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INFORMAL POLITICAL COALITIONS AND PRIVATE INVESTMENT IN CHINA

Abstract
This article attempts to estimate the effects of informal political coalitions on China's private investment. Theoretically, the party-state clients of China's supreme leaders are expected to have stronger incentives to foster economic growth. One way of doing so is to encourage private investment by reducing its political risks. Analysis of provincial-level panel data from 1993 to 2017 shows that personal connections—based on shared experience in the same work unit—between provincial leaders and the Chinese Communist Party's incumbent supreme leader significantly increase the growth rate of private investment. This suggests that informal institutional relations may assist the development of China's private economy by partially compensating for the weaknesses of formal rule-of-law institutions.

Keywords
personal connections, factions, private investment, informal institutions, corruption

INTRODUCTION

Fixed asset investment has long played an important role in promoting China's economic prosperity. Compared with state-owned investment, private investment is more conducive to efficient allocation of economic resources. Due to the importance attached to more market-oriented economic development since the time of Deng Xiaoping's leadership, the Chinese government should have strong incentives to promote private investment. Overall, conventional wisdom ascribes increasing private investment in China to the evolution of Weberian-style formal institutions (Fu 2000). These institutions maintain a balance between decentralization and centralization, through which the high-ups encourage their subordinates to fulfill the party's developmental goals (Miller 2008; Zhou 2018).

Nevertheless, informal institutions are of growing interest to China specialists. More recent studies prove that informal politics, particularly as seen in the factionalism of the Chinese Communist Party (CCP), help to explain a wide range of political and economic outcomes in China (Wang 2000; Shih 2004; Bai, Hsieh, and Song 2020; Jiang and Zhang 2020). This implies that factional ties may assist the CCP's local bureaucracies in their efforts to compete for economic resources and improve development performance. What are the effects of informal political coalitions on the development of private investment in China? Do personal connections with the Chinese Communist Party's supreme leaders bolster provincial private investment? This article hypothesizes that provincial leaders having personal connections with the CCP's incumbent general secretary should perform better in promoting the growth rate of overall private investment at the provincial level. Given weak institutions of private property protection, this patronage network may encourage provincial leading figures to facilitate private investment. It may also attract private investors by reducing the investors' political risks. Thus, informal institutions may not always be synonymous with inefficiency (Jiang 2018; Bai, Hsieh, and Song 2020). Instead, they may serve as a path for cooperation between provincial officials and private entrepreneurs under the CCP's system, which makes connected provinces more attractive destinations for private investors.

In order to test such effects, I design a quantitative analysis on a panel of China's province-level administrations using time-series, cross-sectional data across 31 provinces from 1993 to 2017. The empirical evidence is consistent with my assumption that provincial connections with the CCP's top leaders deliver better private investment performance. During the sample period, the growth rate of fixed-asset investment by private firms in the provinces having a close relationship with the top is about 15 percent higher than in other provinces. This result persists across several robustness checks. Empirical evidence also indicate that governors have more significant effects on private investment growth rate than provincial party secretaries. This suggests that provincial governments exert more influence than party agencies on regional economic policies.

The remainder of the article is organized as follows. The next section theorizes the effects of factional coalitions on private investment. The third section provides a research design. The fourth section summarizes the empirical results; and the final section offers conclusions.

PERSONAL CONNECTION AND PROVINCIAL PRIVATE INVESTMENT

Long-term, rapid economic development is typically based on formal institutions that provide rule of law and transparent, fair market competition (North 1982). Based on this argument, past researchers attribute China's remarkable growth in private investment to its institutional evolution since Deng's reform (Ang 2016). Some assert that China's self-sufficient and internally diversified economy facilitates regional autonomy and reform experiments (Qian and Xu 1993). Tax-sharing programs and state-owned enterprise reforms harden budget constraints and compel local governments to promote growth by encouraging private investment (Cull et al. 2017; Qian and Roland 2018). Additionally, other observers attach great importance to promotion tournaments (Zhou 2004; Li and Zhou 2005). Specifically, the leaders reward those who deliver economic prosperity by providing career promotion, which in turn promotes regional competition and gives local officials enduring incentives to promote growth. Under such pressure, local administrations may foster private sectors as a long-term strategy of increasing economic efficiency.

