

# Protecting Property through Political Office in China

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## Abstract

How do entrepreneurs protect their property and grow their businesses in systems without secure property rights? I argue that Chinese private entrepreneurs seek public office to protect their property from government predation. Drawing on rich empirical evidence including in-depth interviews and a unique national survey, I show how Chinese entrepreneurs deter local officials from demanding bribes, *ad hoc* taxes, and other types of informal payments by securing seats in the local legislature and using their political titles to signal political capital. Using a national survey of Chinese private entrepreneurs from 2000 to 2012, I show that entrepreneurs who serve in the local legislature spend an average of 14.5% less on informal payments to local governments. A simple signaling game further demonstrates how entrepreneurs use their political titles to signal strong political capital and deter expropriation.

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A system of fully protected property rights is usually associated with strong economic growth: It enhances individuals' investment incentives, increases their access to credit, and generates efficiency gains by freeing up producers' time that was previously devoted to solidifying informal claims (Acemoglu and Johnson 2003; Besley 1995; De Soto 2003; Frye 2004; Olson 1993). Any government or political elite interested in delivering economic growth should be motivated to grant property rights to producers and investors.

The Chinese case challenges many of these theories. China has displayed an impressive record of economic growth despite maintaining a legal system that does not protect property rights. The Chinese economy has been growing at a spectacular rate of 9.6% in the past four decades,<sup>1</sup> and the private sector has been an important driver of this boom. It sprang up after the economic reforms that began in the late 1970s to provide employment for more than 100 million people by the end of 2000 (Nee and Oppen 2012). Although the private sector accounts for more than 70% of the country's GDP (Lardy 2014), private property is still fundamentally unprotected from state predation. There is no credible commitment to prevent governments from expropriating property from private enterprises (Che and Qian 1998; Clarke, Murrell and Whiting 2008), and thousands of private entrepreneurs face heavy-handed government expropriation on a daily basis.

How does the private sector in China manage to produce such remarkable growth without secure property rights? Existing accounts mainly focus on informal institutions and arrangements (Oi 1999; Wank 1999). This paper proposes a new answer: Chinese private entrepreneurs use formal institutions to protect their property from government predation. By securing seats in the local legislature, entrepreneurs signal their political capital to deter local officials from demanding bribes, *ad hoc* taxes,

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<sup>1</sup>According to Justin Lin's calculation. See "The Economics of China's New Era" *Project Syndicate*. <https://goo.gl/cKGKEw>. Accessed Dec.11, 2017.

and other types of informal payments. Entrepreneurs protect their property through political office in China.

This study presents a mix of quantitative and qualitative evidence for the argument. Using national survey data on Chinese private entrepreneurs from 2000 to 2012, I show that entrepreneurs who have obtained a seat in local legislatures experience less severe expropriation by local officials. Private entrepreneurs with a seat in the local legislature spend, on average, 14.5% less than those without a seat on informal payments to local governments. Interviews with entrepreneurs and public officials suggest that legislator status sends a signal of strong political connections that deters potential predators. I illustrate this signaling mechanism using a simple model to formalize the interaction between private entrepreneurs and low-level bureaucrats.

This paper makes three main contributions to the literature. First, it qualifies an emerging view that individual firms can strengthen property security through formal means, even when these formal institutions are relatively weak. Prevailing explanations of property security formation treat the state as the primary enforcer of property rights (Acemoglu and Johnson 2003; Levi 1988; Ostrom 1990) or selective property rights (Gehlbach and Keefer 2011; Haber, Razo and Maurer 2003). Recent studies on post-Soviet economies tend to focus on individual firms to explain property security formation in transitioning economies (Frye 2016; Gans-Morse 2017; Markus 2015). My argument is consistent with this firm-centric approach: we treat property security formation as a bottom-up process. In contrast to Jensen, Malesky and Weymouth (2013), who argue that authoritarian legislatures are usually too weak to restrain the ability of dictators or single-parties to expropriate property, I show that individuals can effectively use these authoritarian institutions to deter expropriation.

Second, the paper enriches a burgeoning literature on the returns to political office in authoritarian contexts. Truex (2014) shows that a seat taken by a CEO in the National People's Congress in China

is worth about 7 percentage points in operating profit margin in a given year. My paper extends his analysis to subnational legislatures. Ang and Jia (2014) discover that entrepreneurs who had a legislative seat were more likely to use courts over informal avenues of dispute resolution. Using the same survey but a wider time span, I show that the political influence of a legislative seat goes much further than courts in China. My findings also corroborate Szakonyi (2017)’s analysis that firm directors in Russia who win seats in subnational legislatures can secure huge increases in the firm’s revenue and profit margin.

Finally, this paper contributes to the literature on the business-state relations and nonmarket strategies adopted by Chinese firms. Some argue that “wearing a red hat” (i.e., obtaining CCP memberships) has been a successful nonmarket strategy for Chinese private entrepreneurs to demonstrate political loyalty, to build connections and to develop business (Dickson 2008; Nee and Opper 2012; Ong 2012; Tsai 2007); others suggest that *guanxi*—instrumental-personal ties with government authorities and other elites—has a strong impact on firm performance in China (Park and Luo 2001; Walder 1986; Xin and Pearce 1996). Building upon these foundational works, my paper makes two new contributions. Theoretically, it is the first to systematically analyze the effectiveness of “obtaining political office” as a nonmarket strategy by showing how a legislative seat deters expropriation. The theoretical argument provides a novel signaling account for the institutional function of the Chinese legislatures. Empirically, the paper provides a precise and robust estimate of the value of the nonmarket strategy of running for legislative office in China.

# The Private Sector, Expropriation, and Legislatures in China

Before 1987, when the Chinese Communist Party (CCP) officially recognized the “private economic sector as a necessary supplement to state sector” (Clarke, Murrell and Whiting 2008), private enterprises were officially forbidden. Since 2013, the CCP has recognized both the public and the private sectors as “important components” of the socialist market economy. Yet private property is still considered vulnerable (Nee and Opper 2012; Rithmire 2015). Laws and regulations are not strictly enforceable. The courts do not have the *de facto* power to secure property rights, nor are other government bodies capable of filling this role (Clarke, Murrell and Whiting 2008). Indeed, formal institutions are sometimes used to systematically undermine, rather than protect, property security (Mattingly 2016).

