



# Economic integration in China: Politics and culture



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## ABSTRACT

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The aim of the paper is to explicitly disentangle the role of political and cultural boundaries as factors of fragmentation of economies within large countries. On the one hand, local protectionism plays a substantial role in many federations and decentralized states. On the other hand, if the country exhibits high level of cultural heterogeneity, it may also contribute to the economic fragmentation; however, this topic has received significantly less attention in the literature. This paper looks at the case of China and proxies the cultural heterogeneity by the heterogeneity of local dialects. It shows that the effect of politics clearly dominates that of culture: while provincial borders seem to have a strong influence disrupting economic ties, economic linkages across provinces, even if the regions fall into the same linguistic zone, are rather weak and, on the contrary, linguistic differences within provinces do not prevent economic integration. For some language zones we do, however, find a stronger effect on economic integration. *Journal of Comparative Economics* 42 (2) (2014) 470–492. Frankfurt School of Finance and Management, Germany; Russian Academy of Sciences, Russia.

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## 1. Introduction

The problem of how to create and maintain the conditions for the integration of domestic economies has played a substantial role for many federations and decentralized countries. The existence of border effects in intra-national trade has been broadly acknowledged in the literature (Froot et al., 1995; Wolf, 2000); some studies find them to be larger than the border effect in international trade (Coughlin and Novy, 2009). An important reason for the existence of these local barriers often hypothesized in the literature are the interventions of sub-national governments effectively restricting trade between states, or ‘local protectionism’, which has been discussed for both developed and developing states, like Russia (Sonin, 2010), Kazakhstan (Jones Luong, 2004), India (Das-Gupta, 2006), Canada (Berdahl, 2013) or Switzerland (Feld, 2004).

However, political fragmentation is not the only factor potentially causing the fragmentation of economies. Another important issue can be the impact of cultural diversity (Guiso et al., 2009) and affinity (Disdier and Mayer, 2007). Culture is obviously an important factor of economic connections, particularly if impersonal exchange is less developed and trade and capital movements require significant levels of interpersonal trust, which is of course easier to generate in culturally homogenous communities (Powell and Stringham, 2009). While culture is notoriously difficult to measure, one possible

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approach to capture the specifics of culture is to look at the linguistic differences (Lazear, 1999). The role of language as a barrier for international trade has been well recognized in the literature.<sup>1</sup> Though the simplest possible explanation of why language should matter is the presence of transaction costs, an even more important issue may be that linguistic differences could serve as proxies for culture and identity (Licht et al., 2007). Overall, importance of culture and language as obstacles for international trade and migration is commonly accepted; it is therefore reasonable to assume that cultural heterogeneity within a country is likely to contribute to the economic fragmentation as well.

Unfortunately, identification of the impact of culture on economic integration within federations is a difficult task (much more so than for international trade). Sometimes cultural and political borders within federations coincide. For example, in Russia, in Ethiopia and to some extent in India and Canada (Quebec) federalism was explicitly used as instrument of accommodating cultural diversity within a nation; in Germany, even in spite of re-drawing borders after World War 2, the current structure of federalism is still strongly influenced by the borders of the old German states, and therefore again overlaps with possible local identities. Then it is very hard to explicitly separate different effects. In other federations (like the US) the very problem of ‘traditional’ cultural zones different from the current state borders is less relevant. The aim of this paper is to compare the impact of cultural and political factors on economic fragmentation in a country where it is possible identifying distinct political and cultural territories which only partially coincide – China.

