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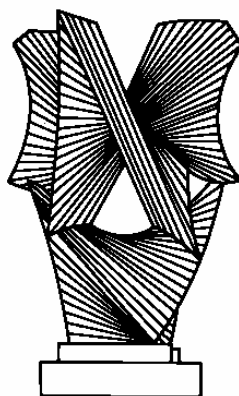
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CHINA AS A TEST CASE
Is the Rule of Law Essential for Economic Growth?

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China is the fastest growing country in the world. Moreover, its economy has already become one of the most important in the world. Many commentators predict that China will surpass the size of the U.S. economy some time in the second decade of this century (although it will, to be sure, still be at a much lower per capita income level). Though these predictions are for most purposes quite misleading,¹ China's prowess in manufacturing is already a challenge to the manufacturing sectors of the most advanced economies, at least in labor intensive industries. Moreover, China is going beyond low-wage manufacturing and entering the high technology arena (from the top down, so to speak) through high-level research backed by a growing army of highly educated scientists and engineers completing graduate studies and through the outsourcing to China of research and development activities from some of the world's most

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¹ The predictions of total Chinese GDP soon surpassing U.S. GDP are based on purchasing power parity (PPP) comparisons, which, whatever their value for certain purposes (see the discussion later in this paper), are almost surely unjustified for any inference about the weight of one country's economy in the world economy for the purpose of predicting national security or foreign policy influence. Cooper (2004), for example, finds that under a market exchange rate comparison, China's GDP in 2020 would still be only 24 percent as large as U.S. GDP and significantly lower than Japanese GDP. See also Cooper (2002). Green (2003, p. 2) also points out that under present growth trends China's GDP in 2025 would be \$5 trillion, about 40 percent as large as the U.S. economy was in 2005. In October 2005 Hu Jintao stated at a G-20 meeting that China "will try to increase its GDP up to around 4 trillion US dollars and per capita GDP to around \$3,000 US in 15 years." People's Daily Online (Oct. 15, 2005). That Chinese GDP figure for 2020 would still be equal to only about one-third of 2005 U.S. GDP and obviously a much smaller proportion of 2005 U.S. per capita GDP.

accomplished high technology firms.

Yet the level of China's adherence to the Rule of Law is frequently criticized.²

How should one put together China's growth rate with its Rule of Law profile? Does the coexistence of the two mean that, contrary to the now prevailing view, institutions are not important after all to economic growth? Should we conclude, at the very least, that legal institutions, and the Rule of Law in particular, are not important?³ One group of scholars, Allen, Qian and Qian ("AQQ"), has reached more than half way to that conclusion:

China is an important counterexample to the findings in the law, institutions, finance, and growth literature: Neither its legal nor financial system is well developed by existing standards, yet it has one of the fastest growing economies.⁴

In arguing that China was a counterexample to the legal institutional approach, AQQ gave China scores on corporate and creditor rights law following the LLSV Law and Finance methodology developed by LaPorta and his colleagues in their Law and Finance article.⁵ In corporate law China was assigned by AQQ a shareholder rights score of 3 (out of 6) and a creditors rights score of 2 (out of 4). This result put China's shareholder rights score below the English-origin average (4) but above the French-origin average (2.33). For creditors rights the AQQ score for China of 2 was below the English-origin score (3.11), but above the French-origin score (1.58) (and, by the way, above the U.S., Canadian and Australian scores of a mere 1).⁶ (China's creditor rights score is nonetheless far below many of its neighbors: Hong Kong, India, Malaysia, and Indonesia all scored a perfect 4.) In any case, if China had been in the LLSV list of countries, it would have ranked right at the average of all LLSV countries (developed and developing) for shareholder rights.⁷

Though one might think that these comparisons leave China in a reasonably strong position, somewhere between the English-origin average and the French-origin

² For a detailed and balanced, if optimistic, view of the Rule of Law in the Chinese context, see generally Peerenboom (2002).

³ Peerenboom (2002, p. 462–463).

⁴ AQQ (2005a, p. 57).

⁵ AQQ (2005a); LaPorta (1998).

⁶ AQQ scores are found at AQQ (2005a, p. 65, Table 2A and p. 66, Table 2B). The LLSV scores are found at LLSV (1998, p. 1130–1131, Table 2 and 1136–1137, Table 4).