However, these formal institutions seem to be less reliable than scholars suppose. This is partly because China has a very strong and effective authoritarian regime. First, central government can change the rules at any time to shrink the pool available for sharing, which may weaken the institutional incentives of economic decentralization (Cai and Treisman 2006). Next, the CCP's leaders are inclined to appoint local officials based on personal favoritism, as illustrated by some recent empirical studies on the homophilic features of political career mobility paths, which leads to dysfunction of promotion tournament (Opper, Nee, and Brehm 2015). Thus, Chinese authoritarianism may undermine the credibility of formal institutions.

Under these conditions, property rights protection remains weak. The formal institutions underlying economic reform may not provide adequate incentives for private investment. However, such less-than-ideal institutions do not necessarily result in low private investment. China's bureaucracy has distinctive ways of regulating markets, which do not function exactly like traditional market-oriented, rule-of-law institutions. Instead, they provide private investors with additional inducements through factional coalitions.

Central leaders' consensus on marketization requires economic growth as a strategy to legitimize the regime. The development of the private economy tends to improve the efficiency of the national economy as a whole. Arguably, then, the party's top leadership seeks to implement policies favorable to private sector growth. For provincial government officials, economic decentralization enables them to have discretion in how the private-sector-oriented policies are enforced in their jurisdiction. They can regulate the use of natural resources, land tenure, labor welfare, investment projects, bank credit, and even environment protection (Huang 1996; Zhou 2008), which are important for the development of the private economy. Therefore, the provincial party secretaries and governors, as the top leaders of provincial governments, may have more tools than the party center to boost economic growth in their regions.

In this case, local officials face two choices. One is to seek career promotion by following the economic development priorities coming down from above. To this end, local governments should rationally allocate resources at hand to induce private investment. The other one is to feather their own nests by engaging in corruption and plundering the private economy. In this case, local officials may capitalize on the power at hand for rent-seeking. Because the party values political loyalty when selecting senior cadres, the officials having factional ties with the party's top leaders are more likely to be trusted and promoted. Therefore, the connected provincial leaders hold stronger incentives to bolster development through inducing private investment. They may help the private investors navigate the complexities of the bureaucratic regulatory system to gain higher returns on investment. By contrast, local officials without connections to the top have weaker promotion prospects and a correspondingly greater incentive to discourage private investment by engaging in corrupt regulatory activities.

Due to frequent transfer and promotion, the provincial leading figures often have short tenures in office of provincial secretaries and governors. Because of this, some may argue that the provincial officials do not have sufficient time to help private sector actors realize a higher return on long-term investments. Yet a few years spent with connected officials are better than nothing. Such officials can help to reduce the political risks of private investment in their jurisdictions. Moreover, those few years spent cooperating with the provincial leaders may provide time and an advantageous position to develop other local connections, among which the city-level leaders may provide more direct and near-term benefits (Landry 2008).

How exactly might private investors benefit from ties with well-connected local officials? First, political backing by connected officials decreases the short-term uncertainty

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of private investment. Empirical evidence shows that officials having factional ties with the party's top leaders are less likely to be purged in anti-corruption campaigns (Jiang and Xu 2015). Because of this, private investment can be better protected through sustained leadership stability and more limited, predictable corruption (Zhu and Zhang 2017a). More importantly, with the help of the connected officials, the private investors may escape from judicial sanctions if they are involved in such illegal business activities as rent-seeking or commercial bribery. Although immoral, these informal channels can help the development of private economies.

Second, political backing by connected officials sustains private investors' long-term confidence. The entrepreneurs who tend to curry favor with promising officials are often rewarded in business. For example, Li Shufu, a rising private entrepreneur, seemed to establish close relationships with the local bureaucracies of Zhejiang province in the 2000s. Li Shufu made a fortune after 2010, when the past leading figure of Zhejiang province, Xi Jinping, became the CCP's general secretary. Therefore, it is the prospect of future rewards that motivates present confidence and activities. Local bureaucracies having a close relationship with the top are more likely to be promoted in the next few years or at least to prolong their political influence (Jia, Kudamatsu, and Seim 2015). If these connected officials are promoted in the future, for example, by entering the Politburo Standing Committee or becoming the CCP's next generation supreme leader, they may enable private investors to gain even greater commercial benefits. In this way, well-connected bureaucracies have a better prospect of continuing the reciprocal exchange of benefits in the future, which makes connected private entrepreneurs believe that their investments are safer and may yield greater long-run returns.