## *Definition and Examples of Expropriation*

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. Throughout the article, expropriation is used interchangeably with “predation” and “extraction.” Expropriation can be direct and complete (i.e., government confiscates all assets of a company) or partial and indirect (Thomas and Worrall 1994). In this paper I only look at partial expropriation, because all companies I study are in operation. Private companies that experienced complete expropriation (e.g., nationalization) would have not appeared in my sample.

Chinese entrepreneurs’ sense of uncertainty is reflected in cross-national indicators of property rights security, placing China on a par with Angola, Belarus, and Azerbaijan and slightly below Russia (Nee

and Opper 2012). In a recent national survey, 53% of private entrepreneurs reported that they had been expropriated by local government to some extent.<sup>2</sup> The entrepreneurs I interviewed indicated that property insecurity is 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). Expropriations can take a variety of forms, including bureaucrats taking products for free or forcing entrepreneurs to grant them a discount. Mr. Zhang, the co-owner of a small drugstore in Hunan, is often visited by tax collectors who take the Chinese medicines produced by his company for free (Interview P137). Mr. Xu, who runs a small retail clothing shop, has also frequently received tax collectors who force him to give them discounts (Interview P138). Expropriations could also occur in the form of “public goods project donations,” “protection fees” collected by local police station, or “extra tax payments” collected by the local taxation bureau (Interviews P135; P1373; P1375). In sum, despite legal developments and official recognition to support the private sector growth, there have been few *de facto* legal or institutional constraints to prevent governments from encroaching on private enterprises in China.

### *People’s Congress and its Deputies*

The people’s congress is China’s legislative body. The National People’s Congress (NPC) is the national legislative body, and local people’s congresses operate at the provincial, prefectural, county, district, and township levels. The representatives in the legislatures are formally called people’s congress deputies. Here I refer to them either as legislators or deputies. The majority of national and local

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<sup>2</sup>The ACFIC Survey (2000–2010). See the empirical section for a description of the survey.

legislators come from government bureaus, CCP offices, and the military. The second-largest group is entrepreneurs. The rest include peasants, teachers, migrant workers, and other sparsely represented occupations.

A quota system ensures that major occupations are represented in the legislatures, but entrepreneurs are overrepresented in this system. At the national level, around 17% of the NPC deputies are CEOs or other company leaders, whereas the population average is close to 0. About 27% are small business owners and entrepreneurs, compared to the population average of 9% (Truex 2014). At the subnational levels, private entrepreneurs take up about 11 percent of total seats at county congresses (Manion 2016). My survey of provincial congresses reveals that in half of all provincial congresses, private entrepreneurs hold at least 15% of total seats (see Appendix Table A2).

Obtaining a seat in the local people's congress is costly and competitive. Since this article focuses on entrepreneur-legislators, I mainly discuss how a private entrepreneur obtains a seat in a local legislature. The process works somewhat differently for candidates from the government, the Party, and the military, because these candidates are, for the most part, assigned by the local Party organization department. In contrast, campaigns for seats set aside for private entrepreneurs are competitive. A private entrepreneur must first be nominated by either the corresponding Organization Department (*zuzhi*) of the local Communist Party Committee, the United Front Work Department (*tongzhan*) of the Party Committee, or collectively by lower-level deputies and individuals. Manion (2014; 2016) refers to candidates nominated by the Party organization department and the Party united front work department as "party nominees" and those nominated by voters as "voter nominees." Private entrepreneurs are usually nominated through the "united front work" channel.<sup>3</sup>

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<sup>3</sup>In some congresses, private entrepreneurs can also be nominated as voter nominees, but usually government of party organizations "worked the system" and got them nominated through this channel (Interview O161).

Manion (2016) provides a detailed description of the candidate selection and election processes in the lowest-level congresses—the township and county congresses, where voters directly elect winners (see Figure A1). In the higher-level congresses, candidate selection follows a similar process: the organization and united work front units of the local communist party committee select nominees. These nominees, together with independent candidates, are vetted by the local communist party-led election committee, which selects the candidates. Deputies to prefectural and provincial congresses are different from elections in township and county congresses in that candidates are elected by lower-level congress deputies rather than voters.

Individuals interested in a position must invest time and money in both the “candidate selection” and “election” stages. In order to get nominated, they lobby the local party committee, the personnel at the local congress standing committee, and other organizations such as the local satellite party committee or the local All China Industry and Commerce Federation (ACFIC) office. If they get on the ballot, candidates continue to work on getting elected, either by voters from the district (township and county-level congress) or by their respective lower-level deputies (all higher-level congresses).

Of the private entrepreneurs I interviewed, 85% described the process of getting a seat in a local legislature as “competitive.” Another recently available survey suggests that only 30% of the entrepreneur-deputies were invited by the People’s Congress (PC) offices or the CCP, while the other 70% went through a competitive process.<sup>4</sup> Candidates spend a considerable amount of time and money to get their name on the ballot and win votes. Recently disclosed scandals further suggest that vote buying might be prevalent among entrepreneur candidates in some districts. In one extreme case, an entrepreneur in Hunan Province secured her seat at the provincial people’s congress by buying votes

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<sup>4</sup>The survey was conducted in November 2013 through a Chinese commercial survey company. The survey sampled 100 entrepreneurs from 21 coastal and inland provinces and 8 industries in China.

from lower-level deputies at a total cost of three million yuan (Roney 2014).<sup>5</sup> A more recent vote-buying scandal caused the national legislature to expelled 45 legislators, the majority of whom were business leaders (Forsythe 2016).

Local legislatures make local policies; only legislatures above the county level are permitted to make local laws. The lawmaking power of local legislatures is fundamentally restricted, because in principle “Chinese legislatures should report to, and get prior approval from, the CCP in all important matters of lawmaking” (Cho 2009, 20). Moreover, similar to the national lawmaking process where drafting has been “the responsibility of the administrative organs of the State Council” (Tanner 1999, 118), at the subnational level, local governments take the initiative in agenda setting and drafting (Cho 2009, 42). As a result, even if the business sector is highly represented in some local legislatures, legislators from the business class are unlikely to be able to initiate laws or regulations to formally provide property protection. And of course, enforcing such laws or regulations is a separate issue.

