
The Societal Cost of China's Rapid Economic Growth*

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Abstract

In China, political control is centralized and economic management is decentralized. This gives rise to a serious principal-agent problem, in which the agents are often better informed than the principal. China also has a semi-marketized economy involving much state intervention. This intervention serves both a political and an economic function. It enables the Communist Party to remain in political command and generates formidable patronage resources. It also provides the policy instruments, including incentive structures for officialdom, to maintain a "developmental state." The combination of economic decentralization and a semi-marketized economy creates a problem of weak accountability and a breeding ground for rent-seeking and corruption. For a quarter of a century China's leadership gave overwhelming priority to the objective of achieving rapid economic growth. This policy was viewed as providing political legitimacy and securing the best protection against social instability. It is argued that the leadership was able to solve the principal-agent problem in its pursuit of economic growth. By contrast, the solution to the principal-agent problem failed in other respects, giving rise to societal costs. Little attention was paid to the dramatic socioeconomic changes—including rising inequality and economic insecurity, environmental degradation, mass migration, rent seeking, and corruption—which accompanied economic growth and posed new challenges. It is argued that these changes help to explain the failure of life satisfaction scores to rise over the two decades from 1990–2010. They can also help to explain the rise in indicators of social instability over that period. It is to be hoped that the new leadership's current anti-corruption campaign, together with its declared policy intention to reduce state economic intervention and increase reliance on competitive markets, will strengthen deterrence and weaken opportunities for rent seeking and corruption. The paper carries the implication that China's economy cannot be well understood except through the lens of political economy.

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I. Introduction

This paper is deliberately pitched at a high level of generality. It draws together several of my publications of recent years to present a plausible account of a major challenge facing China. It combines China's economic growth, the socioeconomic changes that have accompanied that economic growth, the stagnation of subjective well-being, and the threat of social instability, which, taken together, reveal China's flawed governance.

Section 2 concerns China's economic growth and the "developmental state" objectives and mechanisms that contributed to the growth rate. Section 3 examines subjective well-being in China and its determinants, including the socioeconomic changes that affected it. Section 4 considers the various factors that contribute to social instability in China. Section 5 concludes and reflects.

2. Economic growth

When the reformers in China came to power in 1978, they recognized that the Communist Party (CCP) had lost political legitimacy. They tried to restore and solidify political legitimacy by instituting economic reforms and raising living standards. This interpretation of the motivation of the reform leadership is widely accepted, for instance, by Kelliher (1992), White (1993), Naughton (1995), and Xu (2011). The initial reforms were "reform without losers," but gradually vested interests were overcome and the reform coalition expanded. China became a "developmental state."

I define a developmental state as one in which government gives overriding policy priority to the objective of rapid economic growth and installs a set of institutions and incentives that promote that objective. This apposite and useful definition stands in contrast to early definitions that were expressed in terms of particular industrialization strategies—for instance, Johnson (1982), Amsden (1989), and Wade (1990), and more recently Lin (2009).

China's developmental state is based on a successful solution to the principal-agent problem that arises when political control is centralized and economic management is decentralized to the provinces, cities, and counties. China does not have a federal system (in which there are more principals and fewer agents) but one in which there is one principal and many agents. Despite fiscal decentralization, local governments are in many respects agents of the central government. Central government solves the principal-agent problem by creating incentives for state officials at all levels to pursue its own economic objectives. These objectives have primarily been the achievement of rapid economic growth.

The groups that stood to gain from the reforms had to be motivated and the groups that stood to lose had to be made ineffective. The reform leaders had to build up a reform coalition. They did so by developing a system of state appointments, promotions, and demotions; by granting local fiscal powers of revenue retention; and by increasing their powers of patronage. Let us consider each in turn.

The appointment system is an important lever by which the leadership controls and motivates officialdom at all rungs of the hierarchical ladder. It determines every state official's career path. Each level of government controls personnel at the level immediately below: central, provincial, city, county, and township governments.

Xu (2011) describes the system in detail. Evaluation is based on performance in achieving state objectives and targets. Each government negotiates with the subordinate government for performance targets. Officials sign target responsibility contracts with the superior government, and they are evaluated on the degree of fulfillment of their contracts. Performance criteria differ according to the level of government, being broader at the top. The most important criterion, however, has been the achievement of economic growth in the relevant jurisdiction. Common ranking criteria are the growth of local GDP and the attraction of foreign direct investment.

There is competition among local government officials at the same level. For instance, leaders of the top three ranked townships in a county are rewarded and those of the bottom three ranked townships are penalized. Competition among provincial leaders determines the selection process into the national leadership. Performance rankings are regularly published. Thus, officials in the bureaucratic hierarchy compete against each other. In many other countries—those that are more democratic or more federal—the spur to efficient government comes from below, through “exit” (mobility) or “voice” (elections or protests) (Hirschman 1970). In China, the spur comes mainly from above, through competition among personnel, which corresponds to economists' notions of “tournaments” or “yardstick competition.”

Because central government encourages regional experiments as a way of overcoming resistance to reform and reducing the risks of reform, officials have incentives to take reform initiatives. Thus, the performance criteria convert many bureaucrats into entrepreneurs, willing to take risks and experiment. Such initiatives include the promotion or financing of local investment projects and the overcoming of local institutional or resource bottlenecks.

