1980s and 1990s, and it worsened in 2001 and subsequently. In addition, according to the World Bank governance indicators, India's percentile rank with respect to government effectiveness, the rule of law, or control of corruption changed little from 1996 through 2004.

Political checks and balances, however, have become more ingrained in Indian political life. Political fragmentation, which raises the likelihood of coalition governments, increased significantly from the 1980s to the 1990s. The probability that two randomly selected legislators would be from different parties rose from approximately 50 percent in the 1980s to 70 percent in the 1990s (Beck et al. 2001). Coalition governments became imperative in the 1990s: the probability that two legislators in the government coalition were from different parties was less than 2 percent in the 1980s and more than 30 percent in the 1990s. The risk of expropriatory government action therefore declined in the 1990s, consistent with the ICRG reports of improved rule of law.

Other political underpinnings of good governance outcomes, particularly political market imperfections, have changed less rapidly. Parties continued to have difficulty basing their electoral appeal on growth-related policies, including governance reforms. These policies are hard for poor, poorly educated, or isolated voters to observe. In addition, the benefits of growth reforms cut across social lines. The policy preferences that emerge from this political environment are clientelist promises or easily targeted government policies, such as subsidies (see Wilkinson 2006a). For example, not only are market-opening reforms difficult; so also are efforts to improve the quality of the bureaucracy, reduce corruption, or eliminate continuing significant regulatory impediments to growth. These efforts are more difficult because they conflict with, or are irrelevant to, the electoral basis for political success.

Political market imperfections are key to understanding slow reform generally. Most observers attribute slow reform to political fragmentation, but fragmentation is low by world standards, and, moreover, this explanation does not take into account the incentives of individual political actors.<sup>13</sup> Broadly beneficial economic reforms are not politically salient. It is not surprising that Kohli (2006) attributed the reluctance to open markets to a political alliance between politicians and special interests (incumbent firms), leading to policy reforms that encourage incumbents to invest, but that do not allow broad entry.

Infrastructure policy offers another glimpse into the influence of political market imperfections. The availability of infrastructure is widely agreed to be a highly constrictive bottleneck to Indian policy. Nevertheless, infrastructure spending collapsed in the 1990s, falling back to its 1970s levels (approximately 1.5 percent of GDP) from amounts exceeding 2 percent of GDP in the 1980s. This collapse certainly is related to macroeconomic and fiscal problems.<sup>14</sup> Macroeconomic problems, however, do not explain the allocative distortions in infrastructure toward projects with the greatest political payoff, nor do they explain the persistent difficulties in attacking bottlenecks that impose the greatest obstacles to economic growth. Here, the distortionary presence of political market imperfections offers a better explanation (Wilkinson 2006b).

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13. India's political fragmentation in the 1990s was actually low compared with all parliamentary democracies. In the latter case, the probability that two legislators in the parliament were from different parties was approximately 67 percent.

14. This explanation is easy to overstate, however. The reallocation of spending away from politically attractive but nonproductive and scarcely equitable subsidies and improved tax administration likely would be sufficient to fund productive infrastructure.

Since 2004, annual growth has accelerated to approximately 6 percent. It is too early to analyze the roots of this dramatic increase, but it is noteworthy that the Congress Party returned to power in 2004 and, as in the 1970s, again allied with the Communist Party to form a majority. The results have been much different. In the 1970s, the alliance precipitated redistributive policies rooted in expropriation and direct government management of the economy. Growth dropped to nearly zero. A similar coalition, far from reversing the reforms of 1991, has focused instead on pursuing equity and redistribution through more efficient jobs programs. This change reflects not only learning, but also greater awareness of the electoral importance of delivering observable welfare improvements to broad segments of the population. The fact that the policy focus is persistently on redistribution rather than reforms that would promote growth, however, suggests that information and other political market imperfections continue to make it difficult for parties to benefit electorally from such policies.