If these legislatures are “rubber-stamp” institutions with little real power or influence, why do entrepreneurs spend a fortune, and even engage in illegal activities, to obtain a seat? If the costs of getting into the legislatures are so high, what are the tangible benefits one might receive after securing a seat?

## How Legislative Seats Provide Property Protection

My core argument is that Chinese private entrepreneurs, who operate their businesses in an environment where property rights are largely unprotected, secure legislative seats to protect their property. The status of a local legislator sends a credible signal of his strong political network with upper-level officials, and this signal deters predatory behavior by low-level bureaucrats, who are afraid of retribution

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<sup>5</sup>Approximately USD 488,000.

or punishment from the legislator's political network. The ruling elite is aware of local expropriation but does not tolerate unrestrained expropriation. Thus when entrepreneurs obtain a legislative seat to deter expropriation, the process is not necessarily created by a top-down design, but is incentive compatible with the motivations of the ruling elite. The Chinese legislature therefore illustrates Gehlbach and Keefer's (2001) argument that institutionalized ruling parties allow autocrats to make credible commitments to investors and to restrain from expropriation.

Next, I discuss the preferences of the three main actors in the argument: low-level bureaucrats, high-level bureaucrats, and private entrepreneurs. The strength of an entrepreneur's political connections to high-level government officials or bureaucrats varies. The entrepreneur knows the strength of his own political connections, but low-level bureaucrats do not. Low-level bureaucrats infer the strength of entrepreneurs' political connections from their political status and decide who is safe to extract from. A low-level bureaucrat extracts from an entrepreneur if he believes the entrepreneur's political connections to be weak, and avoids extracting from an entrepreneur if he believes the entrepreneur's political connections are strong. Entrepreneurs with high levels of political capital reveal their type by sinking the cost of running for deputy seats in the local people's congress. Therefore, the political status of a people's congress deputy delivers a credible signal of strong political connectedness to these low-level bureaucrats, deterring them from expropriations. High-level bureaucrats allow low-level bureaucrats to expropriate from local businesses, but they might punish their subordinates if they expropriate from entrepreneurs with whom they have a friendly relationship.

#### *Low-Level Bureaucrats*

Low-level bureaucrats are the agents of their high-level principals. Here, I define low-level bureaucrats as subnational government bureaucrats who interact with local businesses across all relevant agencies. These bureaucrats are distinct from congress deputies: they are usually ranked too low to be a deputy in

any local congress. In this stylized argument, I assume that these bureaucrats have two main objectives: to get promoted and to extract rents when possible.<sup>6</sup>

The public choice literature commonly assumes that local bureaucrats have “grabbing hands”—i.e., that they engage in various forms of corruption to personally profit from their positions (Shleifer and Vishny 2002). While a significant number of local bureaucrats in China are publicly spirited and serve their constituents, many are exploitative and extract rents from local businesses (Lu 2000). Low-level bureaucrats extract rents from local businesses by imposing informal taxes, fees and fines through *ad hoc* investigations. Kellee Tsai observed that “[i]n any given week, the typical factory owner may be approached by dozens of different agencies requesting seemingly random user charges, surcharges, and contributions for local projects” (Tsai 2004).

A potential predator could come from any one of many local government bureaus, such as local taxation bureaus, the administrations for industry and commerce, the environmental protection agencies, administrations of work safety and coal mine safety, administrations of quality supervision, the inspection and quarantine administration, and the police bureau. An estimated 2.5% of China’s population is employed in the local public sector, which is more than twice the global mean of 1.1%. Of these local-level civil servants, 61.8% frequently or occasionally interact with local businesses (Hou, Meng and Yang 2014). Therefore, in a typical Chinese prefectural city with an average population of three million residents, 46,375 local bureaucrats could potentially predate on local businesses.

Income from extraction can either end up in line bureaucrats’ pockets or be directed to local government budgets to support the legitimate provision of public goods (Tsai 2004). While it is perhaps more justified to extract from local businesses if this income is invested in public projects, from the

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<sup>6</sup>On this assumption, one might argue that some Chinese local bureaucrats pursue justice and act according to moral and ideological principles, even at some cost to their wealth or career prospects. In those cases, we would observe a very low level of extraction.

perspective of entrepreneurs, any type of extraction is undesirable and is considered an infringement on their property, regardless of where the money goes.

Some low-level bureaucrats might have more information than others about the local elite network, but given the large number of entrepreneurs and the possibilities of making connections with different high-level officials, low-level bureaucrats have limited information about a given entrepreneur: Who might know my boss? Who is politically connected and powerful? Who has friends in his network who might be able to protect him? This private information is mostly unknown to low-level bureaucrats, who usually find it costly (and often impossible) to map all business–government connections. In this limited information environment, bureaucrats have to make careful decisions about from whom to extract rents. Membership in the local congress is a signal of one’s strong local political network. An entrepreneur who is a legislator requires an extensive political network to get elected, and holding this position enhances his access to upper-level officials and the elite network. But since the full extent of that political network is not *observable* to low-level bureaucrats, these bureaucrats are likely to avoid extracting from the business of an entrepreneur–legislator for fear that the connected entrepreneur might marshal his political capital to retaliate, for example by reporting to high-level bureaucrats.

Local bureaucrats look for opportunities to extract rents, but they do not want to be reported for preying on businesses and thus to develop a bad reputation with their superior. They are more likely to be reported if they expropriate from individuals who have access to high-level bureaucrats who are their principals. Although high-level bureaucrats might not necessarily punish extractive behavior by low-level bureaucrats, complaints from legislators can affect the bureaucrat’s likelihood of promotion.