There is considerable evidence that the personnel incentive system is effective. Maskin, Qian and Xu (2000), Chen, Li and Zhou (2005), and Li and Zhou (2005) each established

that the (differently measured) relative performance of province leaders influenced their chances of promotion to the national leadership. Li (2011) found that the upgrading of counties to city status was based on county growth rates and was part of the incentive structure to promote economic growth. Caldeira (2012) adduced evidence of strategic interaction among provinces and concluded that province leaders are most incentivized to raise those expenditures which are important for local economic growth.¹

There is need for qualification arising from the difficulty of ensuring accountability when the principal is less well informed than the agents. Promotion criteria are liable to be distorted. Jin, Qian, and Weingast (2005) provided evidence that factional connections enter into promotion decisions. It is also possible that personnel decisions are subject to political influence and position-buying. Performance measures, also, are liable to be inaccurate. Landry (2008) argued that high mobility from one post to another within the bureaucracy blunts cadre accountability. Zhou (2010) analyzed collusion among local governments and found that it could lead to self-interested goal displacement. Despite these imperfections, there is nevertheless general agreement in the literature that China's personnel policies do provide effective incentives for promoting the central government's growth objectives.

A second form of incentives is provided by the decentralization of fiscal responsibility and power. Early in the reform process local governments at all levels were granted rights to retain revenue, in particular "extra-budgetary" revenue (falling outside the state budget), thus encouraging them to promote economic development. They benefit from local development through the effect it has on their revenues and thus on their expenditures. Fiscal incentives and personnel incentives are separate but they overlap: Fiscal success can help to speed local growth and thus improve promotion prospects.

Fiscal decentralization grew in the reform period up to 1994, as the extra-budgetary revenue of local governments became increasingly important. There is evidence that fiscal decentralization contributed to local economic growth. Lin and Liu (2000) found that the growth of province per capita GDP increased sharply in response to an increase in the marginal tax retention ratio. The marginal tax retention ratio at the province level was high in the case of extra-budgetary revenue (Knight and Li 1999). Jin, Qian, and Weingast (2005) found that the marginal tax retention ratio of provincial governments was positively associated with faster development of the non-state sector. These studies are based on data extending only up to 1993, however.

¹ One study failed to confirm the promotion hypothesis. Shih, Adolph, and Liu (2012), examining party rank, found that the economic growth of a province had no effect on rank level or change. It is possible, however, that party rank is more influenced by factional ties and, in any case, the inclusion in the promotion equation of both province GDP growth and province revenue growth (the latter is found to have a positive effect) might well bias downwards the effect of GDP growth.

The major fiscal recentralization that was carried out in 1994—necessary to protect central government finances—blunted the fiscal incentives of local governments but did not eliminate them. Local officials retained much freedom over some sources of revenue and thus expenditure. Evidence that fiscal incentives have continued to operate since the fiscal recentralization is provided by changes in development strategies pursued by county and township governments. From 1992 onward, local governments were given greater control rights over revenue generated by local land sales; local governments could also retain their revenues derived from local enterprises. From 2002 onward, however, the central government appropriated 50 percent of the enterprise profit tax raised by local governments. The consequent switch in incentives redirected local government policies away from industrial development and the profits that this generated and towards urbanization through land sales and the capital gains that this generated (Kung, Xu, and Zhou 2013).

A third incentive mechanism derived from powers of patronage (Naughton 2008). In the early years, reform was assisted by decentralization of decision-making and a transfer of powers to local officials and state-owned enterprise (SOE) managers, thus producing patronage relations within the hierarchical system via “particularistic contracting.” The web of patronage enabled officials to obtain loyalty and support from subordinates in exchange for advantageous contracts. As market opportunities were created, access to the new sources of income could be made available through patronage. The allocation of loans from the state-owned banks was an important means of creating political clients. Patronage extended beyond the state sector because private businesses had to maintain good relations with government and party officials.

The greater local autonomy, which fiscal decentralization produced, eventually threatened to weaken the power of the center. The fiscal recentralization of 1994, by transferring more revenue to central government for allocation to local governments, strengthened central powers of control. Not only fiscal resources but also patronage resources were recentralized: The additional revenue could be directed in pursuit of central government objectives (Naughton 2008). In general terms, the powers of patronage stem from hierarchical control—the right to grant permissions or refusals—over much of the economy.

Again, there is need for qualification, which weakens, but does not negate, the argument. The same powers of patronage can give rise to rent seeking and corruption. Preferential access to funds, resources, and opportunities mainly affects how the growth of income and wealth is distributed. It also affects the rate of economic growth, however, insofar as less-efficient opportunities and investments are chosen. For instance, it is generally accepted that the banking system has favored state investment projects at the expense of the private sector and has done so increasingly in recent years (Herrala and Jia 2015), despite the evidence that the rate of return on investment in privately controlled industrial firms

has been higher than in the state-controlled industrial firms and that marginal private investment has contributed more to growth (Knight and Ding 2012).

