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Introduction

In March 2015, Wu Hai, the CEO of national hotel chain Crystal Orange in China, published an open letter addressed to Premier Li Keqiang entitled "I am so frustrated after doing business for many years!"[1] The letter openly criticizes the government's preferential treatment of state-owned enterprises (SOEs) and companies with good connections, and explicitly discusses how government agencies selectively enforce laws and regulations. The letter went viral immediately and was well received by many private entrepreneurs who face similar problems. Many of Wu Hai's frustrations relate to predatory behavior by officials.

> [C]an you (Premier Li) believe that whenever the "Three Festivals" take place, all relevant government agencies in City A start to become active and most of their bureaucrats are coming out to every single company to conduct the so-called inspections.[2] Of course, companies with good connections can bargain [meaning to pay less to these government agencies], and sometimes those "special taxes" can be waived.
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> But maybe you would wonder why among the thousands of entrepreneurs in City A, nobody dared to voice our discontent. Because we all know very well that once we do, our company will be finished.

He goes on to describe different kinds of predatory behavior through random enforcement of rules:

[1] *Forbes China*, March 24, 2015. "Wu Hai, the CEO of Crystal Orange, Complains to the Premier: I am too frustrated for many years" (*Juzi Shuijing CEO Wu Hai Xiang Zongli Jiaoqu: Chuangye Zheme Duonian, Wo Tai Biequ Le*). www.forbeschina.com/news/news.php?id=41541&page=1&lan=zh. Last accessed November 8, 2017.

[2] The "Three Festivals" are traditional Chinese festivals: the Duan Wu, the Mid-Autumn, and the Spring festivals. They are all Chinese national holidays.

1. Fines: "Initially, the bureau (unspecified in the letter) wanted to fine us 50,000 yuan. We found someone to lobby for us and eventually we paid a 25,000 yuan fine. What I wanted to ask is: under what condition would the fine be 2,000, and when would it be 50,000 yuan? Why not make the policy more clear-cut? If we had a more 'useful' person to lobby for us, we would only have been fined the minimal 2,000 yuan."
2. Permits: "The commission of housing and urban–rural development requires all real estate developers to use the bidding companies affiliated with the commission to bid for construction teams. Even if we have good construction teams we have worked with in the past, we are required to use their bidding company to select the construction team we have already worked with before. Otherwise we would not get the permit."
3. Identity credentials: "The police bureau requires all hotel guests and visitors to present a valid ID. It is a good policy, but the police bureau gives us all sorts of problems when implementing the policy. The police bureau can fine us hundreds or thousands of yuan as they wish. Why don't they stipulate a clear rule about how much the fines should be?" … "There are so many ambiguous policies and regulations. There is no standard and that makes law enforcement unpredictable. We have to maintain good relationships with all relevant agencies and bureaucracies, and they create fear among us."

The Chinese economy has been growing at a spectacular rate of 9.6 percent since the 1980s.[3] By 2018, more than 50 percent of the country's total tax revenue, over 60 percent of gross domestic product (GDP), and more than 80 percent of the country's employment was contributed by the private sector (Hou 2019) and by privately owned companies such as Crystal Orange hotel.[4] Although big and successful private firms, such as Alibaba, Huawei, and Lenovo, seldom complain about government capriciousness, millions of Chinese private entrepreneurs face the heavy-handed government regulation, expropriation, and corruption described in CEO Wu's letter on a daily basis.

[3] According to Justin Yifu Lin's calculation. See "The Economics of China's New Era" *Project Syndicate*. www.project-syndicate.org/onpoint/the-economics-of-china-s-new-era-by-justin-yifu-lin-2017-12. Last accessed December 11, 2017.

[4] You probably have never heard of the Crystal Orange Hotels. If you ever traveled to China, chances are that you did not stay in one of the Orange hotels. Besides the international brands such as the Four Seasons and the Ritz-Carltons, China's hotel market also has many formidable domestic players such as the Wanda Group and the down-market Home Inns and Hotels Management. The Orange Hotels group is a medium-size boutique hotel chain operating in six cities in China.

