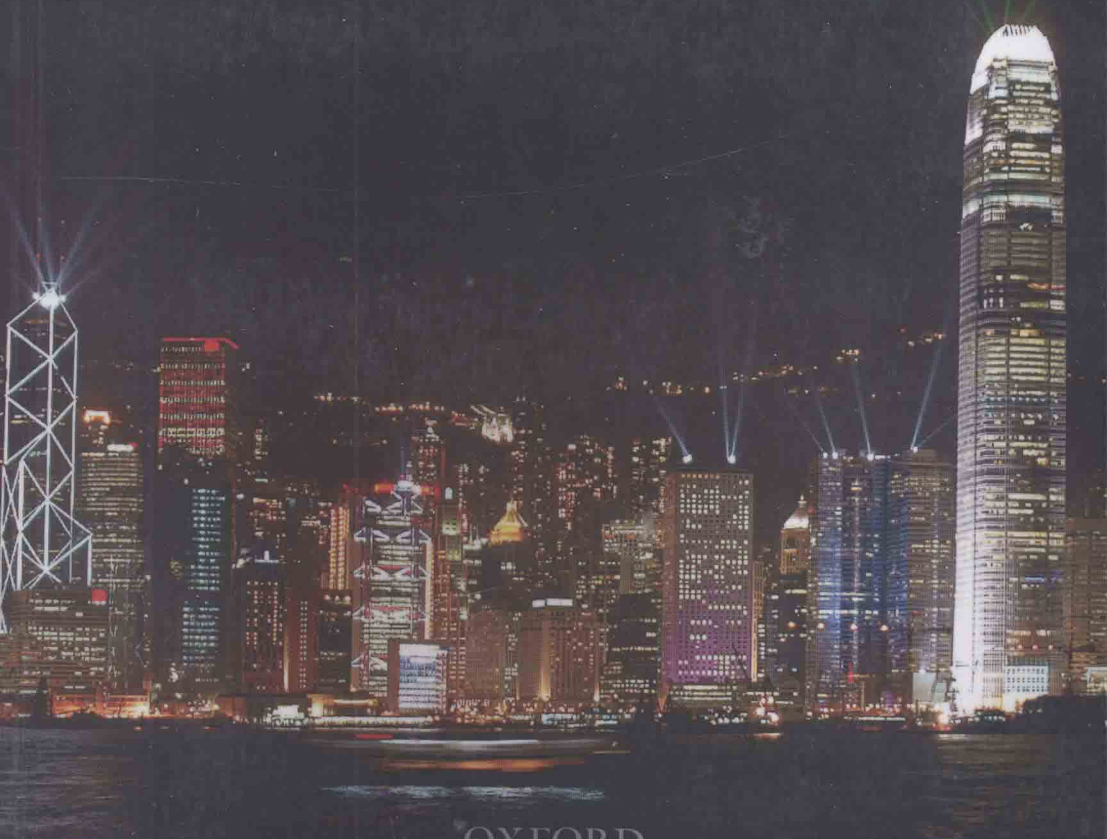
the future of chinese capitalism

choices and chances

Gordon Redding and Michael A. Witt



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Gordon Redding and Michael A. Witt

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Great Clarendon Street, Oxford OX2 6DP

Oxford University Press is a department of the University of Oxford.
It furthers the University's objective of excellence in research, scholarship, and education by publishing worldwide in

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Kuala Lumpur Madrid Melbourne Mexico City Nairobi
New Delhi Shanghai Taipei Toronto

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Published in the United States
by Oxford University Press Inc., New York

First published 2007
First published in paperback 2010

British Library Cataloguing in Publication Data

Data available

Library of Congress Cataloging in Publication Data

Redding, S. G.
The future of Chinese capitalism / Gordon Redding and Michael A. Witt.
p. cm.
Includes bibliographical references and index.
ISBN 978-0-19-921813-4
1. Capitalism-China. 2. China-Economic policy. I. Witt, Michael A. II. Title.
HC427.95.R44 2007
330.12'20951-dc22 2007028208

Typeset by SPI Publisher Services, Pondicherry, India
Printed in Great Britain
on acid-free paper by
Biddles Ltd., King's Lynn, Norfolk

ISBN 978-0-19-921813-4
978-0-19-957587-9 (Pbk.)