The growth of China's GDP averaged a remarkable 10 percent per annum over three decades. The proximate determinants of China's outstanding growth performance have been intensively researched (e.g., Riedel, Jin, and Gao 2007; Brandt, Hsieh, and Zhu 2008; Knight and Ding 2012). Suffice to say here that rapid capital accumulation, conditional convergence from a low base, and drastic sectoral change has been found to be important. High physical capital investment (more than 40 percent of GDP in recent years) was crucial, both for its amount and for its productivity. It could explain 31 percent of the difference in the growth rates between China and other developing countries, and conditional convergence (involving capital stock catch-up) another 47 percent. Three forms of structural change were found to promote efficiency and growth: the transfer of labor out of agriculture, the expansion of trade, and the privatization of production (Brandt et al. 2008; Knight and Ding 2012). Thus, over the experienced range, the share of state ownership in investment and production was not important for the developmental state policies; indeed, the declining state sector share was good for growth.

How much has the structure of incentives that were described earlier contributed to the growth rate? It is not possible to incorporate a variable representing governance incentives into either cross-country or cross-province growth equations. Nevertheless, some of their effect might have been picked up by other explanatory variables such as capital accumulation. The highlighted importance of capital accumulation for China's growth raises a deeper, underlying, question: Why does China invest so much (Knight and Ding 2010)? The high rate of capital accumulation raises the danger that diminishing returns will set in and reduce its marginal product. The rate of return on capital stayed reasonably high, however, and profitability remained promising enough to maintain high investment. This was facilitated by rapid growth of total factor productivity, itself assisted by the economic reforms, and the ready supply of surplus labor that could be combined with the growing capital stock.

Entrepreneurial expectations of rapid economic growth were necessary for high investment. The developmental state was crucial here. Incentives were provided at all levels and in all parts of the state sector. Bureaucrats were rewarded for promoting investment, and business could take investment decisions with confidence that growth policies would be pursued. Neither funds nor saving held back investment. Enterprises that were owned or controlled by government had access to a ready supply of bank loans at low rates of interest, and the non-state enterprises that were not linked to government were sufficiently profitable to be able to rely on their own retained profits. Government took a long term, dynastic view of the distribution of inter-temporal consumption. The fact that investment—increasingly in high technology sectors and embodying new

technologies—was so high in turn accelerated the growth of total factor productivity. In these ways, the developmental state policies generated a virtuous circle of rapid growth (high confidence, high investment, high growth, and high confidence) and kept it going.

3. Socioeconomic change and subjective well-being

China's remarkable rate of growth since the start of economic reform is generally assumed to have raised the economic welfare of the Chinese people dramatically. This is regarded as self-evident from the facts that, in three decades, average real income per capita rose by more than five times, more than 300 million people were lifted out of dollar-a-day poverty, and China's "human development index" nearly doubled. For us to question whether economic growth has raised happiness (or subjective well-being, or life satisfaction) in China appears either absurd or disingenuous. Nonetheless, starting with the pioneering work of Easterlin (1974), economists have increasingly asked this question of advanced economies. It has been shown that in several advanced economies income per capita rose consistently over one or more decades and yet the mean subjective well-being score remained roughly constant. There is indeed something odd to be explained. Few such studies have yet been made for developing countries, probably owing to the lack of relevant time series data on subjective well-being. One would expect, however, that the happiness of people in poor countries is determined in a different way. For instance, it is arguable that the greater concern of poor people is to meet their basic physical needs for food, shelter, and clothing, whereas non-poor people are more concerned with their position and achievement in relation to society. Thus, absolute income might be important to happiness at low levels of income but relative income might be more important at higher levels.

Nevertheless, Easterlin et al. (2012) examined in detail the relevant time series evidence from several sources and was able to conclude that mean life satisfaction in China was no higher in 2010 than it had been in 1990. How is this remarkable result to be explained? Although the time series data sets are not rich enough to permit a direct analysis of the reasons for stagnation, the reasons can be studied indirectly on the basis of five papers reporting research on subjective well-being in China by means of a cross-section national household survey. I follow the argument of our summary paper (Knight and Gunatilaka 2011), but without explaining the methodology or providing the detailed empirical estimates.

Over the period of economic reform and transformation, China has experienced not only great economic but also great social change. The social changes gave rise to new socioeconomic problems. These problems were compounded by the narrow focus of the state personnel responsibility contracts on the primary objective of economic growth.

Thus, for many years of economic reform, officials were little concerned about the newly emerging issues.

The social changes included a great upset in social values as ideology and the impingement of the state into people's lives declined and materialism and markets became more prevalent. Not only rising income but also rising income inequality, vast rural–urban migration, a deteriorating physical environment, an increase in people's sense of insecurity, growing perceptions of procedural injustice and of corruption: these were all changes that had the potential to affect people's sense of well-being. Can socioeconomic changes such as these help to explain the stagnation of subjective well-being in China?

We begin by briefly describing our data and methods. The 2002 national household survey of the China Household Income Project (CHIP), containing rich socioeconomic information, included questions on subjective well-being. The household head, or the main member present, was asked the questions; the respondent is identified. There were three subsamples of the survey: rural, urban, and rural–urban migrant. In this way, it was possible to analyze the effects on subjective well-being of income and its growth, economic inequality, economic insecurity, and various other socioeconomic variables.