⁷ AQQ (2005a, p. 65, Table 2A and p. 66, Table 2B) and LLSV (1998, p. 1131, Table 2).

average, AQQ decided on a different comparison—a comparison based on the number of countries above and below a given sample mean. Abandoning LLSV averages, AQQ emphasized that “[a]lmost half of the countries in the French-origin subsample ... have equal or better measures of creditor and shareholder rights” and that the “overall evidence ... suggests that the majority of LLSV-sample countries have better creditor and shareholder protections than China.”⁸ Although China’s shareholder rights score of 3 was exactly the same as the average scores of the 49 countries in the LLSV sample, AQQ chose to emphasize that 65 percent of the LLSV 49 countries had a score “higher or equal to three.”⁹

Nonetheless, if one takes the LLSV analysis as giving a reliable insight into corporate and creditors rights law, the bottom line is surely that China’s substantive law is not hopelessly weak. Indeed, looking at the LLSV sorting of countries by per capita income, China would rank somewhere in the middle of the pack—slightly below the middle point of the mid 50 percent of countries for both shareholder and creditors rights.¹⁰ Nonetheless, the real question is how well the substantive law is enforced.¹¹ According to an OECD report, surveys show that “China is still seen as comparing unfavourably to its Asian competitors” with regard to “actual corporate governance practices.”¹²

The Chinese Economy: Is a Slowdown in Growth Ahead?

The absolute size of the Chinese economy and the penchant among journalists and economic pundits for mechanical extrapolation into a distant future of current trends lead many a credulous reader and television viewer to believe that the Chinese economy is well on its way to developed country economic status. Nothing could be further from the truth!

⁸ AQQ (2005a, p. 64).

⁹ AQQ (2005a, p. 66, Table 2B). AQQ (2005a) does not state what percentage of the LLSV 49 countries had a score “lower or equal” to three, a category obviously overlapping with “higher or equal.”

¹⁰ See LLSV (1998). Pistor and Xu (2005, p. 191, Table 2) find China somewhat below average for “legal shareholder protection” both as a matter of formal law and regulatory quality among transition countries.

¹¹ AQQ (2005a) not only make the same point about enforcement but also attempt to measure enforcement in China. However, their measures taken from LLSV (1998) are mostly about issues that do not bear on judicial enforcement of substantive law—e.g., risk of expropriation, risk of contract repudiation, and accounting standards—or are much too general to measure judicial enforcement—e.g., corruption and rule of law. AQQ (2005a, p. 68, Table 2C). In any case, AQQ (2005a) does not attempt to rate China on most of their enforcement measures.

¹² Organization for Economic Cooperation and Development (2002, p. 36).

The Chinese economy is well down the list of developing countries in per capita income. In 2003 per capita income (according to official Chinese statistics) was \$1,100 (U.S.) at current exchange rates. Using purchasing power parity (PPP), per capita GDP was \$5,003 in that year. For North American readers, it may be helpful to compare China with Mexico, since those readers will probably be at least somewhat aware of Mexican life, where one can encounter great wealth (often behind high walls) but also millions upon millions of impoverished citizens. At current exchange rates Mexican per capita income in 2003 was \$6,230, well over five times as great as per capita income in China; and Mexico's per capita income on a PPP basis was \$9,168, almost twice as great as China's.¹³

One can argue about the right measure to use for comparisons—PPP or current exchange rates. PPP numbers reflect the buying power of a resident in the local economy at local prices, where money purchases of services and locally produced goods in poor countries are often at prices well below international levels calculated at market exchange rates. In a village in a developing country a local resident can acquire haircuts and the services of domestics at a tiny fraction of what they would cost in a highly developed country (compared at market exchange rates).

In any event and even if one can trust Chinese economic statistics for GDP in Chinese currency, we have every reason to be skeptical of the PPP figures for Chinese GDP. Citing a number of technical but crucial defects in China's collection of the requisite underlying information, a 1994 World Bank report stated that "[t]here is no reliable PPP estimate of China's PPP."¹⁴ The report further concluded that some PPP approximations probably overstated China's PPP GDP per capita and that in any event those approximations varied at the time from \$1,000 to \$3,000.¹⁵ Albert Keidel, who prepared the World Bank report, recently reaffirmed the inadequacy of those approximations, stating:

¹³ World Development Indicators. Available at [<http://devdata.worldbank.org/dataonline/>] (data in current international dollars). In December 2005 the Chinese government announced that its first nationwide economic census revealed that Chinese GDP in 2004 was actually 16.8 percent higher than previously announced, and that 93 percent of the increase was accounted for by a better estimate of the size of the services sector. Revised GDP for 2004 Up By 16.8%, China Daily (Dec. 21, 2005). See Giles (2005).

¹⁴ World Bank (1994, p. v).

¹⁵ World Bank (1994, p. v–vi).