As this example suggests, property rights remain unprotected in China, and the legal system does not protect private enterprises from government expropriation of property. Numerous scholars have studied how the private sector has managed to grow and prosper despite this institutional disadvantage. This book proposes a new answer: Chinese private entrepreneurs actively seek opportunities within formal political institutions that can protect their business interests. By holding seats in local legislatures, entrepreneurs use their political capital to deter local officials from demanding bribes, ad hoc taxes, and other types of informal payments. In doing so, entrepreneurs are creating a system of selective and predictable property rights.

1.1 DEFINITIONS

Identifying privately owned firms in China is a daunting task, because the ownership structure of Chinese firms is complex, and a large number of private firms "depend wholly or in part on investments or patronage by senior government officials" (Kroeber 2016, 90). Yasheng Huang suggests that characterizing a firm as either private or state owned requires carefully examining how the firm assigns its control rights, which include "the rights to appoint management, (to) dispose of assets, and (to) set the strategic direction of the firm" (Huang 2008, 13).

With these nuances in mind, I use Nicholas Lardy's definition of private enterprises: private enterprises refer to the universe of household businesses, registered private companies, and firms for which the majority or dominant owner is private. Private entrepreneurs are therefore owners of these private enterprises (2014, 4).

There are two types of property: *physical* property such as land and capital, and *intellectual* property such as patents and copyrights. I mainly study the physical property (capital) of urban Chinese private entrepreneurs.

According to Haber et al. (2003), "[a] property right consists of three, conceptually distinct rights: the right to use an asset, the right to earn income from an asset and contract with other individuals regarding that asset, and the right to alienate or sell the asset" (21). Similarly, Frye (2004) defines a property right as "a bundle of rights that include the power to consume, obtain income from, and alienate assets, such as land, labor, or capital." It is useful to distinguish *economic* property rights (which give asset holders the "ability to gain from the asset by consumption or by exchange") from *legal* property rights (which address "what the state assigns to a person") (Barzel 1989, 4). While *legal* property rights are a means of achieving *economic* property rights, legal rights are neither necessary nor sufficient for the existence of economic rights. In the absence of legal safeguards, economic rights may still be valued, but the security of property and the exchange of property need to be self-enforced (Barzel 1989, 4). This book focuses on economic rights in places where legal rights are lacking. Cull and Xu (2005) define two dimensions of the security of property rights: "the risk of expropriation by the government and the ease and reliability of contract enforcement" (118). This book studies the first dimension of secure property rights.

I study institutional change in China's property rights regime by examining how individuals creatively use existing institutional arrangements to generate individualized property rights. These choices about property rights, as Susan Whiting points out, are also shaped by the incentives of local state officials and the broader political and economic environments. Property security can be operationalized by measuring the reduction in amount of expropriation imposed by local government bureaucrats on private businesses (Whiting 2004, chapter 4). Here, I define expropriation as government bureaucrats forcefully and unlawfully confiscating or devaluing a firm's assets. In a similar vein, Johns and Wellhausen (2016) use the terms "indirect expropriation" and "creeping expropriation" to describe situations in which a government devalues assets by violating its prior commitments to firms, and in their case, foreign firms. In this definition, expropriation does not equal complete nationalization. Partial nationalization is also considered as expropriation. Throughout the book, expropriation is used interchangeably with "predation" and "extraction." In some contexts legal taxation is considered as extraction. In this book, I look only at illegal extraction. Expropriation can be direct and complete (i.e., a government confiscates all assets of a company) or partial and indirect (Thomas and Worrall 1994). In this book, I look only at partial expropriation, because all companies I study were in operation during the research period. Those that experienced complete expropriation (e.g., nationalization) would not have appeared in my sample. Nor do I study cases when a non-state actor (e.g., the mafia) expropriates from a business.