## **Chinese Governance in the Post-Mao Era**

The policy environment in China prior to 1980 is well known to have been particularly hostile to private enterprise and market incentives, perhaps among the most hostile in the world at that time. The governance environment was equally weak. Individualized rule and highly arbitrary decision making produced a strong sense of insecurity in both party and nonparty members. Shirk (1993) noted that, prior to 1978, “Mao Zedong attempted to sustain his revolutionary charisma and stem the trend of institutionalization . . . by launching mass campaigns such as the Great Leap Forward and the Cultural Revolution” (p. 8). The Cultural Revolution itself represented an effort by Mao to bypass the Communist Party and his opponents within it, and was implemented instead by the Red Guards, whom Mao directly controlled. Thousands of party officials were transferred to lower-level jobs, sent to the countryside for reeducation, or imprisoned during the Cultural Revolution (Shirk 1993). Elite politics under Mao were particularly unpredictable, again signaling the lack of constraints on opportunistic behavior. Two of Mao’s “chosen successors” died politics-related deaths (Whiting 2001, p. 11).

Economic growth exploded not only after reforms relaxed the prohibition on private sector activity, but also after governance reforms relieved this insecurity. From 1952 to 1980, average annual individual incomes increased by

less than 2.5 percent (Shirk 1993). From 1980 onward, growth tripled. Agricultural production rose at a yearly rate of 7 percent from 1978 to 1988, more than three times faster than in the previous 26 years (Shirk 1993). Manufacturing boomed. Between 1978 and 1987, nonstate rural enterprises rose from 8.7 percent of all industrial output to 23.1 percent (Byrd and Gelb 1990).<sup>15</sup> The share of total industrial output produced by nonstate firms—those not controlled by the central government—almost doubled from 1978 to 1988, rising from 22 percent to 43 percent (Shirk 1993).

The policy reforms underlying these changes were dramatic. By 1983, the Household Responsibility System, which made households residual claimants of production on their collectively owned plots, had spread throughout China. Key policy changes also stimulated private sector industrial development. Farm households were allowed to invest profits in farm machinery, trucks, and industrial equipment and to engage in private marketing and manufacturing. Collectively owned township and village enterprises (TVEs) could be leased to individuals and groups (Shirk 1993). Rural investment loomed large: private firms in the rural sector accounted for 19 percent of total fixed-asset investment in the 1980s and TVEs accounted for another 13 percent (Huang forthcoming). Decisions in 1979 expanded foreign trade and allowed foreign companies to invest in Chinese enterprises. The central government also decentralized the administration of foreign trade and investment, allowing localities to deal directly with foreign interests.

Local government officials were at the center of these reforms. Indeed, one rationale for focusing on TVEs was to channel rents to local cadres to offset their losses from decollectivization (Oi 1999).<sup>16</sup> The TVE focus allowed cadres who controlled an earlier variety of TVE—one established under Mao beginning in 1970 (Byrd and Gelb 1990)—to continue to use that variety to distribute jobs and other resources (Oi 1989). These cadres implemented decollectivization because land was still collectively owned at the local level. They hired the TVE managers. As Oi (1999) observed, although TVEs were usually contracted out by town and village governments to private managers, local governments—and the party officials who ran them—retained control

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15. About two-thirds of these enterprises were owned formally by townships and villages in 1987, and about one-third were owned privately by individuals or groups.

16. The TVE focus also softened ideological opposition to the private sector. Oi (1999, p. 74), for example, quoted rural officials in one county who, in the 1980s, referred to private entrepreneurs as “underground snakes” (*ditou she*).

of personnel, investments, and product lines and, ultimately, they were residual claimants of profits. Whiting (2001) has written, “Indeed, township officials themselves approved the number of employees and the total wage bill of each enterprise” (p. 204).

It is likely that local officials also were closely involved with the non-TVE private enterprises. On the one hand, much rural private investment was driven by agricultural liberalization, where the key asset—land—was controlled by local officials. On the other hand, some evidence points to substantial private-investor insecurity during the 1980s that would have been resolved by taking on local officials as partners. In resource-poor Wenzhou City, although local officials were particularly friendly to private investment because of the lack of capital to finance TVEs, concerns about expropriatory behavior led private entrepreneurs to make small investments; shut down their ventures and restart them later; or, having reached a certain scale, shift their profits from reinvestment to the purchase of “extravagant homes or even ancestral tombs” (Whiting 2001, p. 148).