China is a promising field of study for the following reasons. Firstly, China is a vast country that consists of political sub-units, the provinces, most of which have the size of larger European states, thus providing ample space for the emergence of regional economies.<sup>2</sup> However, China is not a federation in the constitutional sense, so that in principle, the institutional setting of market transactions is homogenous across China (e.g. the contract law), although there exists a substantial autonomy of sub-national governments in terms of policy-making and fiscal matters (Montinola et al., 1995; Blanchard and Shleifer, 2001). Secondly, China has undergone a process of marketization during the past three decades, with the vast majority of prices being determined by market forces since the mid-1990s. Therefore, we might suppose that strong forces of integration reigned over the Chinese economy recently. Thirdly, although apart from its Western regions, China is mostly homogenous in terms of ethnic and religious divisions, there is a strong role of local cultural variation, which is also present in narratives about economic development and business cultures (such as comparing the Cantonese, Shanghainese and Fukienese). The attention to culture as a factor explaining Chinese business practices and economic development is almost commonplace in modern economics (see Redding, 1996; Herrmann-Pillath, 2009a; Greif and Tabellini, 2010); therefore it is reasonable to hypothesize that the cultural factors are likely to affect the shapes of economic integration in China as well.

In order to compare the role of the cultural and political factors for Chinese economic integration, we apply a dataset from the prefectural-level statistics (prefectures are the next-lower administrative level beyond the provinces). On the one hand, we compare economic integration between prefectures within a single province and across provincial borders, thus establishing the effect of political boundaries on the economic fragmentation. On the other hand, we group prefectures into ‘cultural zones’, which do not coincide with the provincial borders and which we derive looking at the variation of local dialects – a measure very important for study of the local identities in China, but, to our knowledge, never before used in the empirical literature in economics. Thus we can compare the level of economic integration within and across the borders of the cultural zones and, using the imperfect overlap of administrative provinces and cultural zones, identify the distinctive effect of culture and of politics on economic integration in China. We look at probably the most general measure of integration, concentrating on spillovers in economic growth: if a geographical area is integrated economically, there should be spatial interdependencies between economic growth in the different regions. This co-movement can be caused not only by market forces, but also by other forms of linkages, established, for example, through large-scale government projects or centralized redistribution – thus, we have to refer to ‘economic’, and not to ‘market’ integration in our study. Still, we attempt to differentiate the effect of borders leading to economic fragmentation from two competing explanations: the presence of unobserved province-specific factors (for instance, common policies implemented at the provincial level) and the mutual learning across prefectural leaderships, resulting into homogenization of prefecture-level policies.

This paper is related to several branches of the literature. First, as discussed, it contributes to the studies of local protectionism and intra-national economic fragmentation (Berkowitz and DeJong, 1999, 2001, 2003, 2005; Hillberry and Hummels, 2003; Ceglowski, 2003; Glushchenko, 2003; Daumal and Zignago, 2010; Requena and Llano, 2010) by looking at a dimension, which to our knowledge has been rarely captured in the existing literature, yet alone disentangled from the political dimension. Second, in particular, it is relevant for the rather large literature on the economic fragmentation in China (Bai et al., 2004, 2008; Batisse and Poncet, 2004; Chow, 2003; Eberhardt et al., 2013; Fan and Wei, 2006; Lu and Tao, 2009; Poncet, 2003, 2005; Ritola, 2008; Young, 2000; World Bank, 1994, 2005; for the critical assessment of the literature see also Naughton, 2003 and Holz, 2009), which emerged about two decades ago and in some sense follows the older studies of the ‘cellularity’ of Chinese provinces in the pre-reform period (Donnithorne, 1972; Lyons, 1985). Most of the papers limit their attention to provincial data, although some recent contributions also looked at the sub-provincial data (e.g. prefectures and cities) (Keller and Shiue, 2007; Hering and Poncet, 2010; Tian et al., 2010; Ke, 2010); a number of papers investigate

<sup>1</sup> Anderson and van Wincoop (2004) estimate the language costs in international trade to have an effect equivalent to a 7% tax rate.

<sup>2</sup> The huge economic size of the provinces raises the question of the intra-provincial economic fragmentation, and this particular question has never been asked so far, to our knowledge, and also has been rarely done for other countries. An exception is Brakman et al. (2009); this paper applies a ‘two-level’ approach to estimating economic linkages between and within European nations, but its analysis is very different in terms of econometric technique from the approach presented in this paper.

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