

# **The Property Rights Micro-Foundations of Macro-History: Ray Huang's Analysis of Market Reform in China**

By Andrew Sheng, Geng Xiao and Wang Yuan<sup>1</sup>

## **1. Introduction**

In our earlier presentation to the 1990 Institute/Shanghai Academy of Social Science (SASS), we referred to the point that the lack of a Property Rights Infrastructure (PRI) hindered the development of China's financial system<sup>2</sup>. Using Hong Kong's experiences, that paper examined how corporate governance is closely related to capital market development in particular and property rights infrastructure in general. A well-functioning capital market requires clear delineation, efficient exchange, and effective enforcement of property rights. These functions rely heavily on an array of supporting institutions, or PRI.

This paper undertakes a brief historical review of why the PRI (or lack thereof) occurred historically in China, compared with the West. Whilst renowned macro-historians like Professor Ray Huang were clear-sighted over why China never developed the institutional framework for a market economy, he was not clear how the PRI could be built. We therefore examine his analysis and show how the reform of governance and the governance of reform needs to be considered from a historical and institutional perspective. Specifically, the question of building the PRI is a *technical* question with political economy dimensions, since there is already considerable private and public management expertise developed in recent years in the area of change management that China can now borrow and adapt.

## **2. A Historian's view of Chinese Market Development**

In his comparative overview of Chinese economic history against European development, American Professor Albert Feuerwerker<sup>3</sup> remarked that: -

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<sup>1</sup> Andrew SHENG and Yuan WANG work for the Securities and Futures Commission, Hong Kong. Geng XIAO works for the University of Hong Kong. The paper reflects entirely the authors' personal view and does not represent the views of their employers. Xiao Geng would like to acknowledge the financial support for his research from Hong Kong's University Grants Committee (Project No: AOE/H-05/99).

<sup>2</sup> Andrew Sheng, Xiao Geng and Wang Yuan, "Corporate Governance, Capital Market, and Property Rights Infrastructure: *The experiences of Hong Kong and Lessons for China*, 1990 Institute/SASS, May 2004

<sup>3</sup> Albert Feuerwerker, "Chinese Economic History in Comparative Perspective", in Paul S Ropp, Ed., "Heritage of China", University of California Press, 1990

“For all its bureaucratic sophistication, the Chinese Empire never undertook several basic policies that would have aided economic development. It never developed a funded national debt that untied wealth from the land, it never promulgated comprehensive codes of business law nor created judicial institutions that were devoted to maintaining property rights, and it never developed insurance schemes that could have been used to reduce commercial risk.”

This lack of institutional evolution to protect property rights was also noted by the respected Chinese historian Ray Huang, author of “China: A Macro-History”, who has always remarked that “until recently, China has remained mathematically unmanageable<sup>4</sup>”.

He felt that “when China entered the twentieth century she was still a dynastic state rather than a national state. Her top structure relied on the omnipotent power and the mystic quality of the throne. Remaining on the bottom were many hundreds of millions of small, individual self-cultivators, from who the bulk of the taxes was collected. In between the top and the bottom was the civil service bureaucracy, the criteria for admission to its membership were limited to literary skill and a pledge to the traditional code of personal ethics.<sup>5</sup>”

It was the lack of the middle “superstructure” that made China mathematically unmanageable, because “when the rights of private property of the individual are held inviolable before the law, the authority to perform and the obligations that come along with it can also be added, subtracted, multiplied and divided to correspond to the more refined division of labor. These conditions provide an incomparable advantage [of Western capitalism] in developing science and technology over a society not yet so structured.<sup>6</sup>

In modern parlance, China never developed the property rights infrastructure to enable the market economy to function effectively. The literary bureaucracy that survived for four thousand years lacked the fiscal tools, the regulatory and governance standards and judiciary systems that linked the bureaucracy with the emperor at the top and the agrarian populace at the bottom of the social strata. Throughout history, the fiscal resources available to the emperor and his court was roughly 7% of output, insufficient to deal with foreign invasion, natural disaster and bureaucratic corruption and decay that gave rise to dynastic rise and fall from rebellion/invasion or recovery. A modern state with clear property rights requires roughly 25% of GDP to function effectively.

Throughout Chinese history, it was quite possible that the Chinese bureaucracy consumed 25% or more of output, but a considerable amount must have leaked through corruption and bureaucrat-merchant activities that financed either public officials’ expenditure (in the case of corrupt officials) or public goods (in the case of upright and dedicated officials). In reality, the Chinese bureaucracy in history behaved very much like the Gorbachev description of the Soviet system: “the Soviet worker pretended to work; and the Soviet State pretended to pay them”.