The method was to estimate happiness functions using as explanatory variables the characteristics of the individual, the household, and the community. The key dependent variable is derived from the question, common to all three subsamples: How happy are you nowadays? Five possible answers were allowed: very happy, happy, so-so, not happy, and not at all happy. This can be used as a cardinal variable (with the answers being scored 4, 3, 2, 1, and 0, respectively), or as an ordinal variable. In the former case linear regression, and in the latter case ordered probit analysis, was conducted. Both were estimated but in no case did the choice of method notably affect the interpretation. The cardinal results are simpler to interpret. In the rural subsample, for which a separate module on well-being and a separate question on satisfaction with life were available, the choice of dependent variable made no significant difference to the interpretation: The terms subjective well-being, life satisfaction, and happiness are used interchangeably.

The coefficients in the happiness equations represent associations and not necessarily the hypothesized causal relationships. These might instead reflect the influence of unobserved variables on both the dependent and the independent variable, or reverse causation. In some cases we shall suggest reasons why the independent variable might have a causal effect on happiness but without establishing causation, either because the variable is not germane to the main argument or because a valid instrument is not available. If the interpretation is important to our story—as in the case of income—we try to isolate the effect of exogenous variation in the independent variable by means of instrumenting.

Analyses of the 2002 survey are reported in Knight, Song, and Gunatilaka (2009) and Knight and Gunatilaka (2010a, 2010b, 2011, 2012, 2014). A striking feature of the results in all three subsamples is their regularities. Many coefficients are statistically significant, generally understandable, and similar across samples, and in line with the results from other countries or contexts. The happiness functions are meaningful and informative and they have to be taken seriously, although there can be disagreement about the conclusions that should be drawn from them.

We first report the results of the analysis of income and its change. It is a universal finding in happiness studies around the world that happiness rises in the cross-section—in line with theoretical expectations. The same is true of China, and in all three subsamples of the CHIP 2002 data set (for instance, Knight and Gunatilaka 2011). The effect of instrumenting income is to raise its positive coefficient, possibly because the instrumenting eliminates the effect of an unobserved variable such as aspirations: Exogenous aspirations may reduce happiness but, by fostering ambitions, may also raise income. Knight and Gunatilaka (2012) produced a defensible proxy for “aspiration income,” which was found to rise with actual income. When aspiration income was included in the rural happiness function, it had a negative coefficient. Thus, it appeared that, by raising aspiration income, the effect of higher income on happiness would be dampened, so producing a partial “hedonic treadmill.”

Even in the urban sample, for which the income coefficient is highest, the size of the effect of income on happiness is surprisingly small both absolutely and by comparison with the effect that various other determinants, discussed subsequently, have on happiness: A doubling of income raises the happiness score by only 0.22 points (Knight and Gunatilaka 2011). Thus, income raises happiness but does not play the central role that economists might expect. There are other, more important, determinants of individuals' subjective well-being.

The rural subsample of CHIP 2002 included the question, How has your household's living standard changed over the last five years? The answers permitted were: better, the same, or worse. Current happiness was found to be sensitive to the perceived past change in income. For instance, by comparison with no change a past fall in income decreased current happiness by 0.18 units and a past rise increased it, again by 0.18 units.

All three questionnaires contained the question, How do you expect your income to change over the next five years: to decrease, be the same, increase a little, or increase a lot? Several studies have found that expected future income has a statistically significant and substantively large positive effect on current happiness (Appleton and Song 2008; Knight, Song, and Gunatilaka 2009; Knight and Gunatilaka 2010b, 2011; Frijters, Liu, and

Meng 2012). For instance, in the urban sample the difference between expecting a large increase and a decrease accounted for 0.55 units of happiness (Knight and Gunatilaka 2010b). A possible explanation for this result is that expected future income determines current consumption, in line with the “permanent income” theory of consumption, and that the relationship would therefore not survive if current income were replaced by current consumption in the happiness function. This substitution made no notable difference to the coefficients on expected income in any of the subsamples, however.

Attempts to instrument these backward- and forward-looking relationships have not rejected a causal interpretation (Frijters et al. 2012; Knight and Gunatilaka 2014). Subjective well-being depends on income relative to reference time: People appear to compare themselves now with themselves in the past and in the future, and the comparisons affect their current happiness.

Each of the three surveys asked respondents about their relative income. For the rural sample, respondents were asked to rank their households in the distribution of village income per capita: much above, above, at, below or much below the village average. The coefficients on these dummy variables were large: That of the highest income category is greater than that of the lowest by 1.05 points.² The notion of relative deprivation, as developed by sociologists such as Runciman (1966), appears to be relevant. Despite the apparent unimportance of absolute income for happiness, two-thirds of the rural unhappy gave lack of income as the reason for their unhappiness. It appears that happiness is not only a positive function of income but also a negative function of aspirations, and that the latter are governed by the income of the reference group. The reference group is likely to be determined by the information that people possess and by their social interactions. Most rural people report confining their reference groups to the village: two-thirds made comparisons with their neighbors or fellow villagers. Similarly, urban *hukou* households and settled rural *hukou* households were asked to place themselves in the relevant quarter of their city income distribution. Again, the differences in coefficients were large and significant: Having high relative income is important for happiness. When city average income was included instead of rank by income quarter, it was found to have a negative coefficient.

