

Design Incentive Compatible Institutional Changes: Lessons from China

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IPD China Task Force Meeting, 8 August 2006

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Institutional Changes Should Be Designed as Incentive Compatible

- Incentives in institutional changes
 - Common feature of successful institutional changes: interests of most important stakeholders are taken cared of
 - Political and economic incentives to support/resist institutional changes
 - This is one of the most important lessons of Chinese reform
 - Household responsibility system; TVEs; special economic zones, etc.
- Why are institutional changes are path dependent
 - Existing institutions affect interests of stakeholders
 - How stakeholders support/resist an institutional change deeply affect consequences
 - Later reforms are affected by stakeholders' incentives that are determined by previous reforms
- Security of private property rights vs. Incentive Condition in reform design
 - The ultimate goal of securing property rights is to solve incentive problems
 - How to create private property rights may generate more severe incentive problems that overlooking it can make things worse

Incentive compatibility in reforms

- ‘Big bang’ approach of demolishing existing institutions
 - May deprive major stakeholders’ interests
 - Strong resistance from those stakeholders
 - Replacing demolished institutions takes time
 - Create governance vacuum and chaos
- Evolutionary approach by altering existing institutions
 - Weaken resistance to reforms: Chinese regional decentralization
 - Incentive compatible reforms can be implemented easily
 - Household responsibility system; TVEs; special zones, etc.
 - Prepare reforms step by step through changed incentives
 - Price reform & enterprise reforms → legal reforms → privatization (gaizhi)
- Potential pitfalls of evolutionary reform approach
 - Each reform step may create new stakeholders that holding/expanding their interests may divert reform to wrong directions
 - e.g. Land abuse and Chinese regional governments

Incentive Compatible Reform and Chinese de facto Federalism

- Constitutionally China is not federalism but regional decentralization characterizes its feature historically
 - Regional decentralization as an institutional base when reform (Granick, 1990; Qian and Xu, 93)
- Regional decentralization provides incentives for regional governments to compete in reform
 - Regional government officers' career paths are linked to regional economic performance (Maskin, Qian and Xu, 2000; Li and Zhou, 2006)
 - Build-in incentives to compete in reform and in growth
- de facto federalism facilitates experimental strategy in Chinese reform (Qian, Roland and Xu, 2006)
 - Experiment based agriculture reform; special economic zones for FDI, etc.
- Regulatory federalism as law enforcement mechanism (Pistor and Xu, 2005; Du and Xu, 2006)
- How important regional governments are to performance of firms?

Evidence from a nationwide sampling survey

- Nationwide firm managers believed relationship with regional government had substantial influence on firms' performance (in the scale of 0-5, 5 being indispensable)
 - By ownership:
 - State-owned firms: 4.0
 - Domestic private firms: 2.6
 - Foreign-Chinese joint ventures: 2.7
 - Foreign firms: 2.6
 - By region with strong performance:
 - Beijing: 3.1
 - Shanghai-Jiangsu: 3.3
 - Zhejiang: 3.1
 - Guangzhou: 3.2
 - By region with weak performance:
 - Northeast provinces: 3.4
 - Southwest provinces: 3.3

Evidence: Regional government & firms

- What did government do? specific aspects of government help (0-5)
 - Provision of land, electricity and infrastructure (3.9)
 - 99% firms reported that their land came from government
 - Reducing admin and tax burdens (3.2)
 - External finance (bank loan and go public) (2.8)
 - Business disputes with other firms (1.7)
- Government help and stage of firms' development
 - Importance of government help for growth of start-up firms (3.8)
 - Importance of government help for expansion of matured firms (3.5)
- Perceived reasons why regional governments help local business, by importance (0-5)
 - For local tax revenue (average 4.0)
 - For regional governments' performance (3.7)
 - Implementing policy set by the central government (3.0)
 - For regional social welfare (2.7)
 - Using the local business for government's own purpose (1.3)
 - For government officers' personal gains (0.34)

Evidence: Regional government and law

- Lack of judicial independence makes regional government more important for business
 - 84% firms believed location of litigation is important if a case involves parties from different regions
 - 60% firms believed regional government support is important in winning a court case
- Most firms reported that regional government direct influence to firms is more important to them than law enforcement (3.4 vs. 2.6)
- Trade offs of growing importance of regional governments
 - Without regional governments: danger of governance vacuum
 - Dominance of regional governments: danger of no law land
 - Things can go really bad

Omni-powered regional governments control land, project, credit



Regional governments' micro intervention leads to inefficiency

- Negative roles of regional governments: micro control of firms
- Government's importance on corporate decisions (capital allocation within firm)
 - By ownership:
 - State-owned firms: 2.4
 - Domestic private firms: 0.013
 - Foreign-Chinese joint ventures: 0.04
 - Foreign firms: 0.025
 - By region with strong performance:
 - Beijing: 0.38
 - Shanghai-Jiangsu: 0.30
 - Zhejiang: 0.14
 - Guangzhou: 0.32
 - By region with weak performance:
 - Northeast provinces: 1.8
 - Southwest provinces: 0.53

Conclusion: Problems and Solutions

- Problems with the Chinese de facto Federalism
 - No build-in mechanism for macro control
 - Admin approach for credit control in the mid 1990s
 - Central government's failing in macro control since 2004
 - Build-in mechanism in expanding land use and construction
 - > 1 million cases of unlawful land use nationwide during 1999-2005
 - Most of them were conducted by regional governments
 - Corruption and rent seeking
- Institutional solutions to correct regional governments' incentives
 - Highest priority: Judiciary independence at regional level
 - Should weaken regional governments' influences in some areas
 - Financial sector
 - All competitive areas