China's PPP is really unknown. We have no statistics on what the purchasing power parity measure of China's GDP should be.... And so we're looking at a Chinese economy that in PPP terms is much smaller, in my mind, than the numbers that are usually used.¹⁶

Similarly, Richard Cooper argues:

“Even if one were inclined to a purchasing power parity (PPP) [measure], the PPP data that we have for China can only be described as flaky. That is to say, even if one preferred a PPP measure, we have a terrible time measuring an accurate PPP, and it is subject to all kinds of judgments by the analysts, not least the weights that one attaches to different components of output.”¹⁷

Some critics do not trust Chinese statistics, saying such things as “I'm here to assure you that China will continue to publish 7 percent GDP, no matter what the industrial production numbers will show.”¹⁸ In any event, as Alwyn Young points out, China has used a different method than most countries for arriving at national GDP; it adds up local production reports to reach a national total, with predictable incentives for local overreporting when actual growth is weak and underreporting in periods of overheating in the economy.¹⁹

A further reason for being cautious about past Chinese GDP growth rates has been given by Young: even assuming the correctness of Chinese nominal national income statistics, inflation was underestimated by Chinese authorities so that real GDP growth in the 1986–1998 period was overstated by 3.0 per cent per annum.²⁰ Using Young's analysis, the real growth in GDP during that period was 6.2 percent rather than 9.2 percent. Growth of over 6 percent is still, of course, an extraordinary achievement but would not lead to the kind of assumptions about the future that underpin so much contemporary discussion. Over 24 years, the compounding of 9 percent growth yields an eightfold increase in total growth whereas compounding of 6 percent growth would yield

¹⁶ Statement of Albert Keidel. In Transcript of an IMF Economic Forum, China In The Global Economy: Prospects and Challenges. Washington D.C. October 19, 2004. Available at <http://www.imf.org/external/np/tr/2004/tr041019.htm>.

¹⁷ Statement of Richard N. Cooper, Mauritis C. Boas Professor of Economics, Harvard University. In Compilation of Hearings Held Before the U.S.-China Security Review Commission. 107th Congress, First and Second Sessions. p. 788 (2002).

¹⁸ Statement of Stephen Roach. In Transcript of an IMF Economic Forum, China In The Global Economy: Prospects and Challenges. Washington D.C. October 19, 2004. Available at <http://www.imf.org/external/np/tr/2004/tr041019.htm>.

¹⁹ Young (2003, p. 1224 and n. 5). On the weaknesses of the Chinese statistical system, see Organization for Economic Cooperation and Development (2005b, p. 169-196).

²⁰ Young (2003, p. 1232). See also World Bank (1997, p. 3, Box 1.1).

only a fourfold increase—resulting in a Chinese economy only half as much larger than the base year at 6 percent growth than it would be at 9 percent growth.

The policy question is not what the exact Chinese growth rate is today; whether that rate is in the 9 or 6 percent range, it is important to know whether the growth rate can be sustained. One reason for doubt derives from the recent history of China's neighbors. The uncontroversial fact that China is presently at a much lower level of per capita GDP is key. Japan, South Korea, Taiwan, and several other neighbors grew at least as fast as China when their per capita GDP levels were at the present Chinese level. In that sense China is no outlier in East Asian growth statistics.

Martin Wolf, using data from Angus Maddison's most recent work, summarizes the comparison with the growth rate of China:

China's gross domestic product per head at purchasing power parity rose by 370 per cent between 1978 and 2004, a trend rate of 6.1 percent a year. Yet between 1950 and 1973, Japan's GDP per head had increased by 460 percent, a trend rate of 8.2 percent. Between 1962 and 1990, South Korea's GDP per head rose by 680 per cent, a trend rate of 7.6 percent, while Taiwan's rose by 600 percent, between 1958 and 1987, a trend rate of 7.1 percent.²¹

The important point about the comparison with China's neighbors is that the spurts of growth Wolf refers to (lasting from 23 years for Japan to 29 years for Taiwan) are comparable to the period between the announcement by the Chinese Communist Party ("CCP") under the new leadership of Deng Xiaoping in 1978 that its focus would shift to economic development and the first decade of the twenty-first century. And shortly after the end of their surge of growth, most of the neighbors experienced a substantial slowdown in growth. In the case of Japan, the economic downturn was longer even though Japan's Rule of Law record is stronger than the other neighbors.

The slowdown among China's neighbors such as Thailand, Indonesia, Malaysia, and South Korea was quite pronounced. A careful study using data up to mid-2001 found that the loss from the slowdown beginning in 1997 was never made up and hence the result was a permanent loss in cumulative GDP.²² Data for later years shows, moreover, that the growth rate continued, after the turn of the millennium, to be substantially below

²¹ Wolf (2005).