### *High-Level Bureaucrats*

High-level bureaucrats are the superiors of low-level bureaucrats.<sup>7</sup> Principals (high-level bureaucrats)

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<sup>7</sup>The terms “superior” and “high-level” are relative. For example, when I study county-level tax collectors, their higher-

assign agents (low-level bureaucrats) specific tasks and evaluate these agents based on their performance. Just like any principal–agent relationship, principals cannot always successfully monitor the behavior of their agents. In this context, a main concern of these principals is that lower-level agents sometimes exploit their office for private gain. While high-level officials allow subordinates to expropriate from local businesses to a limited extent, they have developed a toolkit of methods (e.g., see Shih, Adolph and Liu 2012) to monitor and evaluate their agents to make sure they do not expropriate too much.

Local businesses are “central to accomplishing government objectives such as a growing economy, stable prices, high employment, and expanding tax receipts” (Kennedy 2009). In resource-scarce areas, business elites are especially important sponsors of public projects and the functioning of local administration (Lu 2000; Sun, Zhu and Wu 2014). Patron–client ties are also built based on personal connections. Kennedy observes that “[o]fficials provide entrepreneurs access to scarce goods, credit, government and overseas markets, and protection from onerous regulations. Entrepreneurs, in return, provide officials with payoffs and gifts, employment, and business partnerships” (Kennedy 2005, 10).

High-level bureaucrats have plenty of opportunities to befriend entrepreneurs, but they must choose their relationships carefully. It is “safer” for them to have a friendly relationship with entrepreneurs who serve in the congress. Local legislatures provide a formal channel through which high-level bureaucrats can interact with other legislators, many of whom are successful and therefore rich entrepreneurs. Local political and business elites make connections through formal and informal lectures, parties, meetings, and get-togethers organized by various government bureaus, associations, and individual business elites (Wank 1996). Some of these entrepreneurs are already friends with these high-level bureaucrats, and

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level bureaucrats would be their direct superiors—county-level tax bureau heads, and their indirect superior—working at the prefectural, provincial, and national tax bureaus. When I study prefectural tax collectors, the same “high-level” prefectural tax bureau officials become “low-level bureaucrats,” and their higher level superiors include their direct superiors—prefectural tax bureau heads, and indirect superiors— working at the provincial and national tax bureaus.

a legislator status legitimizes an entrepreneur's interactions with high-level officials. New connections are also formed and nurtured through plenary sessions, meetings, visits, tours, and other events related to local congresses, which provide opportunities for formal business-government interactions (Sun, Zhu and Wu 2014).

If a government official is observed having dinner with a private entrepreneur at an expensive restaurant, it might be perceived as a bad thing. But if the entrepreneur is a congress deputy, then others might think that they are having dinner together to discuss (congressional) committee work. The fact that they both serve at the congress is a useful facade (An entrepreneur-legislator, Interview P136).

### *Private Entrepreneurs*

Entrepreneurs have a strong preference for secure property rights which allow them to focus on developing their business. They are aware that local bureaucrats are extractive, and they understand that low-level bureaucrats are more likely to seek rents from companies with weak political connections. The strength of an entrepreneur's political connections is unknown to low-level bureaucrats (but known to high-level ones), but he can reveal his "type"—his political connectedness—to those bureaucrats. I argue that running for and securing a legislative seat sends a strong signal to uninformed bureaucrats about one's high political connectedness, therefore deterring expropriation.

This signal is costly. Becoming a legislator is expensive in China: In some cases it entails bribery to secure a seat. It is also expensive to socialize with other deputy "friends,"<sup>8</sup> and there may also be opportunity costs associated with time spent on collecting public opinion information, writing legislative proposals, and attending meetings.

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<sup>8</sup>Sun, Zhu and Wu (2014) carefully document the costs of maintaining connections with officials.

If an entrepreneur is a member of a local congress, his business is likely to be an established and profit-making enterprise; it is also likely to be a major taxpayer and an important job creator in the local economy. Relatedly, and most importantly, he almost certainly has strong connections with local elites—both those who helped him get elected and new relationships developed while attending plenums, collaborating in working groups, and participating in legislature-related events.

A low-level bureaucrat would therefore be particularly careful when deciding whether to extract rents from an entrepreneur–legislator, since the entrepreneur could contact high-level bureaucrats in his network (potentially including the bureaucrat’s direct superior) to report or complain about the incident. A high-level bureaucrat is not obliged to respond to such a report, and would likely choose to ignore it if he ordered or approved the extraction. However, high-level bureaucrats are more likely to take reports from a fellow legislator seriously and take action, which could range from an oral warning to a serious investigation.

Next I test the empirical implications of this argument by exploring whether a local legislative seat brings property protection to private entrepreneurs and estimating the effect size of such protection.

## Data and Measurement

My primary quantitative data source is a national survey of Chinese private entrepreneurs from 2000 to 2012. It is by far the most commonly used Chinese private entrepreneur survey by political science scholars (e.g., Ang and Jia 2014; Li, Meng and Zhang 2006). The survey was conducted every other year jointly by ACFIC, the China Society of Private Economy at the Chinese Academy of Social Science, and the United Front Work Department of the CCP Central Committee. Hereafter I refer to

the survey as the ACFIC survey. The dataset does not have a panel structure: In each survey year, individual enterprises were drawn into the sample from 31 provinces. The sampling method was multi-stage stratified random sampling, with geographic location (province and prefecture) and industry as strata. Chinese native speakers conducted direct interviews with the main owner of each company using a questionnaire.<sup>9</sup>

The outcome variable of interest is the level of extraction, which is defined as forced payments to local governments as a percentage of a firm’s total expenditure in a given year.<sup>10</sup> Extraction differs from bribes, which are more likely to be captured by the category of “public relations spending;”<sup>11</sup> it is not a legitimate form of taxation, which should be captured by the categories of “taxes” and “fees.” The mean value of extraction level is 0.0525, which means that firms spend on average 5.25% of their total annual expenditures on forced payments to local governments (see Appendix A for summary statistics).<sup>12</sup>

The treatment variable People’s Congress membership (PC membership) is a binary variable that denotes whether an entrepreneur was a local people’s congress deputy in that year.<sup>13</sup> Most legislators in the sample are from the prefectural congresses or below. Firm- and individual-level characteristics are measured in the survey and are either used as covariates or matched on, depending on the specification.