Preface and Acknowledgments

Our objective in this book is to attempt an answer to the question of what kind of economic system—and more specifically, what kind of capitalism—is likely to emerge in the People's Republic of China. Capitalism comes in different varieties, historically grown and shaped by societal forces, and China's will be no exception in this regard. Along with this variety comes specialization in certain types of industries, as evident in varying patterns of comparative advantage across the advanced industrialized nations. What comparative advantages will China develop as its economy grows and matures? The answer will emerge only over time, but its implications will be profound—not only for business inside and outside China, but also for policy-makers as well as scholars in fields such as international business, strategy, political science, sociology, and economics.

We consequently decided to hazard an informed guess—well aware that making predictions is a very difficult thing indeed. In doing so, we draw on knowledge acquired during the more than forty-five years we have, taken together, been following developments in China and East Asia, twenty-four of which living in Hong Kong, five in Singapore, and more than two on the Mainland. Our general approach—that of 'comparative business systems', an emerging field of research also known as 'varieties of capitalism' or 'coevolution'—is inspired by friends and mentors at a number of places, including Peter Hall at Harvard, Arie Y. Lewin at the Fuqua School at Duke, and Richard Whitley at Manchester.

The style of this book may strike our academic readership as unusual. While this is in essence an academic book, aimed to make a contribution to our understanding of the likely evolution of the Chinese business system, we have endeavored to keep the book as accessible as possible to a wider audience, including business people and policy-makers with an interest in China. We have sought to avoid academic jargon to the extent possible, and we apologize in advance if there remain some sections requiring hard thinking. In the interest of focus and legibility, we have also deviated from the convention of citing a large number of sources in the text or in extensive footnotes that can take up much of the page. We keep footnotes intentionally sparse, and the text mostly uninterrupted by citations. Instead, we provide at the end of each chapter a set of main references appropriate for most readers. For specialists with more detailed interest, we include a fuller list of pertinent references at the end of the book.

Like most books, this work owes its existence not only to us, but also to the generous help and contributions extended to us by a number of individuals and organizations. Conversations over time with many people have helped to shape our arguments, and in particular we would like to express our gratitude to Regina Abrami, Bob Baylis, Peter Berger, Michael Bond, Max Boisot, Derong Chen, Philip Chen, Stan Cheung, John Child, Peter Cundill, Ken DeWoskin, Clinton Dines, Doug Guthrie, Yasheng Huang, Barbara Krug, Raymond Lum, Roderick MacFarquhar, Marshall Meyer, Dwight Perkins, Elizabeth Perry, Peter Redding, Victor Shih, Edward Steinfeld, Lily Tsai, Anne Tsui, Wang Zhong Ming, and Richard Whitley. Emilio Manso-Salinas and Ming Zeng conducted a number of interviews with senior executives for us in China and Hong Kong, and their help is acknowledged with much gratitude. Likewise, we would like to thank Ted Chan and Cheong Kheong Tan for their invaluable research assistance. Special thanks are due to Nathalie Gonord for technical help in preparing diagrams and for other support.

We are also very grateful for the organizational support we have received in preparing the manuscript for this book. Profound thanks go especially to the Lee Foundation of Singapore, which generously provided funding of the senior executive interviews undertaken for this project. We are also grateful for support from Erasmus University, Harvard University, the University of Hong Kong, Xiamen University, and Zhejiang University, but particularly we have been supported by INSEAD and the INSEAD Euro-Asia and Comparative Research Centre. Gordon Redding further expresses his thanks to The International Forum for over ten years of joint China explorations, and specifically the exploratory zeal of Michael Alexander and Nan Doyal. The stimulus provided in the two China workshops of the INSEAD/Wharton Alliance was most valuable. We are most grateful for all this help, but we acknowledge our own responsibility for the final product.