According to a recent survey in China, 51 percent of the private entrepreneurs surveyed still reported that they faced expropriation by local government to some extent.[5] The entrepreneurs I interviewed during the research for this book indicated that property insecurity is

[5] The ACFIC Survey (2000–2012). There was no clear change in the level of expropriation over time in this decade. See details about the survey in Chapter 5.

still a major concern. Many entrepreneurs agreed that, although local government has become more service-oriented and now treats the private sector with more respect, many lower-level bureaucrats are still "very ruthless (*ye man*) in getting what they want" and there is "nothing one could do but cooperate" (Interviews P125; P135; P137).

From the perspective of private entrepreneurs, local governments impose two types of "expropriations" (Dai 2008; Fan 1995; Li and Gong 2013). The first type is strictly illegal – bureaucrats taking property away from a firm without formal or legal causes. Bureaucrats or government officials who engage in this type of expropriation usually know that such behaviors are illegal and would prefer not to get caught.

Entrepreneurs sometimes describe a second type of expropriation as "selective enforcement of laws and regulations." In contrast to the first type, such selective law enforcement is legal from the perspective of officials and bureaucrats, because they can usually find laws or regulations to support their actions. They often selectively enforce laws or regulations on particular companies.

It is sometimes difficult to determine whether threats of expropriation are legal or illegal. Like cases in Russia and Ukraine, expropriations in China may "include a municipal court issuing an injunction paid for by a competitor; a policeman shutting down some retailers to intimidate others; a local official pressuring a firm to give a job to his relative lest the company lose its operation license" (Markus 2015, 22). Chapter 4 provides more examples I collected during my fieldwork to describe what expropriation looks like in present-day China.

1.2 THE ARGUMENT IN SUM

My core argument is that China's legislative system provides entrepreneurial actors with opportunities to advance their own interests. Chinese private entrepreneurs, who operate their businesses in an environment in which property rights are largely unprotected, seek office in the local legislatures to protect their property. In an environment characterized by asymmetric information about political connections, entrepreneurs who have a local legislative seat indicate their strong political connections with upper-level bureaucrats. This political status deters predatory behavior by lower-level bureaucrats, who fear retribution or punishment from the legislator's political network. In joining local legislatures, private entrepreneurs build a system of selective property rights.

Political participation takes different forms in different regime types. In a functioning democracy, running for public office is one of the many ways to participate in politics. V.O. Key suggests that "the nature of the workings of government depends ultimately on the men who run it. The men we elect to office and the circumstances we create that affect their work determine the nature of popular government" (Key 1956, 10). Therefore, public service in a democracy ought to be treated as "a social obligation, somehow different from other careers, and the responsibilities, duties, and personal conduct of public officials has been regarded somewhat differently from those of people holding positions in the private economy" (Lazear and Rosen 1980, 101). In addition to being motivated by the preferences and qualities of the policies, candidates are also drawn by the perks of office (Besley 2004; Callander 2008; Calvert 1985). In some established democracies, the personal benefits of holding elected offices are alarmingly large (Eggers and Hainmueller 2009; Querubin and Snyder 2013).

With limited avenues for political participation, individuals in authoritarian countries are motivated to seek political office for various reasons. In addition to gaining partial power and perquisites, my theory suggests that, in non-democracies and democracies with weak rule of law, political office provides opportunities for individuals to secure individualized rights – in the case of the Chinese congresses, property rights. Participating in politics has become a process of rights creation.

1.3 Contribution to the Literature

1.3.1 Property Rights and Economic Growth

Social scientists see private property rights as central to economic development (Acemoglu, Johnson, and Robinson 2001; De Soto 1990; Demsetz 1967; North and Thomas 1973; North 1981). Secured property rights restrict governments' expropriation of wealth and protect private assets. They promote investment in three ways. First, freedom from expropriation promotes investment, because individuals do not worry that others will seize the fruits of their investment. Second, more secure rights make it easier to use assets as collateral, and thus to increase liquidity in the economy and to relax the constraints on funding investment (Besley 1995). Third, secure property rights free up resources invested in protecting assets for more productive investment (Field 2007; Wibbels, Krishna, and Sriram 2016).