²² Cerra and Saxena (2005).

that of the period leading up to 1997. And this was true despite the fact that in 2004, *The Economist* noted that the world economy had been “growing at its fastest rate for almost 30 years.”²³

Thailand grew at rates between 6.8 and 11.2 percent from 1990 to 1996, with 1997 marking the beginning of a recession, but managed only 4.8 percent average growth between 2000 and 2003. Indonesia grew at rates between 7.2 and 9.0 percent between 1990 and 1996, but averaged only 4.1 percent average growth from 2000 to 2003. And Malaysia, which some pundits claimed did not suffer much from the Asian financial crisis because it fenced off its financial sector with capital controls, nevertheless was unable to replicate its 8.9 to 10.0 percent growth of the 1990-1996 period, achieving only an average of 4.7 percent during the 2000-2003 period.²⁴

The reasons for this marked slowdown, especially after the recession, among China’s neighbors are controversial and multiple. One reason is of course that as a country reaches a GDP per capita level closer to that of the developed world, the opportunities for “catch-up” with first world technology and business methods become more difficult and expensive to realize. This was particularly the case of Japan, which reached West European levels several decades ago. Moreover, some of the slowdown was perhaps the result of economic policy errors. It is certainly true that the region was affected during the rest of the 1990s by the 1997–98 Asian financial crisis, which might have been avoided or lessened by different economic policies. Some analysts attribute the Asian financial crisis, for example, to purely macroeconomic factors.

A strong case—indeed, a surprisingly strong case—can be made that the trigger for the Asian financial crisis (which some analysts blame for the subsequent slowdown) was a series of institutional failings. These failings were particularly striking in the financial sector—poor corporate governance, directed and related lending, and the absence of effective bankruptcy laws,²⁵ as well as a perceived implicit government guarantee to banks²⁶ and poor banking supervision facilitating “crony capitalism.”²⁷ An important study by Simon Johnson and colleagues showed that although poor

²³ Dancing in Step. *The Economist* (U.S. Edition, November 11, 2004).

²⁴ World Development Indicators. Available at [<http://devdata.worldbank.org/dataonline/>].

²⁵ For a journalistic review of corporate governance failings and abuse of minority shareholders leading to the Asian financial crisis, see Vines (2000, p. 141–160). See also Six Deadly Sins. *The Economist* (U.S. Edition, March 5, 1998); On the Rocks. *The Economist* (U.S. Edition, March 5, 1998).

²⁶ Bai and Wang (1999, p. 436–437); Krugman (1998).

²⁷ Pomerleano (1999).

macroeconomic management may have triggered the Asian financial crisis, the extent of exchange rate depreciation and of stock market declines among the Asian crisis countries was closely related to their respective weaknesses in legal institutions regarding corporate governance, particularly lack of protection for minority shareholders.²⁸ A statistical study found, with respect to Thailand and Indonesia (the two countries perhaps worst hit by the Asian crisis), significant results suggesting a high degree of expropriation of minority shareholders.²⁹

In Indonesia much of the banking system proved to be insolvent, in large part due to connected and directed lending:

The main cause of private banks' nonperforming loans was connected lending, with these banks being used to channel credits to bank owners. In the case of state-owned banks, the main cause was state-directed lending.³⁰

According to *The Economist*, crony capitalism was remarkably blatant in Indonesia during the Suharto period:

President Suharto's family dominates the economy, owning huge chunks of business, including power generation, an airline, construction, telecoms, toll roads, newspapers, property and cars. Family members and their cronies get first pick of government contracts and licenses, so it helps to have one of their names on the company letterhead. Paying off family members or well-connected officials can add up to 30% to the cost of a deal.³¹

In the case of Japan, it is now apparent that its inability to resume consistent growth has been partly tied up with its weak banking sector, which in turn was related to the insistence of the government, and especially the ruling Liberal Democratic Party, that Japanese banks support sectors and regions important to the government of the day. Lending by banks quickly turned into several decades of nonperforming loans that continue to some extent today.

The question for the future, therefore, is whether China can avoid the slowdown

²⁸ See Johnson et al. (2000) and Claessens et al. (2000) on the shareholding structure that made minority shareholders vulnerable.

²⁹ Claessens et al. (1999).

³⁰ Srinivas and Sitorus (2004, p. 153–155).