Last, but not least, we would like to thank our families. This project would not have been possible without their patient support.

Fontainebleau, April 11, 2007
Gordon Redding
Michael A. Witt

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Another Miracle?

In the last half-century we have witnessed a historically large share of miracles in the field of economic progress. From the wreckage of war there emerged the German miracle in the 1950s and 1960s. Already under way from the 1950s onward, the Japanese miracle became the focus of public attention from the mid-1970s through the 1980s—the period of Western bewitchment by 'Japanese management'. In close pursuit of Japan as the lead 'flying goose' were the East Asian 'dragons' with their own miracles, the Korean of which fell apart in 1997 and has now been reconstituted. It might be argued that the 1990s for the United States were close to miraculous in the creation of wealth, seemingly stimulated by the nebulous and still little understood economic logics of the information technology revolution. A perspective on that is visible in the fact that US GDP has now reached twenty times the level of Russia.

Now we have indications of an economic miracle in China. A cynic would conclude that we may need to be quick to catch this one. A more sober analyst might ponder its size and its evolution and—given the amount of slack to be taken up there—its potential longevity, perhaps reaching an optimistic appraisal. Whatever the viewpoint, any appraisal of the 'China miracle' needs to be informed. It is necessary to understand the surroundings of the complex question: How will China modernize? This book attempts to contribute to such understanding.

China has in the past century been through three massive transformations, with chaotic intervening periods between the first, second, and third. The first was the 1911 overthrow of the Manchu dynasty and is associated with Sun Yat-sen. This led to decades of civil war and was disturbed deeply by World War II. The second was the Communist revolution associated with Mao Zedong, and normally dated from 1949. It led to the world's largest collectivized state, but also to the inanities of the Great Leap Forward, and the insanities of the Cultural Revolution. The third transformation, less seemingly epoch-making in its pronouncement, but perhaps even more of a revolution in practice than the two others, is associated with Deng Xiaoping. It began in 1978, and its progress was marked by a series of brave statements: 'Poverty is not socialism'; 'To be rich is glorious'; 'It does not matter whether the cat is black or white, so long as it catches mice'; 'We will cross the river by groping for stones'. Deng's radical break with dogma was a commonsense acknowledgment of core human instincts—the ownership of property, self-responsibility, and competing for status—and its subsequent momentum has only accelerated. China's vibrant private sector now accounts for about two-thirds of the economy, and is set to continue advancing its domain, leading the charge of Chinese industry into world markets. The scale of this third transformation is breathtaking.

And yet, in those world markets, few consumers could identify a Chinese brand of anything. The labels say 'Made in China', in small lettering, on cameras, toys, electrical goods, clothing, underwear, computers, etc.; the shelves of Wal-Mart, Macy's, Selfridges, Karstadt, and Galeries Lafayettes are packed with goods from China bearing supposedly reassuring Italian or French names, or global brands like Canon and Hewlett Packard. Complex machines, such as automobiles or computers, are full of electric motors, parts of carburetors, memory chips, disc readers, of Chinese origin, not acknowledged in the Japanese, German, or US brand names. This revolution, this trend to become the workshop of the world, is unusual for its unobtrusiveness. Such power needs to be understood, and so too its implications for industry, especially in manufacturing where it is most potent, and where World Trade Organization (WTO) stimulus will see it grow.