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<sup>4</sup> Ray Huang, “Chinese History and Western Civilization”, in *Broadening the Horizons of Chinese History*, ME Sharpe, New York, 1999 pg 127. Professor Ray Huang was a soldier in the Kuomintang army of the 1940s, who later studied Chinese history in the United States and worked with Joseph Needham on the monumental Cambridge study of Science and Civilization in China. His key work was a comparative analysis of why the West overtook China in the 17<sup>th</sup> century in the institutional capacity to foster science and the market.

<sup>5</sup> Ray Huang, “A New Direction for Modern Chinese Historiography”, op cit pg 209

<sup>6</sup> Ray Huang, “Capitalism in Venice, The Dutch Republic, and England” in op cit pg 94

Debasement of the currency, both metal and paper money (the latter of which the Chinese invented) to finance fiscal deficits created inflation and the conditions for the downfall of regimes.

Without an independent judiciary to check the power of the bureaucracy or the emperor, the bureaucracy elite that survived it all through tenacity and Confucian moral authority, “pretended to rule the masses” and “pretended to collect taxes” to finance the state activities. It is this bureaucratic structure and its legacy mindset that may be standing in the way of China’s march to an efficient market economy.

It has been our personal observation that China always seems to eventually get to the right answer by appearing to implement policy the wrong way around<sup>7</sup>. In 25 years of the march to the market economy, despite exhortations from all quarters, including the Washington consensus, China never adopted the creed of privatisation. And yet, at the end of the first quarter century of reforms, the private sector accounts for probably half of value added and perhaps as much as one-third of national wealth.

Ray Huang also likened the Chinese state apparatus as a “pyramid built upside down<sup>8</sup>”. This top-down bureaucracy was not founded on basic property rights of the citizens, thus “setting back democratic potential and obstructing the growth and development of regional and local institutions, also presses the technical impracticalities downward to the bottom.<sup>9</sup>”

What Professor Huang meant by “mathematical unmanageability of China” was not initially clear to Western-trained economists, until he clarified that “this is far more than an economic reform. Nor is it a feudal system that China is trying to do away with. To be razed is the traditional bureaucratism, including the practice of erecting pyramids from the top downwards. Although the work is merely getting organized at this late hour, it still has to start by securing the property rights of the individual; otherwise there will be no practical way to consolidate the infrastructure<sup>10</sup>.”

In other words, a traditional social hierarchy or pyramid along the Anglo-Saxon common law model is founded on the basic property rights of citizens. In the rural villages that evolved, villagers differentiated between individual rights and those of the “common”, or rights to common property, such as the village green. This bottom-up approach to common law was a civil approach to law and property, where elders are elected or selected (such as justices of the peace or lay magistrates) to protect such rights. Later on, full-time and paid judges emerged as a profession, and they also performed a vital function as guardians of individual rights against disputes between citizens and the state.

Ray Huang recognized this impact of property rights on government finances: “A commercialisation of government finance on a large scale cannot do away with civic support the second line and on the third line. Wang Anshi’s failure to do so during the Song Dynasty

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<sup>7</sup> The complexities of Chinese policy making in recent years can be assessed by the study by Kenneth Lieberthal and Michel Oksenberg, “Policy Making in China”, Princeton University Press, 1988

<sup>8</sup> Chinese History and Western Civilization”, in op cit pg 120

<sup>9</sup> op cit pg 123

<sup>10</sup> Op cit pg 155.

provided such a lesson for the millennium. The support only becomes effective when private property rights are secured<sup>11</sup>.”

The common law was built from the bottom up through actual cases of property rights disputes, and such disputes would be settled through higher and higher levels of courts. The lower courts established evidence, and the higher courts established key legal principles, which forms a large body of precedent for other courts to follow. This ensured consistency of application of law, which is one major improvement over administrative decisions that could be arbitrary and therefore inconsistent.

One fundamental strength of the common law court system was also its transparency. All court cases and their decisions were on public record, so that other courts can rely on precedent decisions to rule on cases before them. As the market economy became more complex, property rights disputes can be resolved only on a “case by case” basis, just like the experience of international financial crises. However, after many cases, there are common elements of basic principle of law that emerge, and brilliant judges or lawyers were able to discern such common elements that fundamentally shaped social behaviour. Examples of this are important legal cases in the West such as those that determined the right to abortion or segregation in schooling.

