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A view from behavioral political economy on China's institutional change ☆

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ABSTRACT

A behavioral political economy framework is built on the basis of prospect theory to explain the induced and imposed institutional changes during China's market reform, giving special attention to the integrated effects of economic and political institutions. According to prospect theory, how rulers frame their decisions — in the prospects of gains or losses, influences how much risk they will take. China's market reform has been largely framed in the prospects of economic gains, for which the continuously growing private sector is the driving force. China's central government adopts a growth-oriented incremental reform that coincides with the prediction of prospect theory.

1. Introduction

There have been numerous studies of China's institutional changes since 1978, but few, if any, provide a view from a behavioral political economy framework. This study attempts to address this deficiency in the literature. This analysis is based on a behavioral political economy framework that integrates behavioral economics with political economy.

First and foremost, this research distinguishes China's induced institutional changes from its imposed institutional changes. By definition:

"There are two types of institutional changes: induced and imposed. An *induced* institutional change refers to a modification or replacement of an existing institutional arrangement or the emergence of a new institutional arrangement that is voluntarily initiated, organized, and executed by an individual or a group of individuals in response to profitable opportunities. An *imposed* change, in contrast, is introduced and executed by governmental orders or laws." (Lin, 1989: P. 13)

The topic of institutional change in developing countries has been widely discussed in the economics literature. However, "more often these institutions are treated as a black box, and there is little effort to understand why these institutions vary across countries (Acemoglu, 2003: P.7)." By and large, researchers pay little attention to the forces behind institutional changes. In

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particular, when researchers discuss the market reforms in China, most studies (Fewsmith, 2001; Lin, Cai, & Li, 1993, 2003) simply build on the assumption that China's central government is *the* decision maker of institutional changes, and that it chooses the institutions it will support that it believes most likely to maximize the total surplus of the society. This belief is appropriate to explain the consequences of an institutional change, but it fails to analyze whether this institutional change is (1) simply imposed by the central government (i.e., "top-down"), or (2) initially induced by an individual or a group of individuals and then adopted by the central government (i.e., "bottom up"). Empirical evidence from China's market reforms suggests that there are some imposed institutional changes (e.g., the formation of special economic zones), and also some induced institutional changes (e.g., a surge of private business). This study will place emphasis on the induced institutional changes, because they originate from individuals and groups of individuals that are actually the driving force of the market economy.

Second, this study reviews China's institutional changes from a political economy perspective, a topic largely underdeveloped in the extant literature. From a political economy perspective, the state is neither a "non-actor" in Adam Smith's (1776) world nor a Lockeian (Locke, 1969) "nexus of cooperation" instead, the state is the "grabbing hand" (Buchanan & Tullock, 1962; Shleifer & Vishney, 1998). Economic and political institutions are not independent of each other because political institutions affect and allocate political power, while political power interacts with economic institutions (Acemoglu, 2003).

In an authoritarian regime like China, an induced institutional change from the private sector certainly helps improve economic performance that thereby benefits the central government, but it also results in negative political values that challenge the traditional socialist dogmas favoring public enterprises. Therefore, a political economy perspective examines the integrated effect of economic and political institutions, rather than treating them separately. This perspective was not addressed in depth until this study and a recent literature review by Xu (2011).

The final element of this study applies behavioral economics to examine institutional changes in China. The institutional change literature basically follows the neoclassical tradition that relies on expected utility theory (EUT, hereafter). EUT states that a decision maker of institutional changes chooses among risky or uncertain prospects by comparing the prospects' expected utility values, that is, the weighted sums are obtained by adding the utility values of outcomes multiplied by their respective probabilities (Mongin, 1997). In other words, how we frame information should not affect our judgment, and a rational agent has a consistent risk preference. In addition, EUT assumes that the agent clearly knows the probabilities of all possible outcomes. However, the real question is, "What if the agent does not follow what EUT predicts?" Since 1978 (the year when the open-market reform started), China's central government has appeared mostly risk-averse during market reforms, but occasionally it has exhibited risk-seeking behaviors (1978, 1989, and 1992). Hence, EUT cannot best delineate the story of China's market reform.

Some recent studies (e.g.,Weyland, 1996, 1998; Vis & van Kersbergen, 2007) draw upon behavioral economics to explore institutional changes. Those researchers argue that decision makers systematically violate the axioms of expected utility theory (Kahneman, Slovic, & Tversky, 1982). According to behavioral economics on the basis of prospect theory (PT, hereafter) (Kahneman & Tversky, 1979), how we frame information may influence our judgment, that is, whether information is framed in the prospects of gains or losses and whether the prospects are certain or uncertain. People lean toward risk-seeking choices when facing prospective losses, but opt for risk-aversion when anticipating gains. In addition, PT only requires probabilities to be *sets* (such as likely or unlikely prospects), which complies with China's evolving market reform that is rife with uncertainties. Therefore, it seems that PT, in contrast to EUT, provides a different, perhaps better, explanation of the evolution of China's institutional changes.

Scholars have adopted two approaches (PT or EUT), categorized two types of institutional changes (induced or imposed), and classified two kinds of institutional structures (economic or political). These theories, institutional changes, and structures yield eight possibilities in the cross-product of models:

$$\begin{matrix}\{Prospect\}\\ \{Expect\ Utility\}\end{matrix}\ Theory \times \begin{matrix}\{Induced\}\\ \{Imposed\}\end{matrix}\ Institutional\ Changes \times \begin{matrix}\{Economic\}\\ \{Political\}\end{matrix}\ Institutions$$

Lin and his colleagues (e.g., Lin, 1989; Lin et al., 1993, 2003) have contributed a series of studies on institutional changes of China, which is arguably the prevailing theory on the subject. The specification of their model is:

$$\{Expected\ Utility\ Theory\} \times \{Imposed\ Institutional\ Changes\} \times \{Economic\ Institutions\}.$$

In addition, most existing studies (e.g., Weyland, 1996, 1998) that apply PT to institutional changes belong to the sub-field of either comparative politics or international relations. These studies do not take into account the combined effects of economic and political institutions on institutional changes. The specification of their model is:

$$\{Prospect\ Theory\} \times \begin{matrix}\{Induced\}\\ \{Imposed\}\end{matrix}\ Institutional\ Changes \times \begin{matrix}\{Economic\}\\ \{Political\}\end{matrix}\ Institutions.$$

During the past three decades of market reform, it appears that China's central government has experienced economic gains, but occasionally, has had deep economic or political losses. In addition, China's "market miracle" is characterized with induced institutional changes from the private sector. In this behavioral political economy framework, this author proposes that:

(1) Induced institutional changes are associated with more certain economic gains: individuals or groups of individuals induce institutional changes in order to maximize profits (Lin, 1989); and the central government only adopts those induced