### ***The Credibility Puzzle in Chinese Growth***

Local officials would not have responded to reform with investment on a massive scale without guarantees that they would be rewarded. In fact, Oi (1999) reported that township and village governments required collective enterprises to re-invest, on average, 50 percent of retained profits.<sup>17</sup> Either in their capacity as overseers of TVEs or as private individuals with close personal ties to private investors, why did township officials believe that the central leadership would not expropriate the profits from investments *they* controlled? The Communist Party leadership needed to make credible its promises to cadres (its success in doing so, however, would not be captured in standard indicators of voice and accountability because reforms would extend only to cadres and not to citizens generally).

Che and Qian (1998a, 1998b) argued that, to induce investment, the central government allowed local governments to operate TVEs and implemented fiscal reforms in 1980 to allow local governments to keep all revenues above a

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17. Some fraction of this investment was not productive. For example, some of it likely went to construct new housing for workers (Nee 1992). In addition, there is uncertainty about whether TVEs reinvested or simply had easy access to state bank loans. In either case, rapid output growth is indicative of significant productive investment rather than diversion to immediate consumption.

preset amount. This gave local officials a full claim on all TVE profits above that amount, but also required them to provide local public goods, a reform described as “eating in separate kitchens” (*fenzao chifan*) (Whiting 2001, p. 76). According to Che and Qian (1998b) decentralization worked because local and central governments had similar incentives for providing local public goods, such as local roads, but particularly for maintaining order. This same strategy could not be replicated by private enterprises, which were unable to solve the collective action problems needed to provide those same local public goods.

There are two reasons to consider additional explanations. These fiscal reforms were reversed after the central government saw its revenues dry up (see Wong 1992). Investment continued, however. In addition, local and central governments turned out to have *conflicting* preferences regarding local public goods provision, and the central government exerted considerable effort to ensure the provision of the local public goods it valued. Even in the early 1980s, leaders at the center had to monitor closely the provision of education and the maintenance of social order, highlighting these public goods in performance agreements with local officials.<sup>18</sup> In the 1990s, local and central government interests more clearly came into conflict. For example, local officials increased social disorder by selling off collectively owned land without fully compensating farmers for their usufruct rights or by allowing local firms to ignore environmental restrictions.

### ***Intraparty Institutions and Credible Commitments to Investors in the 1980s***

An alternative explanation of the willingness of cadres to invest is the institutionalization of the CPC—checks and balances at the top and the introduction of expensive and more transparent promotion and evaluation systems. Institutionalization began when Deng Xiaoping came to power in 1977. His challenge was to increase the broad popularity of the CPC, through broad-based economic development that benefited all Chinese people, while ensuring that party cadres would have privileged access to these benefits to maintain their loyalty and commitment to the party. The key to each of these goals

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18. Similar issues arose in macroeconomic policy, where the conflict of interest between local and central government officials was clearer. Huang (1996) argued that the central government used the career concerns of local officials to prevent them from adopting expansionary strategies (that is, with regard to bank credits), imposing inflationary externalities on the rest of the country.

was to increase the confidence of cadres that they would be rewarded by the party if their current decisions led to future economic growth.

The 1980 reforms assigned local officials many of the rents from reform. But to ensure that the reforms would be effective—that they would elicit investment beneficial to all citizens—the rewards promised to cadres needed to be credible. As Huang (2003) noted, because township enterprises were run by government officials with formal civil service status, Deng focused on making the rules for promotion and cadre evaluation more credible. Deng “governed by rules, clear lines of authority, and collective decision-making institutions to replace the over-concentration of power and patriarchal rule that had characterized China under Mao” (Shirk 1993 p. 9; see also Whiting 2006). By 1983, the Organization Department of the CPC had implemented concrete and tangible criteria in cadre evaluations, ranging from gross output and investment in the early years to finer measures of economic growth and social stability in the 1990s. The party also created more room at the top to reward cadres by instituting mandatory retirement for party cadres (Manion 1992).