Yet in some cases the costs of creating a formal property rights regime outweigh the benefits, and a partial property rights system might be more conducive to growth given the poor quality of other complementary institutions (Trebilcock and Veel 2008). When the market environment is highly uncertain, the regulatory environment is unclear, and the transaction costs of creating rights are high, ambiguous property rights might be more efficient than unambiguously defined private property rights (Li 1996).

Accepting these premises, scholars such as Dani Rodrik argue against the simplistic "best-practice" approach to development and propose that developing countries might instead need "second-best" mindsets and institutions that are context specific (Rodrik 2008). To cope with the absence of property rights, entrepreneurs in Russia and Ukraine form alliances with various stakeholders around their firms (Markus 2015), and/or have frequent contacts with private protection rackets (Frye and Zhuravskaya 2000). In Peru, property is secured not by formal but by all sorts of informal and extralegal arrangements. In countries like Ghana and Vietnam where legal recourse is lacking, firms rely on relational contracting to build long-term and personalized relationships and sustain cooperation through repeated interactions (Rodrik 2008).

In China, despite the under-development of secure property rights and the rule of law, the economy has still managed to grow at a rapid rate. Yingyi Qian reasons that China's "transitional institutions" have been able to "improve economic efficiency by unleashing the standard force of incentives" (Qian 2002).[6] My book advances this literature in two ways: first, it carefully describes a selective property rights system and provides micro-level evidence that such a system sustains economic growth in the short (and even medium) run. Second, although I concur that at a certain stage in a country's development, full property rights increase economic efficiency, I argue that a selective property rights regime might not just be a "transitional institution." Given other institutional constraints, such as an uncertain regulatory environment, a selective property rights regime could be the first-best solution.

[6] On the other hand, Yasheng Huang argues that China's growth experience is more conventional than others have suggested. In the 1980s, even if there was little protection of property security, there was "security of the proprietor" (Huang 2008, especially see chapter 2).

1.3.2 Property Protection

The view of an authoritarian state as "the grabbing hand" and a "stationary bandit" is not unique to China: scholars of business–state relations have identified violations of property rights by state agencies in many economies (Frye and Shleifer 1997; North et al. 2013; Olson 1993; Tilly 1985). Friedman and colleagues, using data from 69 countries (many of them developing economies in Eastern Europe and Latin America), find that entrepreneurs in countries with heavy burdens of corruption and bureaucracy are more likely to divert some resources to the unofficial economy to avoid extortionate and arbitrary demands (Friedman et al. 2000). More nuanced country-level studies have been conducted on specific cases (Gans-Morse 2017b; Markus 2012; Rithmire 2015; Shleifer and Vishny 2002, chapter 9). In these systems in which property rights are weakly secured, how do firms fend off the grabbing hands of local bureaucrats? Previous studies have documented various ways in which private firms defend their property rights from expropriation by the state or powerful elites. In these cases, since formal protection is usually either unavailable or ineffective, firms usually resort to one of the following informal means.

First, when formal institutions fail to function, one default option is to resort to *private or corrupt force,* such as the criminal protection rackets and private security agencies that played a central role in property security in early 1990s Russia. Corrupt force includes protection rackets provided by bureaucrats and law enforcement officials, which in Russia replaced criminal protection rackets by the late 1990s. Using state resources, these protection rackets provided private clients with property protection (Gans-Morse 2017b).

Second, firms may resort to forging *informal connections and exchanges*. David Wank documents that in the 1980s China, private firms invited "backstage bosses" – public officials – to join their firms as advisors, shareholders, and board members so that these bosses could assist their businesses with information on business-related policy, lowering tax bills, and preventing government expropriation (Wank 1999).[7] Another important channel of connection is kinship, which provides

[7] These "backstage bosses" can still be observed in the current Chinese economy. In 2011, 49.3 percent of all SOE firms listed in the Chinese stock market have hired retired government officials. See *the Southern Weekly* for a news report at www.infzm.com/content/60155. Last accessed August 1, 2016.

entrepreneurs with access to resources (Ruf 1999). Entrepreneurs with relatives in government share similar privileges with entrepreneurs who hired backstage bosses.