Additionally, it is worth noting that not all the provincial leaders connected with the power center can reduce the political risks of private investors. Elite competition among CCP factions may stimulate intensive anti-corruption campaigns, which often occur during the transfer of power from one provincial party leader to the next (Zhu and Zhang 2017b). When outgoing leaders and their successors belong to competing factions, the successors tend to purge the subordinates of their predecessors. It hinders predictability of provincial leadership and may undermine the associated private entrepreneurs (An et al. 2016). Therefore, general cooperation is sometimes risky for private entrepreneurs, while cooperation with the faction of the party's incumbent supreme leader may offset such risks. This is because the party's supreme leaders rarely if ever become the target of anti-corruption campaigns. They may also preserve their political influence on personnel arrangements after retiring, which may help to protect their old subordinates from political purges.

Based on these considerations, I contend that provinces led by those with connections to the supreme leader are more attractive to private investors. In addition to relying on market competition, China's private investors are always eager to seek and exploit the more reliable patronage networks between local officials and the top. These local factions are often related with the CCP's incumbent supreme leader, the general secretary. This reasoning supports the following hypothesis:

> *Hypothesis: Provincial private investment is higher where provincial leaders have personal connections with the CCP's incumbent supreme leader.*

RESEARCH DESIGN

PROVINCIAL PRIVATE INVESTMENT

Provincial private investment is the dependent variable. The Chinese government has dominance in almost all investment projects. Through national economic plans, governmental scrutiny and approval are required for any fixed-asset investment above a fairly low threshold (Haggard and Huang 2008). Nevertheless, private investors seem to be more sensitive to the factions of provincial leadership than others. In addition to their benefit-seeking motivations and flexibility in decision-making, private sectors are disadvantaged in ideology and politics and thus have an incentive to seek political backing. In contrast, state-owned enterprises (SOEs) already have built-in patrons (Chen et al. 2011). It is costly for SOEs to curry favor with new influential leaders by shifting their investments, because it may offend their old patrons and thus undermine the credibility of the established system of mutual benefits. Therefore, the inflow of private investment may be affected by investors' assessments of changes in the local political environment, whereas SOEs may be more constrained and derive less benefit from seeking new patrons. Based on these arguments, I take the annual growth rate of fixed asset investment by de jure private and individual firms as the proxy for the provincial private investment growth rate. I expect that the provincial leaders' connections with the top may increase the private investment growth rate.

MEASURING FACTIONAL TIES WITH THE CCP'S SUPREME LEADERS

Factional ties are the main independent variable. There are two commonly used approaches to trace personal ties among high-level officials. The explanatory approach uses open qualitative information to identify such ties, while the structural approach uses biographical data and quantitative analyses to code factions (Keller 2016). Through explanatory analyses, we find that, first, Jiang Zemin and Xi Jinping developed most of their factional networks within prefecture-level or even county-level bureaucracies when they were in office as provincial party secretary and governor in Shanghai, Zhejiang, and Fujian; second, Hu Jintao cultivated his faction when he served as the leading figure of the Communist Youth League. It seems quite likely that domestic private investors would be aware of such personal connections—more so, probably, than would foreign investors. In addition, Meyer, Shih, and Lee (2016) derived a series of structural approaches to measure factional ties. Combining the two approaches, I define a provincial leader P as a factional member of the CCP's incumbent general secretary G if and only if all of the following conditions are met:

1. G served as the head of a ministerial or province-level unit, including minister, provincial party secretary or governor.
2. While G was working in the unit, P was transferred into G's work unit or out of G's work unit, except when P was transferred out to the Party Congress or the Chinese People's Political Consultative Conference.
3. Before or after such transfer, P and G have shared working experiences in that unit for over one year within four administrative steps of one another.

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Past research on provincial leadership ties tends to focus on the effects of provincial party secretaries because they are the most powerful leading figures in the provincial-level unit (Sheng 2007). But party secretaries are often focused on personnel management, while governors may have more direct responsibility for economic policy (An et al. 2016). Thus, the governors should be taken into consideration for their potential influence on private investment growth. In order to combine the two, I coded the provincial independent variable value as 1 if the factional variable value of either the party secretary or the governor was 1, and 0 otherwise.

