Available online at www.sciencedirect.com
ScienceDirect
China Economic Review 19 (2008) 308 – 319
China Economic Review

Bureaucratic integration and regional specialization in China☆

Chong-En BAI [a], Zhigang TAO [b,*], Yueting Sarah TONG [c]

[a] School of Economics & Management, Tsinghua University, Beijing, 100084, China
[b] School of Business, University of Hong Kong, Pokfulam Road, Hong Kong
[c] Department of Economics & East Asian Institute, National University of Singapore, 1 Arts Link, 117570 Singapore

Received 24 October 2006; accepted 20 November 2006

Abstract

Fiscal decentralization introduced as part of China's economic reform since 1979 has unleashed strong incentives for China's local governments to pursue economic development, but the same incentives have also led to local protectionist policies inhibiting the process of regional specialization. This paper focuses on the constraints or freedom with which local governments can implement their protectionist policies. Using a panel data of 29 China's regions over the time period of 1985–1997, we find that China's political system of bureaucratic integration (specifically, concurrent appointment of local government officials in the central government) imposes constraints on the local governments from practicing protectionism. We also find that the effectiveness of local protectionist policies is limited by market competition, specifically, competition from foreign-invested firms operating in China and foreign imports. Our results on the role of local protectionism remain robust to controls for the regional variations in the size of the economy and the stage of economic development.

JEL classification: R12; H7; F1
Keywords: Local protectionism; Regional specialization; Bureaucratic integration; Foreign competition; Stage of development

1. Introduction

One of the earliest and most influential ideas in economics is that of the division of labor and specialization (Smith, 1776). With uninhibited trade of goods and services across regions and countries, there are gains from the division of labor, which subsequently leads to regional and international specialization of economic activities. The benefits of specialization have been well articulated in the literature of international economics and regional studies. The challenge is to elucidate the forces for such specialization.

Earlier studies focused on the differences in resource endowment across regions or countries to account for patterns of regional or international specialization (Ohlin, 1935). In the 1980s and 1990s, research emphasis was shifted toward the possibility of increasing returns to scale and its implications. A region or country with significant demand for

☆ Financial support from China National Natural Science Fund (041303021), Hong Kong Institute of Economics and Business Strategy, The University of Hong Kong and National University of Singapore is greatly acknowledged.
* Corresponding author. Tel.: +852 2857 8223; fax: +852 2858 5614.
E-mail address: ztao@hku.hk (Z. Tao).

1043-951X/$ - see front matter
doi:10.1016/j.chieco.2006.11.005

certain goods or services in its own locality or neighboring ones could overcome the fixed costs for producing those goods or services, and subsequently enjoy concentrated production with the increasing return to scale (Davis & Weinstein, 1999, 2003). Meanwhile, the theory of external economies, the history of which dates back to at least Marshall (1920), was revived with the success stories of U.S. clusters such as Silicon Valley in information technology and Hollywood in entertainment businesses (Krugman, 1991).

Recent studies have uncovered more complicated patterns of specialization. Using cross-country data, Imbs and Wacziarg (2003) find that as per capita income increases, countries first have sectoral diversification and then shift to concentrated production. Specifically, sectoral diversification may arise when the diverse demand associated with increasing per capita income cannot be met by imports from other regions or countries due to trading costs. Meanwhile, without effective risk-sharing arrangements, regions would be prone to industry-specific shocks if they were to specialize in only a few industries (Kalemli-Ozcan, Sorensen, & Yosha, 2003).

All of the above market forces for regional and international specialization, however, could work only if the relevant regional and national governments refrain from market intervention in the uninhibited trade of goods and services, the freedom to locate production activities, and the establishment of inter-regional or international risk sharing arrangements. Indeed, as long as the gains from the division of labor and specialization are difficult to re-distribute across regions and countries, the primary concern of both regional and national governments is the financial performance of firms and industries under their jurisdictions. The regional and national governments may thus have incentives to protect their firms and industries by erecting barriers for inter-regional and international trade. Protests by people from all over the world at virtually every World Trade Organization/International Monetary Fund meeting are a vivid reminder of the pressures and incentive for local protectionism. The focus of this paper is to empirically examine the impacts of local protectionism on regional specialization using a panel data of 29 China's regions over the period of 1985 to 1997.

The case of China offers an ideal setting in which the impacts of local protectionism against regional specialization versus those of the market forces for regional specialization can be jointly assessed. Until 1979, the Chinese economy was a centrally planned economy, with virtually every aspect of the economy carried out according to plans and material incentives completely suppressed. Regional governments collected all the surpluses from firms under their jurisdictions and handed them over to the central government. The central government then allocated budgets to the regional governments, but there was no obvious correlation between the surpluses handed over and the budgets allocated back. Under this system, there was no incentive for firms and industries to perform and nor was there any incentive for the regional governments to protect local firms or industries. However, the situation has changed significantly, generally due to the economic reform initiated in 1979 and specifically as a result of the fiscal decentralization policy introduced by the reform. Using aggregated data, Young (2000) finds increasing similarity in the structure of economic activities among China's regions, implying a rise of local protectionism. On the other hand, using input–output tables in 1987 and 1992, Naughton (2003) finds evidence consistent with increasing regional specialization. Using China's industry data from 1985 to 1997, Bai, Du, Tao and Tong (2004) show the degree of industrial agglomeration first decreased and then increased during the sample period, and find evidence suggesting that both the market forces for specialization and forces of local protectionism against specialization were at play.[1]

Direct and comparable measures for the extent of local protectionism across regions are difficult to establish. In this paper, we use some indirect measures related to the constraints or freedom with which the local governments can implement protectionist policies. Our key measure is developed based on some salient features of China's political system that places constraints on regional leaders from practicing local protectionism. All of China's regional leaders (administrative and party) are appointed by the central government in consultation with the opinions of the local people. Some of the regional leaders may have concurrent appointments in the central government (say, membership in the central politburo without specific portfolios), while others do not. Given that regional specialization is good for the national economy but not necessarily for the local economy, regional leaders with concurrent appointments in the central government ("higher bureaucratic integration", see Huang, 1996) should care more about regional specialization and practice less local protectionism than those who do not have the concurrent appointments. In addition to the measure of bureaucratic integration, we also have the ratio of local government expenditure to its GDP, which measures the ability of local governments to practice local protectionism and their propensity for obtaining

[1] For more studies on China's local protectionism, see Poncet (2003), Li, Hou, Liu, and Chen (2004), Gong, Xu, and Tan (2005), Li, Liu, and Chen (2005), and Fan and Wei (2006).