The importance of relative income for happiness might thus help to explain the failure of average happiness to rise with the rise in household incomes. Economic growth tends to raise incomes generally. Insofar as the income of the reference group rises as well as own income, the consequent stability in relative income neutralizes the gain in individual happiness that comes from one's own income rising. As the economy grows, it is important

2 It is possible to distinguish the effects of absolute and relative income because of the great village differences (and also great city differences) in average income per capita.

to “keep up with the Zhous.” Moreover, reference groups are narrow: it is not “any old Zhou” but “the Zhous you know.”

Analyses of the three subsamples provided other possible explanations for the stagnation of happiness over time. Happiness was higher in the rural than in the urban subsample, and higher in the urban than in the migrant subsample, the mean values being 2.68, 2.48, and 2.37, respectively. The surprising result that rural people are happier than the much richer urban people might be explained in the following terms (Knight and Gunatilaka 2010a). On the one hand, dissatisfaction with life is not widespread in rural China despite the relative poverty and low socioeconomic status of its people in Chinese society. The basic reasons are that they have limited information sets and narrow reference groups, they expect their income to rise in the future, and they place a high value on personal and community relationships. On the other hand, the relatively low happiness of urban people, despite their relatively high income and their expectations of higher income in the future, has to do with the nature of urban society that has emerged in recent years. High aspirations, governed by reference groups, appear to give rise to relative deprivation that makes for unhappiness.³

In addition, the greater insecurity associated with redundancy, unemployment, and various other urban social ills also make city-dwellers unhappy. There was a high rate of re-trenchment by SOEs in the years prior to the survey, and retrenched workers found great difficulty in finding re-employment. The social security system was in transition from being employer-based to insurance-based, and unemployment benefits were not reliable, so that many unemployed workers received very little. The experience of current unemployment, and of having been laid off in the past, had a significant negative conditional coefficient, as did the dummy variable denoting that the worker's employing enterprise made a loss, which would increase the employee's chances of being made redundant. Easterlin (2012) noted that, although mean life satisfaction was no higher in 2010 than it had been in 1990, there appeared to be a dip in the early 2000s and then a slight recovery. He attributed the dip to the higher urban unemployment and redundancy and the heightened insecurity in that time of drastic urban reform.

Durkheim's (1897) notion of *anomie* might be relevant. He defined *anomie* as absence of norms, when social rules break down and people do not know what to expect of each other. The remarkable economic progress, the rapid creation of markets, the withdrawal of institutional support, and the demise of ideology might have created a state of *anomie*. Although the survey did not include good attitudinal questions for identifying *anomie*,

3 As Sylvie Démurger noted in her comments, the robust results obtained from our analyses of the effects of relative income on happiness in China are not necessarily replicated in other studies. It appears that some results can be sensitive to the choice of survey being analyzed, the definition of happiness, the comparator group selected, and the definition of a migrant.

when respondents were asked what they considered to be the most important social problem, three suggestive pointers were the negative coefficients on corruption, social polarization, and immorality.

The average happiness score of (settled) rural-urban migrants⁴ was lower than that of rural residents (Knight and Gunatilaka 2010). This appears to be inconsistent with the economic theories of rural-urban migration based on utility maximization. Estimated migrant happiness functions suggested two main explanations. Households living in the city but having rural *hukous* are generally “second class citizens.” When we included various proxies for migrant disadvantage in the happiness function, job dissatisfaction, perceptions of discrimination against migrants, and measures of job insecurity, each had negative coefficients. The unsatisfactory conditions in which migrants live and the insecure and unpleasant nature of their employment depress happiness.

A decomposition analysis of the difference between average rural and migrant happiness scores showed that the migrants had a superior set of happiness-inducing characteristics such as income, but that rural people had superior coefficients in their happiness function. Here the expectations of future income were crucial. With static income as the reference category, the coefficients of migrants were uniformly lower, suggesting that migrants had higher income aspirations relative to their current income. This can be expected if aspirations depend on the income of the relevant comparator group. Migrants tend to occupy the lower ranges of the urban income distribution. If migrants make comparisons with urban-born residents, their aspirations will be high in relation to their current income. It appears that migrants were better at predicting how their income would rise than at predicting how their aspirations would rise as a result of migration. Their reference groups had changed from the village to the city.

These happiness analyses could have been followed up and extended in the CHIP household survey of 2007, which was the first year of an annual panel. Their political sensitivity, however, required that questions on happiness be excluded from the surveys of rural and urban resident households—the implementation of which needed the cooperation of the National Bureau of Statistics.