In contrast, “top-down” law administered bureaucratically cannot cope with the “law of unintended consequences”, in which any written law would meet vested interests and therefore disputes over property rights. If these disputes are handled administratively, the decisions would be seen to be arbitrary, without consistency with other similar cases and subject therefore to accusations of possible political or vested interest interference that give rise to further controversy and therefore lack of public credibility.

The “bottom-up” common law in England solved this problem by ensuring both transparency, consistency and accountability to the public, because it was complemented by legislative made law, through elected legislative chambers, of which one comprised direct elected members, and the other hereditary or elevated “law lords”, which acted as the Privy Council or court of final appeal. This model formed part of Montesquieu trinity of checks and balances between the executive, the legislature and the judiciary that the American system adapted from the English model.

As long as the three channels of the state bureaucratic structure functioned well together, they helped to maintain a stable market economy, because all three bodies were checks and balances against each other, and all three functioned to resolve fundamental property rights disputes within and without the state as follows: -

- The Executive was responsible for defence and foreign affairs (in terms of disputes between the citizens and foreigners) and also implementing public policy objectives. In more recent years, independent regulatory bodies were established to deal with specific areas requiring market regulation<sup>12</sup>;

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<sup>11</sup> Western Civilization, Op cit. pg 162

<sup>12</sup> For example, the central bank emerged in Holland in the 17<sup>th</sup> century to regulate banking, whilst in 1930s, the Americans were the first to create a specialist securities regulator to protect investors.

- The Legislature approved the financing of the Executive [no taxation without representation] and also laws that complemented the judge-made law;
- The Judiciary arbitrated between disputes of property rights between individuals and also was a check against disputes between the Executive and individuals

The market economy then became stable, if citizens have certainty over property rights (so that there would not be capital flight) and they trust the system to resolve all disputes in a fair and transparent manner. This was the stable property rights pyramid that characterized a market economy.

If Ray Huang's analysis of the inverted pyramid is correct, then the key challenge to China's move to a market economy is to build the regulatory, legal and judicial systems that protects property rights fairly and transparently. In Ray Huang's terminology, the challenges in that transition are as follows: -

- First, the "top-down" bureaucracy faced the perennial problem of raising sufficient fiscal and monetary resources to feed the population, maintain social stability and state machinery and provide for old age pension and social security;
- Secondly, the bureaucracy (including the existing judiciary) faced the problem of ensuring that property rights disputes between citizens and between state and citizens are considered fair and transparency, without such problems exploding into social discontent;
- Thirdly, as China converges with the market-based Western economies, it will have to adopt international legal, financial and technical standards and therefore behave according to such standards;
- Fourthly, since China does not as yet have these standards or the laws, norms and structures are "incomplete", it will have a transitional period in which there is a huge "heritage" of stock of past problems, (as these are marked to global market standards), as well as a phase of "flow of new problems", as the Chinese nation (state and private enterprise) learns to cope with international norms.

The problem with the present "top-down" bureaucratic structure is that the unitary system tries to resolve most or all property disputes through administrative means. As the failure of central planning demonstrated, no single bureaucracy, however efficient, can cope with the complexities of the market. Whilst the Chinese bureaucracy has devolved since 1979 into more specialist regulatory structures, by first dividing the state as owner and the state as regulator, it has not been able to resolve "market" property disputes, especially dealing with financial crime and market misconduct, including the enforcement machinery to protect property rights. Without the transparency and the accountability of the "bottom-up" common law, as well as established laws of bankruptcy, financial institutions are unable to enforce their lending rights, resulting in continued emergence of non-performing loans in the banking system.

In essence, simple property rights disputes, including resolution of failed state-owned enterprises or bank restructuring, end up as administrative decisions and often political conflicts. The administrative machinery cannot cope with these complex disputes, and often arbitrary solutions are adopted that make the disputes even more political. Disputants seek higher and

higher levels of political authority in order to resolve such disputes, rather than tackling these issues through the court or a formal arbitration system.

In simple terms, the trinity of legislature, judiciary and executive act as three “vacuum cleaners” to resolve property right disputes in an economy. As long as such disputes are continually resolved, there is social stability and equilibrium. The media and the transparency of the market economy ensure that disputes are properly aired and disputants feel that there is fairness and justice in all dispute resolution cases. When the populace feels that they do not “have their day in court”, then discontent brews and the system becomes more and more clogged with “dust and pollutants”, so that eventually the whole system can become dysfunctional and unstable. In other words, a single executive-led “vacuum cleaner” may not act as efficiently and effectively in resolving daily property disputes in a market economy as a three or multiple “vacuum cleaners” of an independent regulatory and judicial system.