The Chinese private-sector revolution, especially as it has picked up speed since the 1990s, is also introducing a new feature on the demand side. A huge new market is growing as the Chinese people, having 'stood up' in 1949, now turn their attention to *catching up* on the thirty lost years which that form of standing up cost them. There is a deep and powerful urge to make up for lost time, to consume, to compete, to achieve, and to find security from the turbulence they have seen as inevitably their lot. For thirty years they acted out the roles demanded of them. Now they are choosing to behave according to their own instincts. One of the deepest Chinese instincts is to engage in business and to do it independently. This is now in full flow.

In longer-term historical perspective, China has for centuries been attempting to deal with the shifting currents of national success and failure, looking backward to the time between a thousand and five hundred years ago, when it could justifiably claim to be the world's greatest civilization. This was an era during which Chinese mastery of the most advanced technologies of the time provided them with a lofty independence, and a clear and justified sense of superiority to other nations. This was Marco Polo's land of wonders. They could put a million-strong army in the field and provide it with explosive weapons at a time when England would wage war with 20,000 soldiers and longbows. They had the printing of books and widespread reading, when in Europe a truly rich individual might possess half a dozen handwritten volumes. They were so advanced in navigation and the calculation of both latitude and longitude that they seem to have made voyages of world discovery seventy years before Columbus and Vasco da Gama, and three centuries before John Harrison's chronometer would give the West the handling of longitude. Zheng He's oceangoing ships of the fifteenth century included more than sixty that were 385- to 440-feet long,[1] when Columbus's flagship was 70 feet.

This dominance would be challenged. Another miracle, that of Europe's bursting out from its supercharged space, between the fifteenth and nineteenth centuries, driven by—among other things—the mastery of science on the basis of rational enquiry, the political Enlightenment, and the connecting of technical invention to commerce, would succeed in moving China aside. China is too large ever to have been irrelevant but, by the nineteenth century, it was left as a backwater, in any case seeking isolation, protecting itself from invasion, but above all else remaining under the tight control of a central government and thus premodern.

The current agenda in China, in both economics and politics, is the entry of the world's largest society to the modern world for the first time. The essential difficulty, in that context, is the dismantling of central power and its replacement with other forms of stable order. Such a transformation, and on such a scale, is a challenge of formidable dimensions. There lurks always the possibility that it may not succeed.

Being modern is in essence having a society in which the problem of mistrust has been solved sufficiently well to allow most people to take the risk of transacting business (at least potentially) with most other people,

[1] Dreyer 2007.

even if they are strangers. This means escaping from the limitations of trusting only those you know, or who are recommended by friends, and moving into the realm of being able to transact with anybody within reason. The result is an exponential increase in the total volume of business that a single individual can initiate and handle, and which, given a mass of interacting people, can drive national wealth upwards to previously unheard-of heights. In Japan and the West this was achieved over a long period by the accumulation of reliable laws, institutions, stable forms of government, and the development of associations outside state control in what is commonly called 'civil society'.

The kind of institutions which the West built over the centuries, and which made exchange easier and more reliable, are visible in the world of commerce. Here, the rules for everyday transactions such as borrowing, lending, making payments, taking out insurance, keeping trustworthy and understandable accounts, employing agents, all crystallized out in the experimental social structures of the mediaeval and Renaissance worlds, in places such as Augsburg, Florence, Paris, Bruges, London, and the Hanseatic and Mediterranean ports. Many of these systems owe much to the interplay between major civilizations, and they were not always Western monopolies in their origins. Accounting and mathematics use Arabic numerals, for instance. The use of the zero has an Indian beginning. The great European trading centers were points of exchange and cross-fertilization, and the absence of such crossroads in China would eventually weaken its capacity to understand the outside world, and to connect with the fast-moving technological advances of that world.

By the nineteenth century, when national legislation began to fix the European patterns into commercial law, most of the structures for modern capitalism were already available. Accounting, banking, insurance, securities, and trading methods were all exhibiting the traces of evolutionary processes going back centuries. A key aspect of their transformation into the institutions of the present day was the fact that most of them were the preserve of freestanding bodies whose interest lay in protecting the rules of a trade or profession. Examples would be societies or guilds, of bankers or accountants, and the networks of the insurance industry that began in Lloyds coffee house in London much earlier. They were all bodies that found their justification in setting and maintaining rules for conduct. When those rules were kept, the economy benefited from the stability and predictability that resulted. Members of such bodies also were able to achieve status and security in exchange for the benefits they delivered.