4. Social instability and its causes

It is arguable that the Chinese government views “social instability” as a threat both to continued CCP rule and to continued rapid economic growth. China’s leadership has often publicly expressed its concern to maintain social stability. For instance, according to Shirk (2008) the term “social (in)stability” appeared 700–800 times a year over the

4 The median length of stay in the city of the sampled rural *hukou* households was seven years.

previous decade in the *People's Daily*, a CCP mouthpiece.⁵ Social unrest, as proxied by a proliferation of citizen protests and petitions, has indeed been rising in China. The number of "mass incidents" (cases of civil unrest, officially recorded) rose from under 8,000 in 1993 to 180,000 in 2010.⁶ Minzner (2005) quoted a statement of a public security official to the effect that the foundation of social order in China is fragile and that social stability is achieved within an environment of "unceasing, tough public security measures."

There is evidence that concerns about social instability have moulded economic policy-making. It was argued in Section 2 that the reform leadership's overwhelming policy priority was to achieve and maintain rapid economic growth. For the first quarter of a century of economic reform, rapid growth was viewed as the one true path to secure political legitimacy and to avoid social instability, but the remarkable transformation of China's economy and society that rapid growth entailed itself posed new threats. The leadership's subsequent secondary objective of promoting a "harmonious society" is a response to the need to maintain social stability in the evolving circumstances.

There is an international literature on the effects on investment, or on economic growth, of factors which might cause political or social instability (for instance, Mauro 1995; Alesina and Perotti 1996; Easterly, Ritzen, and Woolcock 2006; Aisen and Veiga 2011). This literature provides a good deal of cross-country evidence that political and social instability can have an adverse effect on growth, and that this effect can come through a fall in investment. Persistent social instability can cause persistently slow growth. Nonetheless, there is also the possibility that an adverse shock, produced by an outbreak of social protest, will break the virtuous circle of China's rapid growth. Moreover, any slowdown in the economy might, in turn, cause hardship or disappoint expectations and so generate more social instability. Thus, there can be aggravating interaction between social instability and faltering growth. A qualification is in order: Localized and uncoordinated cases of instability do not pose a threat to expectations of continued rapid economic growth. For investor confidence to be shaken so that investment fell and growth stalled, social protest would have to be more widespread and coordinated than it has been so far.

The methodological difficulties confronting economic research into social instability are to measure this elusive concept, the effects of its hypothesized socioeconomic determinants, and its hypothesized effects on economic outcomes. The more authoritarian the state, the more difficult it is for researchers to obtain relevant information. The causes of unhappiness might provide pointers to the sources of social instability. Of course,

5 There might be some overstatement of the danger insofar as the CCP wants to present itself as the bulwark against chaos.

6 Perhaps for political reasons the figure was not officially reported beyond 2008 (when it was 127,000). The figure for 2010 is attributed to Sun Yiping of Tsinghua University.

individual unhappiness does not necessarily translate into the expression, or even the feeling, of social discontent. It may require the perception that unhappiness is man-made and remedial by government for people to express their discontent. Nevertheless, we draw on the analyses of subjective well-being and its determinants made in Section 3, as well as on other sources.

The analysis of income in the cross-section happiness function found that the effect of absolute income on happiness is small both absolutely and in relation to some other determinants of happiness. The effect may be even weaker in the time series. The positive correlation over time between own income and reference group income implies that, as own income rises, the tendency for comparator income to rise as well offsets the effect of own income on happiness. If many people do not feel more satisfied with their lives over time, this might arouse social discontent.

China's consistently high rate of growth ensured that most respondent households had experienced an increase in income over the past five years. Our estimated coefficients imply that this reference-time effect has been good for current subjective well-being. Similarly, consistent rapid growth induced many respondents to expect that their household income would be increased over the following five years. That, also, would have raised current happiness. These backward-looking and forward-looking coefficients imply that China is vulnerable to a fall in the growth rate. This point is emphasized by Appleton and Song (2008) and Frijters, Liu, and Meng (2012). Continued rapid economic growth makes an important contribution to happiness in China. It may also be important for avoiding social instability.

The rise in economic inequality that has accompanied economic reform and economic growth poses a threat to China's social stability. Having been low by international standards at the start of economic reform, the national Gini coefficient of household income per capita was 0.38 according to the CHIP 1988 survey (then mainly regional) and 0.49 in CHIP 2007 (then the joint highest in Asia according to Asian Development Bank 2007).

It is not yet possible to measure the effect of rising inequality on happiness and its distribution. Nevertheless, Easterlin et al. (2012) found evidence of a marked increase over two decades in the inequality of the life satisfaction score. This finding is in line with the positive association between household income per capita and life satisfaction that is revealed by the cross-section data. The plausible hypotheses that the effect of relative income on life satisfaction becomes more important as income inequality rises (because relative deprivation is felt more strongly), and that average life satisfaction falls as income inequality rises (because social cohesion is weakened) remain to be tested in China (Knight 2012), however.

Whyte (2010) conducted a national sample survey in 2004 to make a sociological study of Chinese attitudes towards inequality. He found that half of respondents “agreed” or “strongly agreed” that the income gap threatened social stability. Nevertheless, the conclusion drawn from the survey taken as a whole was that Chinese people were in general not averse to the degree of inequality that they observed, particularly if it was based on merit, effort, or risk-taking. Inequality, like rapid economic growth, appeared to offer people opportunities for improving their economic positions. This interpretation corresponds to the first stage of the “tunnel effect” hypothesized by Hirschman and Rothchild (1973).⁷ By contrast, inequality based on unfairness in access to opportunities was generally disliked. China's semi-marketized economy offers much scope for such sources of inequality. It was notable from the survey that injustice was felt more strongly in urban areas than in rural areas, and least among farmers, who are the poorest group. Actual income is a poor guide to perceived distributional injustice because people's information sets and their aspirations are also important.