A number of conditions raised the central government’s cost of abandoning these rules. First, the rules were expensive to implement, involving re-training of thousands of cadres and constructing a costly bureaucratic process for evaluation. This investment was lost to the leadership if it disregarded the newly established rules.

Second, Deng Xiaoping was personally credible. He had incurred significant personal costs in advocating the same cadre management system under Mao: Mao used the Cultural Revolution not only to dismantle the system, but also to purge Deng himself (Manion 1985). By having paid a high price for his advocacy of systematic cadre management under Mao, Deng was credible in advocating support for the system when he came to power in 1978.

Third, the plan passed through a series of intraparty checks and balances, the most important of which was the core group of senior leaders. With the death of Mao, authority was spread to a greater extent among the top leadership of the party. Deng, for example, deferred to party elders. Leadership succession at least loosely followed formal rules, but clearly was also a shared decision of 30 or more leaders (Shirk 1993).<sup>19</sup> Shirk further pointed out that policy movement in the 1980s was slowed by lack of consensus among leaders

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19. Here is a prominent example of this looseness: although the collective consent of numerous top leaders was essential to oust Hu Yaobang as general secretary of the CPC in 1987, the leadership chose to ignore the formally required procedure of seeking the ratification of the Central Committee (Shirk 1993).

at the top. Although this made reform more difficult, it also made reform more difficult to overturn. In the context of personnel reform, the difficult decision to eliminate lifetime tenure for almost 20 million cadres was agreed by the top leadership only after meaningful compromise to satisfy the interests of multiple leaders (Manion 1992). These same checks and balances impeded unilateral changes to the rules for cadre promotion or the disregard of promotion criteria for cadres. In practice, as well, the promises were kept. Between 1978 and 1995, Li and Zhou (2005) have found that the likelihood of promotion for provincial leaders increased with a province's economic performance, and the likelihood of termination decreased.

### ***Sources of Investment and Good Governance after 1990***

In the 1990s, the development model shifted, and investments from non-cadres, especially from foreign investors, substantially increased. Combined TVE and rural private fixed-asset investment dropped steadily as a fraction of total fixed-asset investment, whereas the share of urban and foreign-invested firms rose to approximately 14 percent of total investment in 2001–03, compared with less than three percent in the period 1986–1990 (Huang forthcoming). This shift in strategy raises two questions: how did governance arrangements of the 1980s change to encourage foreign and noncadre domestic investment? and how did this change enable the leadership to continue to balance cadre interests with those of citizens more broadly?

The 1980s model of growth that relied heavily on local cadres confronted three difficulties. First, local cadres had strong political and private incentives to maximize revenues and employment, but weaker incentives to maximize profits, thus encouraging them to take on debt and build up tax liabilities that were sustainable only as long as growth continued. In 1989, approximately 18 percent of TVEs had severe difficulties: the government allowed 800,000 TVEs to close and another 2.2 million to merge with other enterprises or be restructured (Nee 1992). The process culminated in 1997, when the central government shifted influence over lending decisions away from local governments, closing hundreds of local banks and financial institutions and transferring lending authority within the four major state banks away from local and provincial offices to Beijing (see Shih 2004).

Second, the 1980s model starved the central government of revenues, which fell as a fraction of GDP from 30 percent in 1970, to 23 percent in 1985, to 12.6 percent in 1993, to 10 percent in 1995. This loss left central

leaders with little choice but to modify the fiscal arrangements developed in the 1980s that had left local governments with the lions' share of revenues (Yang 2004).

Third, local officials proved to be less reliable agents of the party than leaders had hoped. Concerns about the erosion of the central government's authority were voiced widely in the late 1980s and early 1990s (see Nee 1992). On the economic front, the most obvious manifestation of this erosion was the establishment of interlocality trade barriers to protect local firms from outside competition.