The example of Japan shows that modernity is not a Western prerogative. While Japan was almost completely cut off from trade with the rest of the world for most of the Tokugawa era (1603–1868), domestic commerce flourished and in some respects even surpassed developments in the rapidly modernizing West. For example, the world's first trading of futures, on rice, occurred in Osaka. A key element in the prosperity of the time was the emergent merchant class. In line with Confucian thought, the Japanese government of the time viewed trading and commerce as putting profit and self-interest above virtue and the public good. Competition was closely circumscribed, as government officials were concerned about a possible threat to social harmony (*wa*). Violations of any of the manifold government rules, or any action that could be interpreted as challenge to the ruling samurai or the social order they put in place, found severe punishment, often execution.

The crucial question for the merchants of the time was thus how to thrive and justify their existence in a system that essentially viewed them as parasites. A number of responses emerged. One was the use of guilds as a means of collective enforcement of proper conduct. Guild members normally lived in close proximity, enabling them to watch over one another. Similar to their European counterparts, the guilds controlled quality and prices; pooled resources in storage and shipping; set wage levels; outlawed advertising and the luring away of customers; collectively punished dishonesty by members or suppliers; and in emergencies provided loans to one another. Among the sanctions available for breach of guild rules was the forcible closure of the offending member's business.

Internal codes of ethics supplemented external enforcement of proper conduct by the guilds. The most important objective for merchants of the time was the survival of the 'house,' that is, the maintenance of the family business as a going concern. Allowing the decay of the house's fortunes, or even its closure by the government or the guild, meant bringing disgrace and dishonor not only on oneself, but more importantly on one's ancestors. The intention behind house rules was to inculcate internal values conducive to long-term prosperity. Assiduously observed, the house rules stressed, among others, the importance of honesty as a basis of long-term prosperity. In the words of Hirschmeier and Yui (1981: 40, partially quoting one of the house rules), 'Even a blind man, a child or an ignorant peasant' should be able to buy without being cheated.

Arguably, this spirit of honesty, and thus potential for anonymous exchange, continues to permeate Japanese business to this day. That is not to say that there are no crooks or opportunists; but there is a general understanding that this type of behavior is deplorable rather than a sign of shrewdness in business, and that it should and will be sanctioned by society.

The evolution of the modern West, and by a different but parallel trajectory that of Japan, point to a set of questions that pose challenges for China as it modernizes. The most important of these pertains, as already stated, to the establishment of horizontal order. More specifically:

Question 1. How does the society build stable, widespread horizontal order of a kind that fosters efficient exchange between economic units across the society? On what basis does trust work and how?

Connected to, and interdependent with, this first issue are questions concerning legitimate purpose, authority, and innovation in society. Specifically:

Question 2. How does the society make a tight set of connections between the purposes (for economic action) seen as legitimate by most people, and the rationally organized pursuit of those purposes?

Question 3. How does authority in the society come to work effectively to channel the behavior of people in work? Where does legitimate, motivating authority come from?

Question 4. How does innovation become part of the behavior in the economy, and with it the flexibility of the system and the organizations within it?

Not only the Western advanced industrialized nations, but also Japan and South Korea, have found answers to these questions, though to different extents and in different ways. How and to what extent China may find its own answers is one of the key issues we seek to address in this book, because until they are dealt with, no amount of gyrating around with other issues will produce annual wealth of $30,000 per capita.

