Comments on Chenggang XU, "The Institutional Foundations of China's Reforms and Development"

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Prof. Chenggang XU has written a very original and provocative paper, reviewing and analysing comprehensively the institutional foundations of China's economic reform. I like this paper very much. This paper has many rich details and potential extensions and deserves a most careful reading and re-reading.

I have not worked in the area of institutional design myself, but would like to offer the following observations from the perspective as a lay person.

Prof. XU correctly pointed out that China has operated more or less successfully for two millennia. The dynasties that ruled China successively as a unitary state had an average life of close to 300 years. The Chinese economy was the largest economy in the world until the 19th Century. There must have been some elements in its institutional framework that accounted for the relative success of the Chinese system. (For example, China has been often credited with the invention of "bureaucracy"). Problems of incentive and control mechanisms have long existed but have also been successfully solved in practice in different ways, even in China. We can learn a great deal by examining the Chinese historical experience. Let me give a few examples.

First, on the problem of managerial incentives, the Shansi banks (山西票号) which dominated Chinese banking until the late 19th Century, had a rather ingenious solution. The Shansi banks had a rule that strictly separated the ownership and the management—the owner/controlling family would never manage the bank itself, it would always employ a professional general manager (东家不上柜). The professional general manager was typically given a fixed-term contract of five years and with it a virtual free hand in running the bank. He had a good salary, and potential performance bonuses, but most importantly, he was given significant sweat equity in the bank (it was not an option but part of the compensation package). When his term was up, a new professional general manager would be engaged. However, the former general manager could not withdraw his sweat equity right away, but had to wait another five years. Thus, he would have the incentive of leaving the bank in relatively good shape (for example, not deferring needed maintenance), and helping to find a good successor (so as to preserve the value of his sweat equity). As the former general manager, he would have the right to inspect the bank's books at any time. Since he would know the bank's business even better than the owner, his examination of the books would be far more effective than the owner's own examination. The former general manager had the option, at the end of the third year after he stepped down, to convert his sweat equity at the then market value into interest-bearing debt—this would mean that he would no longer participate in the ups and downs of the bank, but would become a pure, unsecured creditor. If he chose this option, it would be a strong signal to the owner that the former general manager had lost confidence in the current general manager, and that he'd better do something about it very soon. This mechanism served the Shansi banks very well, until they failed to compete with the modern banks like the Hong Kong and Shanghai Banking Corporation in the late 19th Century.

Second, on the question of central-local relations, I would like to make two points. First, historically, Chinese central governments had two major responsibilities that transcended the localities: the maintenance of the irrigation and flood control systems and national defence (e.g., the Great Wall), which affected the welfare of the entire country. Local governments acting by themselves could not perform these two functions, and that is one of the reasons why China could remain a unitary state—a central government does add value. Second, also historically, many customs and practices were adopted to augment the capacity of central control. For example, a native son of a province would never be appointed to be a major official in that province; there would be a strict rotation of officials—no official was allowed to stay at the same province for more than 3 years; officials were discouraged from close association with businessmen, especially local businessmen; censors (御史) and other central government emissaries would be sent periodically from the capital to the localities to check on the performance of the local officials and to receive petitions locally; and of course, there was the custom of a direct personal appeal to the capital (上访) which is still with us today.

Third, the so-called "best practice" depends not only on the time and circumstances, but is also path-dependent, as Prof. XU pointed out, and also more fundamentally culturally and environmentally dependent. In some sense, the cultural dimensions are the most important, and ultimately they depend on the intrinsic value system of the people. Prof. XU suggested judicial independence and pres freedom as the keys to checks and balances on the power of the government, central and local. I agree with him in principle, but we must be careful to note the potential pitfalls in the absence of a strong underlying supportive non-monetary value system. We cannot afford to give judges who can and are willing to be bought too much independence. Many newspapers (e.g., some in Hong Kong) find it profitable to distort the news and to instigate discord rather than reporting news truthfully and objectively. We cannot rely on a newspaper that focuses only on making money and has given up on being objective to provide checks and balances. Such a newspaper is merely another rent-seeker. All of this suggests that ultimately China must try to rebuild an underlying value system that is not limited to only money and power and that is shared by all or most of the people. Recently, the United States Supreme Court has ruled that corporations (as well as labour unions and other organisations) can spend unlimited amounts of money to support candidates and causes in election campaigns. I personally believe this is a bad decision, with huge negative consequences for U.S. democracy and society. It means ideas can prevail not because they are right, but because they are supported by more money. China should avoid going on this path.