At the same time, the party's always high need for committed cadres was lower in 1990 than in 1980. Early in the reform process, party leaders could not be confident that market reforms would deliver the large payoffs to average citizens that they eventually did. Given the risks of failure, it was particularly important to sustain the loyalty of the cadres. This necessity had diminished by 1990, when market-oriented reforms had demonstrated their success. The cost of maintaining cadre loyalty also had risen because party members had better outside opportunities in the 1990s than in the 1980s. Nee and Oppen (2006) noted, "The lure of lucrative career opportunities in the thriving market economy has led many government bureaucrats to seek jobs in local businesses after leaving the government" (p. 11).

Instead of TVE and cadre-driven investment, therefore, the center turned also to FDI and, later, to domestic, private investment. In 1991, private firms of all kinds accounted for only 5.7 percent of industrial output value, compared with almost 52.7 percent for all nonstate firms, largely TVEs (Huang 2003). FDI increased from 0.9 percent of fixed-asset investment in all firms in 1983 to 15.0 percent in 1997. Relative to all nonstate firms (TVEs, essentially), FDI was 2.6 percent of fixed investment in 1983 and 31.7 percent in 1997. By mid-2003, TVEs (collectives) accounted for a small fraction of sales and profits—a share that continued to fall rapidly, dropping by almost half in mid-2005. Private firms financed by foreign or domestic investment produced the lion's share of manufacturing sales, holding nearly 60 percent by mid-2005 (World Bank Office 2005).

Huang (2003) attributed the upswing in FDI to government financial and legal policies that favored foreign investors over domestic ones. These policies also can be seen, however, as efforts to maintain rewards for local cadres. For example, until the mid-1990s domestic private firms were obligated to register as collective firms, which formally placed them under local government control (Huang 2003).

In any case, in 1992 the environment for domestic private enterprises also began to change when Deng called for more private firms. In 1998 the central bank relaxed lending quotas that had severely disfavored private firms, and the government finally allowed these firms to export. By 1999 the private sector was recognized in the Chinese Constitution as an integral part of the Chinese economy and placed on equal footing with other firms.<sup>20</sup> In July 2001, Jiang Zemin announced that private entrepreneurs should be allowed to join the ranks of the Communist Party (Huang 2003). The ratio of foreign-financed to private fixed investment fell from 48 percent in 1996 to 29 percent in 2000 (Huang 2003). One sign of policy friendliness to private investment is that China seems to have vaulted ahead of other poor countries in lowering costs to investors. According to the World Bank Doing Business indicators, by 2004 China's employment rigidity and contract enforcement costs were almost one standard deviation better than those of other countries, controlling for income per capita.

As before, the key question is, why did investors, particularly foreign investors, respond to these policy changes? The credibility of the cadre evaluation system that protected local officials from arbitrary treatment by the party in the 1980s would not seem to offer similar protection to foreign investors in the 1990s. Recalling the evidence in Fan et al. (2006), the size of the Chinese market alone might have attracted huge amounts of private capital when investment prohibitions were eased. At the central government level, intra-elite competition continued to exhibit increasing regularization through the 1980s and 1990s. Under Mao, intra-elite struggles sometimes ended violently. This was less the case under Deng and even less so after him, when the penalties associated with losing a leadership contest have fallen farther and are no longer as dramatic as arrest or worse. The growing institutionalization of intra-CPC political checks and balances increased the difficulties confronting any single party leader seeking to act opportunistically.

Increasing political checks and balances provided a credible underpinning for continuing administrative and judicial reforms throughout the 1990s. Under the auspices of the Administrative Litigation Law of 1989, nearly 10,000 cases were filed against government agencies in 1989; this rose to 98,000 in 1998. Of the 460,000 total cases filed over the period, plaintiffs won 35 percent of the time (Yang 2004). Clarke, Murrell, and Whiting (2006) have

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20. Foreign-invested enterprises had enjoyed constitutional recognition since the 1982 Constitution (Huang 2003).

pointed to the growing institutionalization of legal dispute resolution, replacing the administrative, cadre-centered resolution of disputes that would have favored TVEs. Administrative reforms culminated in 2005 with the passage of a comprehensive legal code governing civil service, consolidating the regulatory effort to modernize China's state bureaucracy (Nee and Oppen 2006).