Understanding Business and Its Context

The regeneration of China begins with the political will to change, and three features of the context have promoted this. First, the collapse of Communism as a viable ideology has been virtually complete, even though there may be many remnants of the power it accumulated. Second, the pressure on the Chinese government to feed, provide with livelihoods, and keep from staging a revolution, 1.3 billion people concentrates the mind on what works best. Third, what works best, in terms of those challenges and on the present evidence, is market-driven capitalism.

This does not prescribe what *kind* of market-driven capitalism should be developed—and an important second theme of this book is that there are several kinds—but it does channel the direction of movement away from more state-controlled alternatives. Two forces already heavily constrain the choice, and they are referred to among researchers as *path dependence* and *embeddedness*. Path dependence means that systems of economic organization get shaped by earlier formative influences and tend to perpetuate the responses they have learned. Embeddedness implies that they also exist in a societal context, and their evolution, as it works itself out today, is connected with that context. The societal context and the system of business evolve together and remain permanently interwoven. These influences mean that choice is severely constrained both by history and by the present. It is the understanding of these forces that will lead to a better appreciation of the options available, and also of the outcomes and future effects of such interactions.

We explain the way we propose for viewing this continuing evolution in Chapter 2, but a note of introduction to the core idea is appropriate here. The boundary of a nation-state normally encompasses a distinct language, often a specific religion, or an ethnic identity, and it usually contains legal structures, educational processes, and many rules for the conduct of life that are specific to that country, for instance, commercial law and taxation. These add up to a distinct context within which a business system evolves, and also a shared history presenting a legacy of experience and ideals. It is only necessary to go from the United States to Mexico, from Germany to Italy, or from Japan to China, to feel the sense of these contrasts, and to see them present in behavior.

The 'rules of the game' in doing business—which in their totality make up a system of ways of doing things, or a 'business system'—reflect such distinct contexts. As later chapters will make clear, to work in a Japanese factory is very different from doing so in a Chinese factory; being out of work in Germany is very different from being out of work in the United States, in terms of how society treats you; and chairing a board in Korea is very different from chairing a board in the United States. It is possible to examine these and other contrasts systematically and in doing so to create a sense of how the differences have emerged.

This is done by seeing the business system as embedded in the fabric of institutions in the society, and that fabric in turn shaped by the society's culture. The total, seen in terms of these three layers of mutually interacting features, is affected by external influences that can be taken into account. So, in brief, culture shapes (and is shaped by) institutions, which in turn shape (and are shaped by) the way business is conducted. The process is a continuous flow of influences, with everything connected together. Each society produces its own solution, in line with its own ideals and historical experience.

The introduction of the notion of 'ideals' brings out a further key feature of this book. That is its examination of the reasons why senior executives act as they do, not in a micro sense covering the specifics of behavior, but in a macro sense, looking at their views on why firms exist. What is economic behavior intended to achieve and how is sense made of that? What is it all about?

It turns out that in real life, the standard business school answer—'to maximize shareholder value'—applies almost exclusively to one context only, the Anglo-Saxon one. We report the finding of substantial differences in this rationale across societies generally. If the purposes of economic action are different, it is then not surprising to discover, as we also show, that the business systems themselves vary greatly. This adds further complexity to the issues of change and evolutionary options. Such boardroom mentalities, as well as being largely unresearched, are also both hidden from view, and silently potent.

Models for China's Evolution

The evolution of China's economy is not then a matter of entirely free choice. As well as the forces of history suggested earlier, there are also the circumstances of the present day. Among these, there are three that stand out. The first is negative: it is now clear what does *not* work, and that is state domination of economic life. The second is positive: it is now clear what *can* work, from the experience of the ethnic Chinese in East and Southeast Asia, from Hong Kong, and from China's own test beds along the coast in the special economic zones (SEZs). Third, the evolution of world trade presents certain growth options, and especially certain paths of access to markets, to capital, and to technology.