CONTROL VARIABLES

To isolate the confounding effects of provincial economic performance from the key factional effects, I introduced a vector of economic control variables capturing provincial economic conditions. They are *GDP* (annual provincial GDP value), *GDP growth* (annual provincial GDP growth rate value), *Per Capital GDP* (annual provincial GDP per capita), *Manufacturing/GDP*, and *Service/GDP* (provincial manufacturing and service industries added values as a percentage of provincial GDP). To isolate the confounding effects of certain key characteristics on leader competence and policy preferences, I include the *Age*, college *Education*, and *Tenure* length of the provincial leaders. I also control for *CYL*, career experiences in the Communist Youth League, and *EXP*, career experiences in some prosperous provinces (Beijing, Tianjin, Shanghai, Jiangsu, Zhejiang, Fujian, and Guangdong).

DATA SOURCES

The data for this study come from several sources. The economic statistics were from the National Bureau of Statistics of China (NBS) website and the annually published China Statistical Yearbooks. I changed the current economic statistics to the constant value of the year 1997 because the data of Chongqing begin in that year. The biographical information was manually collected from Jiang's (2018) Chinese political elite database.

BASELINE SPECIFICATIONS

The hypothesis above presumes that the effects of personal connections to supreme leaders on private investment do not change with regions and time. In this case, a two-way fixed-effects regression makes it possible to control for unobservable heterogeneity across provinces and years. The model equation takes the following form:

$$\textit{Private Investment Growth}_{p,\ t+1} = \alpha_0 + \alpha_1 \textit{Personal Connection}_{p,\ t} + \alpha_2 Z_{p,\ t} + \gamma_t + \eta_p + \varepsilon_{p,\ t}$$

where *Private Investment Growth*$_{p,\ t+1}$ indicates the growth rate of private investment in province p at time t+1. I set the dependent variable at t+1 to mitigate time lag and reverse effects. *Personal Connection*$_{p,t}$ reflects affiliation of the provincial leaders with the currently ruling supreme leader at time t. Z is the vector of controls, including provincial

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economic attributes and provincial leaders' demographic characteristics. Time-related terms γ_t are included to capture omitted country-wide economic and policy shocks. Province dummies η_p capture time-invariant heterogeneity among different provinces. To avoid correlation of the residuals with the province-level clusters, I applied clustered standard errors to estimate the significance of the coefficients.

EMPIRICAL RESULTS

Table 1 presents the effects of personal ties on the province-level private investment growth rate from 1993 to 2017. Model 1 show the most parsimonious results without control variables. Model 2 and Model 3 add the economic attributes and demographic characteristics respectively. Model 4 includes all of the variables in my baseline specification. They provide remarkably similar results. Personal connections with the CCP's incumbent supreme leader, whether held by the province party secretaries or the province governors, produce positive and statistically significant effects on the growth of private investment. Model 4 estimates that, all else equal, the growth rate of fixed-asset investment by private firms in the provinces having a close relationship with the top is about 15.0% higher than in other provinces. This is a considerable performance premium. The private investment for each province in this study is 171.7 billion yuan (24.2 billion US dollars) on average. Every year, a personal connection with the top provides an additional 25.8 billion yuan (3.6 billion US dollars) of private investment.

As robustness checks, I use several procedures to modify my models. First, I apply alternative coding strategies for age and tenure controls by designating age dummies for over 65 years old (less than or equal to 65 years old being the reference group) and tenure length dummies for one year, one to three years, and three to five years (more than five years being the reference group). Second, I use alternative time-related

TABLE 1 Baseline Models

Dependent Variable	(1) Private Investment Growth (t+1)	(2) Private Investment Growth (t+1)	(3) Private Investment Growth (t+1)	(4) Private Investment Growth (t+1)
Personal Connection	0.167***	0.156***	0.156**	0.150***
	(0.061)	(0.046)	(0.061)	(0.047)
Constant	0.079	−0.480*	0.181	−0.326
	(0.054)	(0.258)	(0.280)	(0.314)
Economic Attributes	NO	YES	NO	YES
Demographic Characteristics	NO	NO	YES	YES
Province Fixed-effects	YES	YES	YES	YES
Year Fixed-effects	YES	YES	YES	YES
Number of Provinces	31	31	31	31
Number of Observations	680	680	680	680
R-squared	0.579	0.587	0.578	0.583

Note: Independent variables are one year lagged. Robust standard errors clustered at province level
*** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$