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<sup>9</sup>An individual may own or have joint ownership in multiple firms, but since the survey is anonymized, I am unable to identify them. Because the unit of analysis is the firm, I believe the possibility of multiple ownership issue does not affect the inference.

<sup>10</sup>In some survey years, total expenditure was reported as a stand-alone value. In other years, the category did not exist. To be consistent across all years, I constructed a new variable—total expenditure—defined as the total amount a company spent on taxes, fees, extraction payments and public relations in a given year.

<sup>11</sup>Choi and Zhou (2001) suggest that some entrepreneurs “openly use their money to get appointed or elected.” Those costs, clearly correlated with the whether one is a legislator, are more likely to be accounted for under the category of “public relations spending” instead of “extraction payment.”

<sup>12</sup>Note that there are three cases in which the variable extraction level takes a value of 1, suggesting that these companies pay no taxes or fees, and spend no money on public relations but are shaken down for *tanpai*. It is possible that these companies are shaken down completely by local governments in one year, or it could be a reporting error. None of these companies have a people’s congress deputy. I include these cases in the analysis, but excluding them does not change my conclusions.

<sup>13</sup>Please see the appendix for the original wordings of these questions.

Firm-level variables include: how long the firm has been in operation, whether the firm was a State-Owned Enterprise (SOE) in the past, which industry the firm belongs to, and which province the firm operates at. Characteristics of firm owners include: Age, Gender, Education level, Whether the owner is a CCP member, and Whether the owner worked in the government in the past (see Appendix Table A3 for summary statistics of all variables).

A few caveats need to be made regarding the quality of this survey. First, the organizations conducting the survey did not report a response rate, and the entrepreneurs responding to the surveys could be qualitatively different from those who chose not to respond. Therefore, the inferences I make in this article only apply to those who chose to answer the survey. Second, it is a self-reported survey, and entrepreneurs could choose not to answer some of the questions for reasons we cannot identify; thus this dataset suffers from a missing data problem. I address the missing data problem by comparing the results using datasets generated from multiple imputation (results presented in Table A9).

Finally, the survey responses were all self-reported, and the data could suffer from non-negligible measurement error, especially with regard to the main dependent variable *Expropriation*. For instance, entrepreneurs who are legislators might either be more honest about reporting their informal payments, because they are better protected by the government, or be more cautious about not reporting the expropriation of their profits out of political sensitivity or political correctness considerations. Ideally, I could use the actual level of extraction to benchmark the self-reported values of extraction, but there is no reliable data on this. Nevertheless, I am still confident about using this survey to estimate the effect of being a legislator on deterring expropriation. Over-reporting is less of an issue for the purpose of this study: Even if all legislators over-reported the level of extraction they experienced, the estimated effect size would have become a lower bound and the true effect size would only have been more significant. Systematic under-reporting, however, could have been a more serious issue, but

systematic under-reporting would only have happened if political sensitivity is a stronger concern for legislators than for the non-legislators. Based on my interviews, the entrepreneur-legislators did not appear to care more than the non-legislator entrepreneurs about political sensitivity, although this might have been a concern for both groups.

To understand the business environment for private entrepreneurs and state-business relations in China, I conducted 106 semi-structured interviews with Chinese private entrepreneurs, government officials, scholars, and journalists across four provinces in China between 2012 and 2015 (see Appendix B for a comprehensive description). These interviews were arranged through a combination of local government and academic contacts, as well as my own solicitations. All interviewees were guaranteed anonymity. The four provinces— Zhejiang, Hunan, Guangdong, and Guizhou—were selected to reflect differences in terms of private sector development as well as regional differences in business-state relations. Zhejiang and Guangdong provinces, located in coastal China, have the most developed private sectors in the country, whereas the private sectors in Hunan and Guizhou provinces in inland China are much less developed. Zhejiang and Guangzhou are often ranked in the top five provinces in terms of “healthy business-state relations” and Guizhou and Hunan are usually ranked in the lower half of all provinces by the highly cited Chinese marketization index, which takes into account of a variety of criteria including government intervention in local business, level of local taxes and fees, and the size of the bureaucracy (Fan, Wang and Zhu 2011). These in-depth interviews helped me develop a deep understanding of everyday business-state interactions in China.

## **The Impact of Legislative Seats on Deterring Extraction**

On average, entrepreneur-legislators experience lower levels of expropriation than non-legislators:

the mean value of expropriation level is 4.11% among legislators and 5.52% among non-legislators. The biggest threat to the inference of the effect of PC memberships on the level of extraction is that PC memberships are not randomly assigned. A brief look at the data shows that entrepreneurs who are members of people’s congresses are different from those who are not. Consistent with interview evidence, entrepreneurs who are PC deputies have bigger and older firms. Most PC deputies are CCP members and male, and they are more likely than entrepreneurs who are not deputies to have worked in the government in the past. They are also slightly older and more educated than non-PC entrepreneurs (see Appendix Table A1).

To address these concerns, I estimate the effect of PC membership on the level of extraction using a variety of reweighting and matching methods. I first estimate a simple linear model controlling for firm- and individual-level covariates.<sup>14</sup> I always include industry, provincial, and year fixed effects. All individual level covariates are strictly pre-treatment. Both firm level variables—the age of a firm and whether a firm was an SOE before—are also pre-treatment, because an entrepreneur’s legislator status would be obtained after his company was established, and converted from an SOE, if applicable. My fieldwork of investigating the deputy selection process suggests that these are the most relevant set of observables from the survey to be included in the analysis. Note that firm sizes are always incorporated, because the level of extraction is normalized by total expenditure.

I then employ an entropy-weighted linear model, a method that ensures perfect balance on covariate moments, to create a more comparable control group. To further ensure that the findings do not rely on a linear and additive parametric model, I use matching methods to test the robustness of the findings. In the matching specifications, entrepreneurs with a PC membership in the same province and industry

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<sup>14</sup>Firm-level covariates include: Firm age and Whether a firm was an SOE in the past; Individual-level covariates are: Entrepreneur age, Gender, CCP membership, and Education.

are matched to other entrepreneurs based on their Mahalanobis distance of the above covariates. I tried three different numbers of matched pairs for each PC member:  $M=1$ , 2 and 4. When  $M=1$ , for example, each PC member is matched with an entrepreneur who is not a PC member and who is “closest” to him in the value of the covariates.