At least in part, these efforts all were aimed at creating a safe climate for investment. As Yang (2004) wrote, "For Deng Xiaoping, political stability, particularly the continuity of Communist Party leadership, was a necessary condition for further economic reforms. Deng clearly recognized that the promotion of economic development through further economic reforms would be essential if the ruling elite were to regain the sort of performance legitimacy it had acquired in the 1980s" (p. 6).

Finally, the Chinese government has used its enhanced fiscal position to increase investor rates of return directly, using massive infrastructure investment—investments that precisely expanded the size of markets, magnifying one of China's principal advantages. From 1990 to 1995, for example, China increased its total road network by 23 percent, and by 50 percent in 2002 (World Bank 2005b, *World Development Indicators*). This attracted private investment for two reasons. First, although most observers agree that much public investment in China has low returns, partly because it is targeted ahead of demand to poor areas of the country, high-return productive infrastructure has increased dramatically. Chinese ports, for example, are world class, thus raising rates of return to private investment in the production of tradables. Second, productive public investments constitute a bond that the government has put up: they have a high political payoff only if private investors take advantage of the new infrastructure. If the government acts opportunistically, investors depart and the investment in infrastructure is lost, just as the earlier investments in cadre evaluation systems would have been lost if the government returned to opaque criteria for cadre advancement.

### ***Governance Stress in the 1990s***

Why have other one-party states not adopted the strategies of the CPC and enjoyed similar economic success? In fact, as the Chinese example makes clear, it is costly for leaders to establish large parties that are organized to protect members from arbitrary decisions by the party leadership; hence their rarity (Gehlbach and Keefer 2006). For example, to engender party member loyalty, members must receive larger rents than they could receive outside the

party. As their numbers rise, so too does the share of rents owed to party members as a whole.<sup>21</sup> Investments in elaborate intraparty evaluation and promotion processes, such as those China introduced in the 1970s and 1980s, are also expensive and they limit executive discretion.

Power sharing also is less likely when a single leader of the unelected government commands disproportionately more influence (military, popular, or otherwise) than do the others. When this is not the case, political checks and balances emerge naturally as the consequence of a balance of power among key leaders. When the distribution of power within the leadership group is unbalanced, as in China under Mao, it is difficult to establish political checks and balances.

Therefore, although the significant adjustments of the 1990s demonstrate the adaptability of the Chinese leadership to shifting political and economic challenges, it should not be surprising that the new bargain between party leaders and cadres has not been an easy one to sustain. The 1990 adjustments—the decline of TVEs, falling access to capital, and reduced tax shares—moved substantial rents and authority away from local officials. To soften the loss of rents to cadres, the central government privatized 250,000 small- and medium-size enterprises in 1997, selling many at low prices to party members. Nevertheless, the net effect of these reforms appears to have increased the relative benefits to cadres of pursuing privately beneficial actions that impose costs on society, and specifically on the party. Corruption, land grabs, and a lack of vigilance with regard to provision of local public goods (education, environmental safety, and so forth) are activities that disgruntled cadres might pursue. Strengthened institutional checks and balances at the top may not have offset weaker incentives to pursue good governance at the local level.

To the extent that the shifting cadre–leadership bargain has weakened cadre discipline and governance at the local level, we would expect to see some citizen reaction. According to Huang (forthcoming), the total number of demonstrations that occurred annually between 1993 and 1997 rose from 8,700 to 32,000. Officially reported incidents of social unrest rose from 58,000 in 2003 to 74,000 in 2004. These increases seem directly tied to efforts by local officials to raise their rents, including the transfer of land away from farmers to industrial and other uses and weak oversight of the environmental degradation caused by local enterprises. For example, results of a survey, conducted by Anthony

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21. The exception here is ideological motivation. To the extent that party leaders can use ideology to mobilize followers, they can provide fewer financial rents to supporters.

Saich of Harvard, showed that support for the central government has remained “extremely high” over the period 2002–05; this is not the case for local governments (“Good Things” 2006, p. 15). In his report to the 16th National Congress in November 2002, Jiang Zemin insisted, “If we do not crack down on corruption, the flesh-and-blood ties between the party and the people will suffer a lot and the party will be in danger of losing its ruling position, or possibly heading for self-destruction” (Yang 2004, p. 257).