Third, private actors might use *non-state arbitrators*, such as business associations, to enforce property rights. In the late medieval period, merchant guilds helped protect their members from abuses by city governments by coordinating punitive actions against predators (Greif, Milgrom, and Weingast 1994). In a similar fashion, business associations in Russia provide property security exclusively to their members by establishing norms of transactions and resolving disputes when necessary (Gans-Morse 2017b).

Fourth, firms sometimes creatively construct *partial ownership structures* and forge *sponsorships* that protect their property and property rights. For instance, in China, "backyard profit centers" of state agencies are entities registered as independent public enterprises that are managed by incumbent or former public officials or persons they trust. These relatively undocumented entities receive favorable regulatory and funding treatment from, or with the help of, their government-sponsoring agencies and *de facto* state protection for their private property rights (Lin and Zhang 1999). In the 1990s, entrepreneurs could also seek partial local government ownership of their businesses, which helped limit state predation (Che and Qian 1998; Oi 1992). This method of ownership disguise ceased to be necessary when the private sector was officially recognized first in the 15th party congress in 1997 as "important component" of a socialist market economy and in the country's constitution in 1999 (Dickson 2008, 39).

Fifth, firms can make *alliances with stakeholders* such as foreign investors, regional communities, and organized labor to protect property rights through exerting pressure on the state (Markus 2012; 2015). This strategy points to the conceptual watershed among different protection strategies discussed in the literature: joining the state (either formally or informally) versus counterbalancing the state (through stakeholder alliances or business associations).

In present-day China, private entrepreneurs have a toolbox of strategies to protect themselves. They still actively engage in informal connections and exchanges (Chen 2018; Kennedy 2005; Pei 2016); they sometimes use political connections to facilitate the use of the courts (Ang and Jia 2014; Wang 2015); they creatively register themselves as foreign investors and use "round-tripping" to avoid heavy taxation and regulation (Xiao 2004); they continue to partner with the state and foreign investors (Huang 2005); they obtain Chinese Communist Party (CCP) memberships to develop ties with the party elites (Dickson 2008); and they rely on organizations such as business associations (Kennedy 2005). In this book, I do not dismiss any of these strategies as ineffective or unimportant. Instead, I propose an important addition to the "toolbox" of strategies: Chinese entrepreneurs, in addition to using many informal coping strategies, join legislatures to protect their property from predation.

Ishow that this strategy is different from others in two important respects. First, compared to strategies that rely heavily on informal political connections, the strategy of using one's legislator status to protect property can be purely formal. An entrepreneur does not have to go through any informal exchange to establish or enhance his political capital once he has a seat in the legislature. In this process, legislators use their political position to defend their property rights as well as to legislate. A second distinction is its relatively cost-effective nature. Although securing a legislative seat might incur high costs, once an entrepreneur has a seat in the legislature, his position serves as a signaling mechanism to deter potential predators without any additional investments. The informal strategies described above, such as forging informal connections or relying on partial ownership, can only be sustained through iterated and costly interactions between entrepreneurs and other political entities.

In contrast to existing approaches that view the emergence of property rights as outcomes of efficiency pursuits or state mandates, this book contributes to a new theoretical approach that sees the emergence of and changes in property rights regimes as outcomes of political interactions (Haber, Razo, and Maurer 2003; Rithmire 2015). This approach better explains why property rights are sometimes provided as private goods rather than public goods and how a selective property right system does not necessarily sacrifice efficiency in the short or even medium run.

1.3.3 Authoritarian Institutions

Earlier scholarship on authoritarian institutions views authoritarian legislatures as "rubber-stamp" institutions that are symbolic but have little impact on policy. Rustow (1985) sees legislative elections as a merely "political tactic" that "pay[s] homage to virtue" in the authoritarian Middle East. Magaloni (2006) argues that elections help the Institutional