There appears to be an inconsistency between Whyte's (2010) finding that people accept income inequality in itself, that is, they may view it as a good signal, and the findings from the 2002 CHIP survey that local incomes relative to own income reduce subjective well-being. Knight, Song, and Gunatilaka (2009) provide a possible reconciliation. They find that subjective well-being is lowered by other incomes in the village but raised by income inequality in the county, as measured by the Gini coefficient. This suggests that inequality, as it touches people most closely, reduces happiness, but when it is viewed more broadly, is perceived to offer opportunities for higher income.

Prior to the reform of the SOEs, which started in the mid 1990s, urban resident employees enjoyed “iron rice bowls” in mini welfare states provided by their employers. Over the following decade the urban economy underwent the drastic reforms needed to sustain economic growth. The iron rice bowl provided by firms collapsed and its replacement by broader social security arrangements was tardy and incomplete. Urban unemployment—both actual and threatened—rose sharply from previous low levels and only gradually declined. As Easterlin et al. (2012) noted, the low point in life satisfaction matches the high point in urban unemployment and in people's sense of insecurity. The happiness functions reported earlier suggest that subjective well-being is sensitive to people's perceptions of insecurity. Their implication is that a sudden economic downturn could create unhappiness and social discontent.

7 They illustrated the possibility of changing tolerance for inequality in a developing country as follows. Two lanes of cars are stuck in a tunnel. If one lane begins to move, this is initially welcomed by drivers in the other lane because it suggests that their turn will come soon, although this may eventually turn to anger if their lane continues to remain stuck.

Corruption is a potentially serious source of social discontent. This issue is not played down by the leadership, both under Hu Jintao and (especially) Xi Jinping. According to the former, the resolute punishment and effective prevention of corruption was essential to the survival of the CCP (Wedeman 2008). Since taking office in 2012, the latter has launched a relentless drive against corrupt officials.

It is difficult to gauge the extent of corruption in China. It is the perception of China's people, however, that better indicates the threat to social stability posed by corruption. Respondents in the urban sample of the 2002 CHIP survey were asked what they considered to be the most serious social problem. Corruption (reported by 21 percent) along with lack of social security (also 21 percent), came second, after unemployment and lay-off (32 percent). Since 2002, corruption has probably worsened and social security and job security have probably improved.⁸

In the absence of policies to protect the environment, the income elasticity of environmental damage might well be at least unity. China's rapid growth almost inevitably meant that the environment deteriorated. Because producers generally do not compensate fully for the damage they do to the environment, their private costs are lowered and GDP growth is higher than the social costs warrant. The pollution of air, water, and land is a visible result of economic growth. The emission of fine carbonaceous particles is a serious threat to ecological and climate systems (Streets 2005). The effects of pollution on human health have been noted (for instance, in Chen et al. 2013). China has indeed introduced a series of government laws and regulations but their enforcement has been weak because governments have prioritized economic growth. The 2002 CHIP survey did not explore this issue sufficiently but perceptions of environmental pollution, fostered by rising prosperity and the spread of information, are likely, increasingly, to reduce subjective well-being and to be a source of social instability.

Citizens lack both effective political institutions to participate in the decisions that affect their lives and effective legal institutions to protect their rights. As a result, people's grievances have been channelled into mass protests and petitions. Much social unrest in China is due to citizen dissatisfaction with local government actions, including corruption and illegality, arbitrary or excessive taxation, and neglect of pollution. The confiscation of land or property without adequate compensation is a widespread source of complaint. Here the actions of local officials are often to be explained by rent sharing with developers, with the proceeds going into either local government coffers or their own pockets. The system of governance creates opportunities for abuses of this sort because the accountability of local officials is so weak: They enjoy extensive control over local media

⁸ Judging by recent corruption trials, the problem extends into the top leadership itself. The current campaign against corruption is no doubt widely welcomed but—as Mary-Françoise Renard pointed out in her comments—it can also diminish people's confidence in government.

and judiciary, local legislators and village committees. Higher tiers of government attempt to restrict such abuses by means of incentive structures, for instance by using the degree of local social unrest as a criterion for disciplining, rewarding, and promoting local officialdom. This also produces the perverse incentive for local officials to stifle the expression of discontent through intimidation or coercion (Minzner 2005), however. In these ways the institutions of governance fuel social unrest, in the form of citizen petitions and mass protests.

It is possible that, despite continuing growth, social instability will continue to rise, fed by the underlying challenges that China faces and by greater flows of information including the Internet, and rising levels of education. There are three main potential responses: repression of discontent, promotion of nationalism, and pursuit of harmonious society policies. Repression might not be a long-term solution and it damages China's status as a rising power in the world. The pursuit of nationalism might damage economic ties with the world and can have unpredictable consequences. Promotion of harmonious society policies (aimed to redress the new challenges to social instability) might well prove to be the best for China's people and its leaders.