In principle, the leadership should be able to clamp down on corruption and nonperformance by local cadres. In fact, the government increased its prosecution of local corruption, targeting especially senior cadres in province, prefecture, and county governments and demonstrating its intent to stifle local officials who shirk their duties or collect illicit rents at the expense of the party’s ability to deliver growth. The share of party members disciplined who were senior cadres was three times higher in 2000 as in 1993. Every year between 1995 and 2000, from 4,000 to 6,000 senior cadres at the province, prefecture, or county levels were punished by the disciplinary inspection committee (DIC) system. Economic offenses, including corruption, were 22 percent of the cases that province-level DICs filed in 1987, but 48 percent of the cases filed in 1997; major cases—those involving more than 10,000 yuan—increased from 6 percent to more than 30 percent in 2000. Of those offenders subject to disciplinary action, 25 percent were expelled from the party, 69 percent were subjected to milder party sanctions, and 6 percent were referred to the judiciary (Wedeman 2004).

The government does not have a free hand here, however. Cadre loyalty rests on the transparency with which cadres are evaluated. Transparency is easier to sustain when the goals are few and easily documented. When they are many and hard to measure, as is the case in battling corruption, the aggressive prosecution of corruption creates a risk of leadership being perceived as arbitrary by cadres. For example, the leadership still places significant weight on economic growth and job creation. Whereas social peace and environmental improvement enter into cadre evaluation schemes, economic growth is the most important factor. Without undermining the clarity of its promotion criteria processes to all cadres, the government cannot easily punish cadres who succeed with respect to growth but are less successful on other margins. As a consequence, anticorruption crackdowns have been sporadic, incomplete, and sometimes politically motivated (Yang 2004).

The costs of an ill-fought campaign against corruption—that is, the costs of alienating cadres—are significant. Connections to local cadres still provide

security for private investors, which would be lost if the credibility of leadership promises to cadres were to fall. Local cadres collect taxes, are responsible for law and order, and conduct other indispensable and hard-to-monitor tasks for the center. In addition, some of the troublesome rents earned by cadres bind them more closely to the party: cadres can earn these only if the party remains in power and only if they remain in the party.

To offset increased governance problems at the local level, the party has strengthened institutions to oversee local officials and offered expanded avenues of redress. These institutions all work from the top down and maintain control over cadre careers firmly in leadership hands. They also are more accessible to individuals with more resources and a bigger stake in the outcome: it is costly to pursue legal appeals, to travel to Beijing, and to gain access to the right officials. Bottom-up institutions for the evaluation of local cadres, particularly local elections, have been adopted more tentatively. These institutions have the advantage of vesting the responsibility for sanctioning cadre malfeasance in the hands of better-informed citizens. They do, however, have the severe disadvantage of detaching cadre career advancement from the decisions of the top party leadership.

Regardless of its specific evolution of governance in the 1990s, China is noteworthy for having strengthened institutions to improve governance and support broad-based growth. This distinguishes China from other countries without competitive elections, where reliance on cronyism has been more marked. For example, Mexico under Porfirio Díaz managed to use crony relationships (personal relationships between entrepreneurs and political leaders) to generate investment and growth. But the concentration of economic activity and the concentration of rewards among Díaz's cronies became a target for revolt, ultimately culminating in the Mexican Revolution in the early 1900s (Haber, Razo, and Maurer 2003).

## What the Future Holds

The experiences of China and India in the 1980s and 1990s underline, first, the importance of governance for growth and, second, the importance for good governance outcomes of institutional and political arrangements that enable government leaders to make credible promises to a large fraction of their citizenry. Both of these countries only started to grow after they improved their governance environments from low levels. Although governance

outcomes in both countries generally have been average, the two countries make clear the challenges of achieving even average outcomes, whether in countries with competitive elections or in countries without them. China has reached a delicate balance between satisfying party members and the population as a whole, while institutionalizing competition between leaders at the top of the party, that has eluded leaders in other countries. Governance in India has advanced despite the shadow of clientelist politics that diminish political incentives to maintain it. Both countries highlight the role of political checks and balances, whether between parties or branches of government, as in India, or between factions of a party, as in China.