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trend terms to replace the year fixed-effects. They are *Hu Era* from 2002 to 2012 and *Xi Era* from 2013 to 2017. Third, I adopt the Arellano-Bond Generalized Methods of Moments (GMM) procedure to estimate the coefficients (Arellano and Bond 1991). Fourth, I follow Meyer, Shih, and Lee's (2016) broad tie measurement to assess whether a provincial leader is connected with the CCP's general secretary. Here, two officials sharing a native place and institutions of higher education are also coded as factional allies. In Table 2, Models 1–4 exhibit all these empirical results, which are consistent with the main results in Table 1. I also regress the effects of provincial party secretaries and governors in Model 5. It shows that, while the factions of both party secretaries and governors have some positive effects on private investment, the effects of governors are much more significant than those of party secretaries. Overall, my hypothesis is strongly supported.

CONCLUSIONS

This article discusses the relationship between the CCP's patronage networks and the growth rate of provincial private investment. Based on a quantitative research design, I find that the provincial leaders' personal connections with the CCP's incumbent general secretary significantly increase the growth rate of private investment. This might happen through several channels, all of which can be outlined as areas for further research. First, due to career promotion incentives, the cronies of the supreme leaders may have stronger incentives to promote economic development by fostering the private economy. Second, cooperation with the connected provincial leaders may foster private investment by reducing private sector political risks. If these causal mechanisms do exist, future research should investigate in detail the specific favorable treatments and privileges that the connected provincial leaders provide for private investors. Case studies may offer details regarding these open or clandestine transactions, while data analyses may show the extent to which these additional benefits, along with the reduced political risks, stimulate private investment. In addition, firm-level analyses may help to decipher how the factional ties interact with other individual characteristics to affect private sector investment behavior.

China's market-oriented reform is not a matter of expediency, but a long-term strategy for the survival of the CCP. Due to the elites' consensus on marketization, the CCP's economic reform intentions have been coherent since at least the mid-1990s. However, because the party is not willing to fundamentally transform the authoritarian regime, its efforts to establish market-oriented, rule-of-law institutions are greatly constrained. Thus, the institutions underlying the development of the private economy are still weak. Nevertheless, informal institutions seem to provide a sub-optimal alternative for privatization reform (Dickson 2008).

Under these conditions, the implications of the informal institutions for the broader system are of growing interest to scholars. More recent studies disagree on whether political connections affect corporate investment efficiency and profitability of private firms. Some of them find that political connections help to protect private firm equity values. This is because seeking new and strong political connections may enhance private sectors' relatively weak position, given China's weak legal infrastructure and discretionary, preferential treatments and policies (Wang et al. 2018), as compared to SOEs (Chen

TABLE 2 Robustness Checks

	(1) Alternative Age and Tenure Control	(2) Alternative Time-related Trend Control	(3) GMM Regression	(4) Broader Personal Connection	(5) Separate Personal Connection
Dependent Variable	Private Investment Growth (t+1)	Private Investment Growth (t+1)	Private Investment Growth (t+1)	Private Investment Growth (t+1)	Private Investment Growth (t+1)
Personal Connection	0.148***	0.137***	0.170***		
	(0.046)	(0.030)	(0.066)		
Personal Connection (Broad)				0.056**	
				(0.027)	
Personal Connection (Sec)					0.066
					(0.061)
Personal Connection (Gov)					0.166**
					(0.076)
Hu Era (2003<=year<=2012)		0.006			
		(0.039)			
Xi Era (2013<=year<=2017)		−0.421***			
		(0.061)			
Constant	−0.492	−0.788**		−0.313	−0.230
	(0.299)	(0.347)		(0.310)	(0.308)
Economic Attributes	YES	YES	YES	YES	YES
Demographic Characteristics	YES	YES	YES	YES	YES
Province Fixed-effects	YES	YES	YES	YES	YES
Year Fixed-effects	YES	NO	YES	YES	YES
Number of Provinces	31	31	31	31	31
Number of Observations	680	680	558	680	680
R-squared	0.584	0.256		0.577	0.584

Note: Independent variables are lagged one year. Robust standard errors clustered at the province level are reported in parentheses.
*** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$

et al. 2011). However, the uncertainty of political turnover may reduce investment and profitability of private firms (An et al. 2016). The results of this study offer some additional support for the hypothesis that, in reform-era China, informal institutions may provide a partial, sub-optimal substitute for traditional rule-of-law institutions.

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SUPPLEMENTARY MATERIAL

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CONFLICTS OF INTEREST

The author declares none.

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