I estimate the effects of PC membership on the level of extraction using linear regression models, OLS with weights determined by entropy balancing, and Mahalanobis matching. The results from these models are shown in Figure 1 and presented in Table A4 and A6.

I first examine the OLS model without weights. The OLS model estimates a negative correlation between PC membership and the level of extraction: Entrepreneur who are PC deputies spend 0.641% less on extractive payments to local governments than those without legislative seats. On average, Chinese entrepreneurs spend 5.25% of their total expenditures on involuntary payments. Thus, the OLS model estimates that becoming a PC member would save an entrepreneur 12.21% ( $= 0.641\%/5.25\%$ ) of his expenditures on extraction. This effect is substantively large and statistically significant. The level of people’s congress memberships—i.e., whether one is a provincial, prefectural, or county legislator—does not seem to matter. Being a higher-level legislator (e.g., a provincial legislator), although more powerful in many other respects, does not yield a higher level of protection than being a lower-level legislator (e.g., a county-level legislator).

To ensure a better balance on covariate moments and to reduce possible model dependency, I employ entropy balancing (Hainmueller 2009). This method gives weights to control units such that after weighting, the marginal distribution of covariates is the same for the treated and control groups in order to satisfy a set of moment conditions, while keeping the weights close to equality. I include the same covariates as those in the first OLS model. In this analysis, entropy balancing is successful at achieving full balance on the covariate distribution between those who are PC deputies and those who are not

(covariate balance is shown in Table A5). I then employ these weights in OLS regressions with year, province, and industry fixed effects to complete the required conditioning.

Similar to the estimates from the OLS model, this model suggests that being a PC delegate saves an entrepreneur 0.761% of his total expenditures on forced unofficial payments to local governments. Thus, an entrepreneur with a PC membership would save 14.5% ( $= 0.761\%/5.25\%$ ) of his expenditures on extraction. Again, the level of the legislative body does not seem to affect the estimation. Estimates from Mahalanobis matching analysis are consistent with these regression estimates in both magnitude and significance. These results are summarized in Figure 1 and Table A4.

Finally, I use quantile regressions to study the effect of PC membership on the levels of expropriation at different quantiles. Results show that the effect of PC membership is larger at higher quantiles: while on average being a PC delegate saves an entrepreneur 14.5% of his expenditures on forced unofficial payments to local governments, the effect size becomes 20.78% at the 80th percentile and 30.48% at the 90th percentile (see Table A11 for results). These findings suggest that the protective effect of political office is stronger when expropriation is more severe.

## Unpacking the Mechanism

Having established a strong association between PC membership and the level of extraction, I now discuss possible mechanisms that explain the protective effect of legislative membership. This section first rules out the “supervision power” mechanism. It then presents a simple game to illustrate how entrepreneurs use their PC membership to signal their political capital and deter expropriation.

Chinese legislatures perform four main functions: legislation, supervision, representation, and regime maintenance or support (Cho 2009). As established earlier, the legislation function at the local level

remains weak. Could it be the case that a legislator's supervision power, and more specifically, their power to appoint and dismiss government officials, deters low-level bureaucrats from expropriation?

Chinese people's congresses were invited to oversee policy implementation in the 1980s (O'Brien 1994). Although government officials are formally appointed and, in rare cases, dismissed by local people's congresses, the decisions are usually made in advance by the Party and the local governments. Legislators rarely appoint or dismiss government officials of their own accord. Local party committees usually nominate the candidates; deputies only have access to the files of each candidate right before the voting process. They usually vote yes, since they believe the nomination is already "set in stone" and that their votes are not likely to matter (Interview M131). Deputies are sometimes assigned into an appraisal or supervision group that corresponds to a specific government agency. These groups usually visit the assigned agency only once a year, and government agencies and deputies usually operate under the implicit agreement that this type of supervision and appraisal does not mean much (Interview P154). Although deputies rarely exercise their supervision and appraisal power, in the shadow of this formal power, entrepreneur-deputies could exploit it to gain a more advantageous bargaining position when dealing with local officials. I do not completely rule out this possibility, but the fact that deputies and government officials seldom mentioned these formal powers suggests that they are not the main mechanisms to explain why officials treat legislator-entrepreneurs preferentially.

I argue that the political capital associated with being a legislator explains why low-level bureaucrats are deterred from expropriating from entrepreneur-legislators. Being a legislator sends a strong signal of one's political connections. An entrepreneur-legislator needs a great deal of political capital to get nominated and elected. After he is elected, an entrepreneur-legislator expands his network to incorporate political elites who are also local legislators through attending required plenums, collaborating in working groups, and participating in congress-related events.

A low-level bureaucrat, well aware that entrepreneur–legislators are elected by mobilizing their political capital and, after they are elected, gain access to an extensive network of political elites (potentially including the bureaucrat’s own superior) will be particularly careful when deciding whether to extract rents from, especially when he lacks information about an entrepreneur’s political connectedness. If he decides to extract from an entrepreneur who is a legislator, the entrepreneur may contact relevant higher-level officials in his network to report the extractive behavior. Such a report could be detrimental to a local bureaucrat’s career.

Interview evidence suggests that bureaucrats indeed use entrepreneurs’ political status to infer the strength of their political connections. When I asked a prefectural-level tax collector whether he would collect extra taxes from a firm headed by a local legislator, he gave a quick and certain no, because “membership in the congresses means good connection with superiors,” and he does not want to “receive a call from his superior” and “get in trouble” (Interview G133).

Entrepreneur–legislators believe their political status deters expropriations: when they are in trouble, they can call friends in their political networks. If predatory bureaucrats do not take this signal of “political connectedness” seriously, there are potential consequences. Mr. Xu, a fourth-term prefectural congress deputy, recalled that things like “investigations, requests to join government-affiliated organizations” happened in the past to his company but not anymore (Interview P134).