The Chinese government's continued success in balancing popular and cadre demands has been key to achieving average governance outcomes. As wages rise and extraordinary profits from large markets fall, still better governance will be key to continued fast growth. This will require that the leadership succeed in advancing farther its agenda of institutionalizing intraparty constraints on opportunism by government officials. For example, local and national people's congresses have exercised increased influence over lawmaking, appointment ratification, budget and policy reviews, and the monitoring and supervision of agency's and officials' behavior (Whiting 2006). Evidence of their growing importance is the number of provincial party secretaries who chair provincial people's congresses—a number that has risen from 13 out of the 31 held in 1998 to 23 out of 31 in 2003 (Yang 2004). Future governance outcomes will depend on the extent to which these institutions can provide greater security to investors and citizens without jeopardizing the rewards to CPC cadres.

As the CPC shifts rents and control away from local cadres, it will need to provide them with exceptional rewards, above and beyond what they can achieve outside of the party. For example, to the extent that greater institutionalization requires more aggressive crackdowns on corruption or the subordination of local cadres to local courts of peoples' congresses, increased compensation may be needed to maintain cadre loyalty. Singapore has been very successful in using this model.

The stability of the cadre–leadership bargain rests as well on the entrenchment of the party. If the government experiences severe popularity shocks, or if social unrest increases more rapidly than the government can move in renegotiating the cadre–leadership contract to improve local governance, the price of cadre loyalty will rise, making governance more difficult to improve. China's cautious approach to major macroeconomic policy changes, such as

financial sector reform or exchange rate flotation, underlines its sensitivity to popularity shocks, such as those precipitated by adverse economic events or unexpected citizen dismay at particular aspects of government policy. The experience of 1989 demonstrates, as well, that reactions to popularity shocks have been directed at the domestic private sector: following the Tiananmen Square events that year, the official attitude toward private entrepreneurs deteriorated dramatically (Huang 2003). To the extent that growth depends more on private investment, as it does to a much greater extent in China now than it did in 1989, such a strategic shift would have more noticeable effects on growth and investment.

India is well endowed with external institutions of credibility—political checks and balances, for example, that do not depend on any particular party. These have been sufficient to yield average governance even in the face of economic shocks and significant political instability. Economic and political shocks are unlikely to pose a particular threat to governance and growth in India. In the face of political market imperfections, however, political checks and balances that are the key to moderately secure property rights in India are also a barrier to reform. The key issue for the future is improving governance and policy generally: greater opening of the economy to allow more entry, more innovation, and wider participation across all markets. Political market imperfections have reduced the electoral payoffs to pursuing this agenda. Cleavage-riven social settings, lack of education, isolation, and poverty itself conspire to make voters responsive primarily to clientelist promises and easily observed subsidies.

India, however, also has embarked on a vast program of decentralization, instituting local elections and putting greater revenue and public service responsibilities in the hands of local governments. It has experimented aggressively with institutions to bring the disadvantaged into politics, including reserved seats on local government councils for women and for lower castes. These new local governments hold the promise of overcoming some of the obstacles to improved governance—for example, by removing some of the information barriers that make electoral accountability difficult to generate at higher levels of government.

Finally, India and China provide hopeful signs of a virtuous circle, signs that growth can help propel governance reforms in countries able to achieve even a moderate level of governance to begin with. Wilkinson (2006b) has argued that growth in India seems to be creating a constituency less tolerant of clientelist political appeals. In China, growth in the 1990s gave the Com-

unist Party leadership sufficient confidence in the party's public approval that it risked opening up the economy to private investment and cracking down on excessive rent-seeking by party members in the 1990s. It has enabled the leadership to demand more of cadres than mere growth, where the benefits have been easy to share between party members and citizens more broadly; to embrace higher quality public services, reduced pollution, and more transparent local land management, where the sharing is more difficult.