### **3. *The PRI as a Public Good***

Whilst we would all agree with Ray Huang’s brilliant diagnosis of the traumatic journey of China moving towards integration with Western civilization, his work did not suggest how the institutional structure of property rights can and should be built.

Indeed, as China moves towards a market economy and also collective responsibility at the leadership, including constitutional checks and balances from the National People’s Congress, she begins to face greater vested interests in changing laws and also the administrative, regulatory and judicial structures that are necessary to create an efficient PRI.

An obvious example of the power of the vested interest is in the reform of the capital market. Two thirds of the listed company market capitalization are “legal shares” or effectively owned by the state that is non-tradable. The non-tradability of such stocks had two side effects. First, the shortage of float (liquid stock) relative to demand meant that Chinese listed shares had a Price Earning Ratio of 30-35, above the international norm of 15-20. Market resistance to the sale of state-owned shares was so strong that it had to be abandoned in late 2002. This meant that the structural defect of the capital market would not allow it to perform proper price discovery, since all shares listed did not reflect true market prices. Second, the objections to sale of state-owned shares meant that the inherent value of state-owned shares (estimated at US\$400 billion) could not be realized to offset the contingent fiscal liability of the state in meeting its retirement and social security obligations and also the fiscal need to recapitalize the banking system for its NPLs.

Another example of the impediments to market reform is the existence of “original sin”. Clearly, twenty five years of rapid emergence of the private sector entrepreneurs has resulted in a whole class of “nouveau riche” that cannot explain their wealth legitimately, arising from the possible evasion of taxes, extra-legal transactions or the misuse of state assets. There is no mechanism to “legitimise” such wealth and it is politically unacceptable to grant amnesty for such wealth, since it was considered in a socialist context as exploitation from the masses<sup>13</sup>. The Chinese legal and political system does not have an answer to the resolution of original sin. Investigations of all private wealth always end up in tragedy, as new entrepreneurs cannot explain

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<sup>13</sup> For an economic analysis, please see Sheng, Xiao and Wang, “A New Institutional Analysis of Original Sin”, April 2004, Perspectives (Chinese edition), Beijing.

their wealth. The lack of certainty and protection of property rights also explain the huge pressure for constitutional protection that was passed by the NPC in March this year.

In the Shanghai 1990 Institute/SASS Conference paper, we argued that corporate governance and capital market cannot function independently of the political, social, legal, and economic environments. Hence underlying corporate governance and capital market is the property rights infrastructure (PRI). PRI comprises the system that delineates, registers, transfers and protects property rights in the jurisdiction. If any part of the PRI is defective, corporate governance cannot function effectively.

Hong Kong has a complete PRI arising from its colonial history. The common law jurisdiction under which Hong Kong operated in have brought with it a complete set of property rights infrastructure: land and stock registers, warehouse registers, accounting, commercial and financial law, courts, various specialized tribunal, arbitration centres, free media, stock exchanges, and commercial and financial intermediation services. All of these institutions operate together in an integrated system to transfer property rights in Hong Kong. Property rights in Hong Kong can be transacted with great legal certainty, transparency and accountability and ultimately low transaction costs.

Many of these institutions already have been built in the Mainland, but realistically, many are not functioning effectively either because of weaknesses in the ethics, the processes and structure. For example, the defects in the property rights are reflected as NPLs in the banking system, mainly because the banks cannot manage their credit risks well, as the defective accounting and weaknesses in bankruptcy laws do not allow them to exercise credit discipline.

In other words, the present state-led structure is not functioning well as a PRI to resolve property rights disputes within the emerging market economy. The lack of clarity of property rights (particularly lack of enforcement against abuses) creates the opportunities for market misconduct that leads to corruption, theft of state assets and growing NPLs.

Once the policy makers understand that the PRI is a public good that must be built and maintained in order for China to integrate into the global market economy, then China must have a roadmap to put in place that PRI. Since PRI involves a change in the bureaucratic (including judicial) structure, a New Institutional Economics way of explaining this is that the roadmap is about the Reform of Governance and the Governance of Reform of the PRI in China. In other words, although it involves the political economy, it is essentially a technical or management solution that is necessary.