Next, I present entrepreneur–bureaucrat interactions as a signaling game of incomplete information (Figure 2). The sequence of the game is as follows. Nature moves first and assigns an entrepreneur to be either the connected type (C) with probability  $P$ , or the unconnected type (UC) with probability  $1-P$ . After nature’s move, the entrepreneur, who knows his type, chooses “to run” (R) or “to not run” (NR) for a people’s congress seat. The low-level bureaucrat does not know the entrepreneur’s type, but observes whether the entrepreneur decides to “run” (R) or “not run” (NR). The bureaucrat chooses

either to “expropriate” (E) or to “not expropriate” (NE).

I make a number of simplifying assumptions. The starting point is that an entrepreneur is connected (C) or unconnected (UC) in the local political network. Both types of entrepreneurs generate the same amount of revenue  $r$ , but their costs of running for a people’s congress seat are different. The cost is much higher for an unconnected entrepreneur than for a connected one:  $c_c < c_{uc}$ , because the unconnected entrepreneur needs to exert more effort to make friends and to get himself on the ballot. I assume, in this game, that all entrepreneurs who run for a seat win. In addition to using the legislative seat as a signal, entrepreneurs who gain a seat also enhance their political connectedness. In this game, the enhancement of political connections results in stronger punishments for low-level bureaucrats.<sup>15</sup>

I also assume that the low-level bureaucrat expropriates from an entrepreneur for a fixed amount of  $e$ , regardless of the type of entrepreneur. The bureaucrat does not know whether an entrepreneur is the connected or the unconnected type. If the bureaucrat expropriates from a connected entrepreneur, the bureaucrat faces punishment from the superior in the amount of  $p_c$ . If the entrepreneur is a legislator, the bureaucrat faces additional punishment due to the enhanced political connections in the amount of  $p_l$ , regardless of the type of the entrepreneur. Because bureaucrats observe running and not running, they observe  $p_l$ . Finally, because a bureaucrat sometimes refrains from expropriation, he has to be deterred from doing so in certain situations. Therefore, I assume the worst possible punishment he will receive is greater than his expropriation income, that is,  $e < p_c + p_l$ .

The game has a separating equilibrium when  $c_c < e < c_{uc}$  (see Appendix C for proof).<sup>16</sup> In this equilibrium, the connected entrepreneur always runs for office and the bureaucrat avoids expropriating

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<sup>15</sup>In reality, enhanced political connections should also increase an entrepreneur’s payoff, e.g., in the forms of government contracts, or easier access to land and credit. Because this model only looks at expropriation, the enhancement of political connections is only reflected in the more severe punishment of the extractive bureaucrat.

<sup>16</sup>The model produces the same equilibrium if I set  $p_l$  to zero. I keep  $p_l$  in the model to entertain the possibility that the deterrence effect could come from both signaling and political capital enhancement.

from the entrepreneur–legislator; the unconnected entrepreneur does not run for office, and the bureaucrat expropriates from the unconnected entrepreneur. Running and being a legislator sends a signal of high political connectedness to the predatory bureaucrat and deters him from expropriation.

## Conclusion

In this paper I examine how Chinese private entrepreneurs use legislative office to deter expropriation and to ensure property security. Through membership of a local people’s congress, a private entrepreneur signals his extensive political network to deter potential predators. The results show that entrepreneurs with a legislator status on average experience 14.5% less expropriation by local governments. Legislative seats indeed protect entrepreneurs from the grabbing hand.

This study contributes to an emerging literature that focuses on individual firms’ role in establishing property security in places with a weak rule of law. It also offers new insights for scholars into authoritarian institutions and challenges the dominant views that assumes authoritarian institutions are instruments primarily for the autocrats. This study also provides new and nuanced micro-level evidence to help understand the value of political offices and the relationship between political connections and property rights in an authoritarian context.

Has President Xi’s ongoing anti-corruption campaign affected entrepreneurs’ political participation and the business-state relations? On the one hand, the campaign has been successful in forcing many government officials to pull back from “practices of collecting bribes,”<sup>17</sup> and as a result, we might observe a decreased level of extraction. On the other hand, it has not fundamentally changed the business-state

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<sup>17</sup>China’s Fierce Anti-Corruption Crackdown: An Insider’s View. NPR. December 24, 2014. <https://www.npr.org/sections/parallels/2014/12/24/372903025/chinas-fierce-anti-corruption-crackdown-an-insiders-view>. Accessed April 27, 2015.

relations, because the government continues to be heavily involved in the economy. In these “sensitive” times, legislator status is even more helpful in bringing legitimacy to business-government interactions. Entrepreneurs and government officials still interact frequently, and informal transactions continue to proceed on a daily basis, further increasing entrepreneurs’ incentive to invest in political capital to advance their business interest.

Do Chinese entrepreneurs have the potential to be agents of change? Will their growing numbers and wealth eventually make them a credible political threat (Ansell and Samuels 2010)? North and Weingast’s (1989) seminal work on the institutional development of 17th century England documents how the wealth holders gradually gained their decision-making power through their representatives in the parliament, which established the government’s commitment to honoring its agreement and the promise not to appropriate wealth. Contrary to Dickson (2008) and Tsai (2007), I assert that it is still too early to conclude that Chinese entrepreneurs are not onto a democratizing path. Institutions are sticky, but even relatively powerless players within authoritarian institutions might have started to use whatever little power they have to reshape institutions from within. In the case of China, there might exist a benevolent cycle in which entrepreneurs increasingly use formal means to secure property, and formal institutions eventually start to change to reflect and respond to these demands.

The results of this study also have implications for innovation and long-term economic growth. Development scholars have argued that innovation might be less important for “late developers” because they first take shortcuts through emulation (Gerschenkron 1962). But in the long term, there is very little disagreement that innovation is crucial for growth. As Acemoglu et al. (2013) show, subsidizing incumbent firms reduces growth and welfare, because such a policy deters the entry of new firms that might have higher innovative capacity in the long run. I show that newer and smaller firms are less likely to obtain a seat in local legislatures, and are more likely to be expropriated. It would be even

more concerning if, instead of investing in innovation, firms invest in cultivating political connections because they see a higher return from the latter type of investment. Such a system would likely hurt firm-level innovation and productivity growth in the long run.