5. China's effective but flawed governance

China's system of governance has been effective in achieving the leadership's overriding economic objective: rapid growth of the economy. The incentive structures that were put in place were successful in solving the principal-agent problem that arises when political control is centralized and economic management is decentralized. By this means China became a successful developmental state.

Nevertheless, China's governance has been flawed in two senses. The flaw in the first sense is the single-minded pursuit of economic growth despite the socioeconomic changes that growth itself created, and the tardy and partial revision of policies to address the ensuing challenges. The incentive structures that were put in place for officialdom contributed to China's remarkable growth rate but they were confined to the leadership's growth concerns. Recognition of the emerging socioeconomic problems that had accompanied growth led in the mid 2000s to the leadership's introduction of new objectives in addition to the growth objective. The so-called "harmonious society" policies of recent years have been pursued in various ways. One way was to modify the targets laid down in the responsibility contracts negotiated with officials at different levels. Some incentives for local government cadres now operate in relation to non-growth targets as well as growth targets. These include, for instance, rewarding city officials who achieve redistributive objectives such as the introduction and raising of city minimum wages, rewarding local officials who achieve targets for reducing environmental pollution, and punishing officials held responsible for causing local social discontent. Another form of

harmonious society policies was to provide support and subsidies for the poor, especially in rural areas (Li 2014). However, the harmonious society policies of the previous leadership did not address forcefully the problems of rent seeking and corruption associated with weak governance.

The second flaw is deeper and more firmly embedded, being systemic. Although the central government principal has incentive structures in place to ensure that its local government agents pursue its objectives, the agents are often better informed than the principal. This opens China's system of governance to rent seeking and corruption and to profit opportunities for those with power and influence.

The problem is magnified by the still semi-marketized economy involving much state intervention. This intervention serves both a political and an economic function. It assists the CCP to remain in political command and generates formidable patronage resources for that purpose; it also provides the policy instruments to achieve and maintain a developmental state. The semi-marketized economy is a breeding ground for rent seeking and corruption of bureaucrats and party officials.

The World Bank's annual worldwide governance indicators (World Bank 2014) throw light on the relative quality of China's governance. The bank combines several independent evaluations to produce six indicators of the quality of governance in each of 215 countries. These include, among others, government effectiveness, control of corruption, political stability and absence of violence, and voice and accountability. Countries are ranked according to percentile, with 0 indicating the worst governance and 100 representing the best. The worldwide governance indicators are generally available for the years from 1996 to 2013.

China scores quite well, especially among developing countries, on international rankings of government effectiveness. For instance, it was generally in the fifth decile, and rose in percentile rank from 47 percent in 1996 to 54 percent in 2013. China scores less well on control of corruption, however. Its percentile rank was 47 percent in 1996 but fell to an average of about 33 percent over the period 2002–10. Improvements (relative to other countries) occurred after 2010, especially in 2013, when the percentile reached 47 percent. The indicator political stability and absence of violence saw a deterioration in China's rank, falling from the 41st percentile in 1996 to the 27th percentile in 2013. The most startling result is for voice and accountability, in which China scores terribly: It ranked in the 12th percentile in 1996 and in the 5th percentile in 2013. Thus, only 11 countries ranked below China on voice and accountability in 2013. The rule of law index for 2012–13 from the World Justice Project (2013) placed China in the 11th percentile out of 97 countries for government accountability, meaning the extent to which officials' powers are limited by the law, the courts, and civil society.

China relies on top-down accountability (pressures from above) rather than bottom-up accountability (pressures from below). Pressures from below correspond to Hirschman's (1970) "exit and voice," meaning the ability of the governed to avoid or complain. Top-down accountability is difficult to implement if agents (lower tiers of government) are better informed than the principal (higher tiers). People's perceptions that officialdom is not sufficiently accountable for its actions are a potential source of unhappiness and of social instability. There is a systemic need to strengthen accountability and transparency at all levels.

China's economy cannot be well understood except through the lens of political economy. The societal cost of China's rapid economic growth has been imposed by the overriding pursuit of economic growth to the neglect of other objectives, and by the system of governance, which has failed to provide sufficient accountability. The societal cost has taken the forms of stagnating levels of life satisfaction and growing expressions of social discontent. Both require greater policy attention.

These problems are currently being addressed by two recent policy initiatives under the new leadership.⁹ The current anti-corruption campaign—which is reflected in the recent improvement in China's international ranking on "control of corruption"—serves as a powerful deterrent to corrupt behavior. Moreover, the systemic flaw in governance that provides opportunities for corrupt behavior is liable to be eroded by the reform plans to reduce economic intervention and resource allocation by the state and to expand the role of market competition. The dangers are that the anti-corruption campaign might weaken the incentives inherent in the developmental state and that further marketization might be resisted by interest groups.

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9 I draw on the abridged version of the document "The Decision on Major Issues Concerning Comprehensively Deepening Reforms," adopted in the Third Plenary Session of the 18th CCP Central Committee in November 2013.

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