#### **4 *Reform of Governance and Governance of Reform***

The dialectics of Chinese reforms (chicken vs. egg) is very evident in the transformation of the Qing military campaign to resist Western intrusion. The Qing dynasty recognized that it needed to rearm in terms of a modern army and navy in order to defend its territorial integrity. Li Hongzhang had to engage in state-owned enterprises to raise funds to built a modern navy, but corruption and lack of logistical and financial support meant that in the first sea-battle against the Japanese in 1902, the Qing Beiyang navy ran out of ammunition and was badly defeated, culminating in the humiliating unequal treaty that ceded Qingdao to the Japanese. In Ray Huang

parlance, it was mathematically (or fiscally and logistically) impossible for the Qing bureaucracy to finance and logistically support a modern navy. Hence, the historical Chinese dilemma was how to transform the bureaucracy and support the market, in order to extract sufficient resources to finance a larger and modern bureaucracy able to develop the market and delineate and protect property rights, including disputes with foreigners?

Contemporary Chinese historians admit that the Qing dynasty was not institutionally equipped to deal with foreign intrusion. It took two revolutions to achieve some self-strengthening through a closed economy that gradually began to open up to the marketplace. Whilst Chinese manufacturing, under the introduction of modern technology and capital from overseas Chinese and foreign multinationals, can compete globally, Chinese financial institutions are clearly not yet ready to meet such competition because they carry both stocks and flows of NPLs that ultimately demonstrate their inefficiency and inability to protect their stakeholders.

The Chinese reformers of the 21<sup>st</sup> century now face the same cross-roads of the 19<sup>th</sup> century Qing Beiyang admirals, having modern hardware, without the software and institutional/logistical support to back up the hardware in order to compete against the West.

Compared with the Qing Dynasty, contemporary reforms in China benefited from the large scale return of overseas Chinese entrepreneurs from Taiwan, Hong Kong and Southeast Asia, as well as graduates sent to US, Europe and Japan in the 1980s and 1990s. Whilst these were successful in the manufacturing areas, the penetration and impact of “return” expertise in the financial sector was relatively limited. Indeed, there is now one generation of foreign trained graduates, called the returned turtles faction [海龟派]”, emerging in the bureaucracy. As can be expected, the impact of this reform group can be constrained, as their influence will be resented and resisted by the majority of cadres who are trained domestically.

Change management of the entrenched bureaucracy would require considerable ownership of change, probably reinforced either by crisis or by the threat of external or foreign competition. How to induce such change, without creating instability, is the key challenge in the immediate future.

## **5 Concluding Remarks**

As argued in the Shanghai paper, China has reached the stage of economic development when the macroeconomic conditions provide a favour opportunity for the next stage of reform. The key obstruction to a full-fledged market economy is the construction of a robust PRI to allow more efficient and orderly exchange and protection of property rights. Whilst Hong Kong has already an international financial centre with a PRI competitive and transparent by world standards, how the Hong Kong experience can assist the building of the PRI in the Mainland remains an intriguing and challenging proposition.

To use Ray Huang’s language again: “To draft a fundamental law is a relatively simple matter. To change a nation’s function, organisation, and bodily structure is by no means so simple, as no one can command a walking beast to turn into a flying bird<sup>14</sup>.”

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<sup>14</sup> Ray Huang, “Capitalism in Venice, The Dutch Republic, and England,” in “Broadening the Horizons of Chinese History”, pg 96.

“The many years of reading and reflection have now crystallized into the conclusion that the hardships and discomfiture that China has endured over the past hundred years are the necessary steps within a full-scale reconstruction in preparation for the merger of Chinese history with Western civilization.<sup>15</sup>”

The key challenge in changing the Chinese economy therefore is one of statecraft, where the market demands equitable and firm and fair treatment of property rights that the historical legacy of a state-centric bureaucracy is not well equipped to handle. In other words, we need a process to manage the process of change. In the West, this is now known as change management.

A market economy is stable so long as the policy outcome of effective delivery of social good coincides with policy objective of growing prosperity and social stability. However, as all students of sociology and anthropology would understand, the vested interests in the bureaucracy can stand in the way of social progress as much as the vested interests in the market.

In the next paper in this series, we will try to introduce international experience in change management, particularly changes in public governance. We shall also draw on Chinese philosophy and history, specifically the Legalist work, such as those of Han Feitzu<sup>16</sup>, to unlock how ancient statecraft dealt with the Reform of Governance and the Governance of Reform. In the formative years of China’s Warring Period, the feudal lords sought to control their bureaucracies as means to control the populace in order to have effective states that can withstand invasion. Much of the statecraft learnt in that period can be adapted for a Chinese interpretation of the change management that is need for the transition to a market economy, where contest is today through market competition.

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<sup>15</sup> Ray Huang, “Chinese History and Western Civilization”, in op cit, pg 105.

<sup>16</sup> Burton Watson (translator), “Han Fei Tzu: Basic Writings”, Columbia University Press, New York, 1964.