The failure of state-controlled industry, following the Soviet model, is now so apparent that it needs little analysis. The absence of the discipline of markets and competition, and the inability of central planning to cope with the immense complexity of China, led organizations toward the buildup of huge inefficiencies. Factory space grew to about twice the amount the market could logically sustain. The wish of the state—that welfare responsibility should be discharged through the state-owned enterprises, and in a more decentralized manner through the 'collectives', added to the burden. Ideas such as 'profit', efficient return on assets, and response to market demand were excluded. A typical attitude was reported in Doug Guthrie's study of eighty such enterprises; when, irritated by his questions, a CEO eventually banged the desk and shouted 'I don't do profit'. She then explained her duties to the workforce and its thousands of dependants.[2]

A model that works was waiting in the wings. Chinese capitalism was alive and well in the countries around the South China Sea, and had accumulated a set of advantages of the kind China needed when the return exodus began. Over fifty million ethnic Chinese live around the borders of the South China Sea, mainly now descendents of refugees from China over the last century and a half. They took themselves out of poverty to become the dominant economic elite of the region. The *Nanyang huaqiao* (the ethnic Chinese 'sojourners' of the Southern Ocean) had developed skills in organization, connections into world markets, the acquisition of technology, large volumes of capital, and an understanding of environments where political power still counts in the economy. They have one extra characteristic: they share a wish to see China restored to its former glory, a feature commonly associated also, in individual cases, with a strong sentimental attachment to the ancestral home area.

The form of capitalism with which the ethnic Chinese entrepreneurs had come to dominate the economies of East and Southeast Asia in the second half of the twentieth century, was family business, or at least personally owned and dominated business. We will refer to it as 'private business'. It took a number of forms, but with clear common denominators. Small and medium enterprise (SME) was the most common form, usually based on family ownership or partnership, and this type came to dominate fields such as retailing, distribution, professional services, small-scale manufacturing, and entertainment. In manufacturing, their instinctive skills for networking allowed them to transcend the scale limitations and

[2] Guthrie 1999.

to build industrial competence via the integration of separately owned units in components supply, subassembly, and assembly. By this means they came to dominate, quietly and unobtrusively, the world's use of original equipment manufacturing (OEM) methods in a wide range of industries, without facing the growth dilemmas of large-scale enterprise.

They also produced larger versions of the family business form, in the shape of closely held conglomerates, a form we shall come to refer to as 'clan conglomerates,' to reflect the typical dominance of extended family in both ownership and control. Typically also this form would be subject to the domination of strategy making by a single powerful individual, often a founder or his immediate successor. The preferred fields of such enterprises reflect a *rentier* perspective. For instance they dominate the region in banking and property development, and they have strong positions in many countries in key infrastructure domains such as power, telecommunications, transport, hotels, and container ports. They are also major actors in forestry and agribusiness. Given their size and sophistication, such enterprises are often also partners with Western or Japanese multinationals in the opening of new fields, especially where technology needs to be built into the set of competences. The great hidden strength of this conglomerate form of regional enterprise is its mastery of the art of co-opting political support, a key aspect of the building of unassailable barriers to entry. Such skill is likely to remain crucial in the context of China for a long time to come, and decades of experience in its practice outside give them a head start against other contenders for the opportunities that China now presents.

Much less likely to 'fit' the Chinese context are other major forms of capitalism, as represented by the United States, Japan, Germany, and South Korea. While China must feel the temptation to copy 'best practices' piecemeal from these (and other) nations, path dependence is likely to get in the way more often than not. Most of the key patterns that give these systems their distinct flavors and institutional comparative advantages are incompatible with the existing context in China, which raises the question of how well foreign institutional imports will work. This is true particularly for the cases of Germany and Japan, but also that of the United States. Perhaps the least unrealistic model to emulate for China is the South Korean one, though even this is likely to be a long shot.

While the business model of the Regional Ethnic Chinese is well suited especially for SMEs, one thing that it does not produce is modern multinational enterprises (MNEs). Since MNEs are perceived to represent one way