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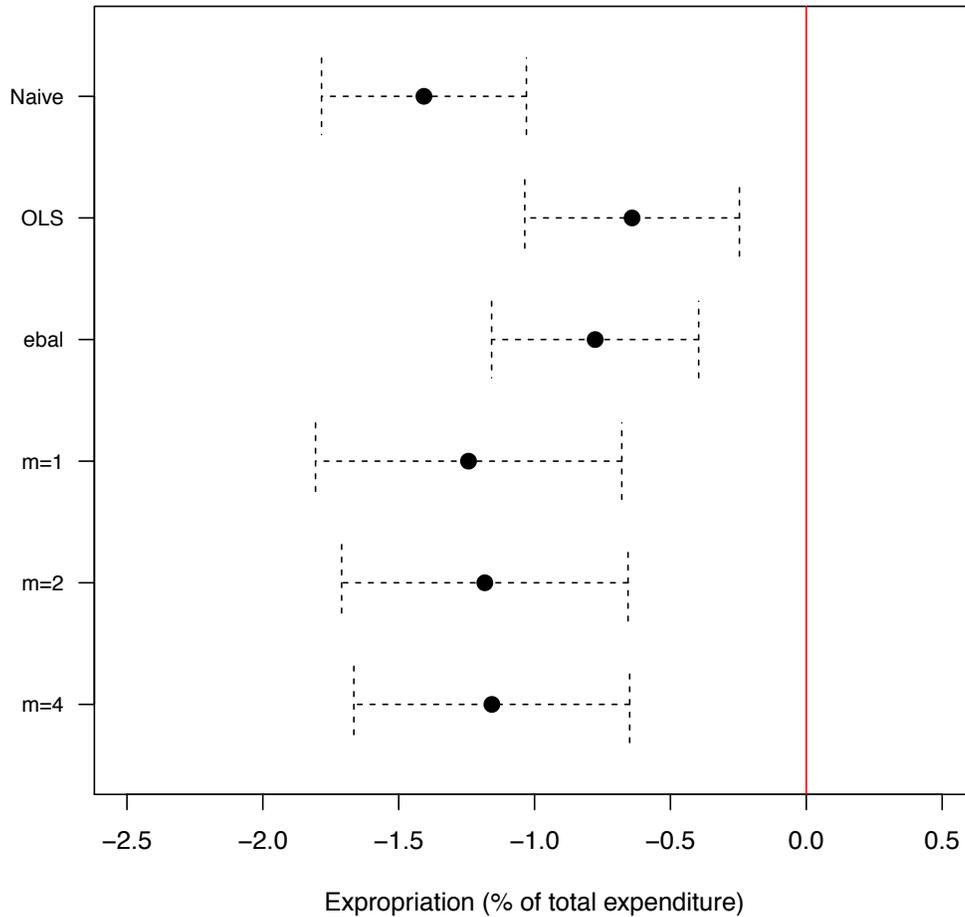
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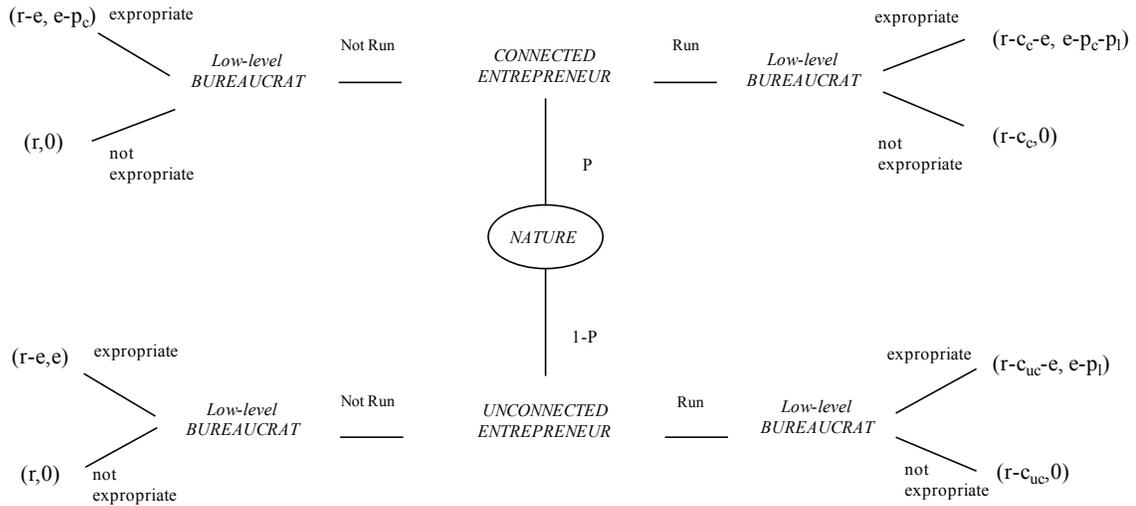
# Figures

Figure 1: Effects of PC Membership on the Level of Extraction under Different Specifications



*Note.* Summary of effect estimates of PC membership on extraction under five models: OLS with covariates (OLS), entropy balancing followed by weighted OLS with covariates (ebal), and nearest neighbor matching: 1-to-1 (m=1), 2-to-1 (m=2), and 4-to-1 matching without replacement (m=4). The top bar shows the naive difference in means between the two groups. All models find that having a PC membership reduces an entrepreneur's spending on extraction by 0.641 to 1.243 percentage points. That is, regardless of the model used, being a legislator saves an entrepreneur about 12.21% to 23.68% in total expenditures.

Figure 2: Signaling Game between Entrepreneurs and Low-level Bureaucrats



Notes. The payoffs are as follows. For the entrepreneur,  $r$  represents the revenue from running the business;  $c_c$  is the cost of running for connected entrepreneurs,  $c_{uc}$  is the cost for the unconnected entrepreneurs and  $e$  is the amount expropriated. For the low-level bureaucrat,  $e$  is the amount gained from expropriation,  $p_c$  represents the amount of punishment from his superior when the bureaucrat expropriates from a connected entrepreneur; and  $p_l$  represents the level of punishment when he expropriates from a legislator.