³¹ Six Deadly Sins. *The Economist* (U.S. Edition, March 5, 1998).

experienced by its neighbors. Will its institutional weaknesses, especially in the financial sector, endanger continued Chinese growth rates just as similar weaknesses reduced the growth rates of its Asian neighbors? The World Bank Country Director for China recently laid out the risks:

While China has grown well since 1990, it is remarkable how much savings and investment this has required.... On the one hand, the need for such a large amount of investment for China's level of growth reflects the inefficiency of the financial system and the preference of local governments for large amounts of investment. A lot of bad investments are financed which ultimately produce little value. This is wasteful for China in real terms, and also creates the financial sector problem of a large volume of non-performing loans. This situation creates a systemic risk for China, in which some kind of internal or external shock could set off a costly financial crisis.

It also seems clear that this pattern of growth cannot be sustained indefinitely. Investment cannot just keep rising as a share of GDP and it will be increasingly difficult for China to keep increasing its share of world trade at the same rate.³²

In short, according to this line of analysis, the weak and inefficient financial sector will either lead to a crisis similar to the Asian financial crisis or to a less rapidly growing China. Either way, a weak financial sector is likely to create a slowdown in growth.³³

A Closer Look at the Chinese Growth Record

Before looking more closely at China's Rule of Law weaknesses, it is worth examining the nature of Chinese growth in recent decades and comparing it with the growth of China's neighbors during their period of rapid growth. An understanding of China's growth, in comparison to that of other Asian countries, can be gained by using the tools of a branch of modern economics known as growth accounting. This approach involves breaking down the sources of growth into capital and labor inputs. Both of these inputs can be adjusted for quality—labor, for example, can be adjusted for the levels of growth in human capital (represented, say, by increasing years of education of the labor

³² David Dollar. Improving the Efficiency of China's Growth Is Important for the Whole World. Slides available at [<http://www.cgdev.org/docs/DDollarslides.pdf>] (undated but presented in June 2005).

³³ This analysis involves a short-term slowdown in Chinese per capita growth. Over the longer term a slowdown in the growth of total GDP seems inevitable due to the demographic structure of China, created in large part by the one-child policy. China's population profile is aging more rapidly than most other Asian countries, notably India.

force). The residual of the overall growth, which is that portion that cannot be explained by adjusted capital and labor inputs, is usually called Total Factor Productivity (“TFP”) and is usually taken as a measure of the portion of growth attributable to added efficiency from, say, innovation. TFP “represents the proportional increase in output that would have occurred in the absence of any input changes.”³⁴

The enthusiasm about future growth now so apparent in the case of China was widespread with regard to China’s Asian neighbors in the early 1990s. A highly popular 1997 book titled *Megatrends Asia* carried the excitement right up to the 1997 Asia financial crisis, celebrating “Asia’s rapid ascent to global economic dominance.”³⁵ Against that romance of unlimited growth, however, a 1994 article in *Foreign Affairs* by Paul Krugman turned out to be prescient; using already published growth accounting research, he showed why the tendency to extrapolate current growth mechanically into the future was the economic equivalent of driving by looking in a rear view mirror.³⁶

Krugman’s key point was that the growth of the so-called Asian Tigers (also called the Asian NIEs—newly industrialized countries) had been based on increasing capital and labor inputs—particularly labor inputs—and that TFP (which would refer to increasing efficiencies, including catching up with advanced country technologies and management techniques) had made little or no contribution to the Asian Tigers growth rates.³⁷ Relying in part on an article by Alwyn Young, Krugman pointed out that Singapore’s growth between 1990 and 1996 (per capita income doubling every decade) could be explained by the increase in the share of the population employed from 27 to 51 percent and by an investment rate of 40 percent. He further argued—the critical point—that there was no sign of increased efficiency (that is, no increase in TFP). Since Singapore could not be expected once again to nearly double the proportion of its population employed (given that 51 percent were already employed) and since an investment rate much above 40 percent was difficult to imagine, it was obvious that Singapore’s growth rate would have to slow down.

Krugman analogized the success of Singapore to the success of the Soviet Union in its early years of rapid growth through an “astonishing mobilization of resources”:

³⁴ Young (2003, p. 1223).

³⁵ Naisbitt (1997, p. 14).

³⁶ Krugman (1994).

³⁷ See summary of studies with regard to other rapidly growing Asian countries in Rodrik (1996) and Felipe (1997, Appendix).

“Asian growth, like that of the Soviet Union in its high-growth era, seems to be driven by extraordinary growth in inputs like labor and capital rather than by gains in efficiency.”³⁸ What is particularly interesting about the Krugman article, and the research by growth economists on whom he relied, is that the predicated slowdown in the Asian Tigers became manifest within only a few years. Although some have blamed the slowdown on the Asian financial crisis of the late 1990s, the fact is that once the bulk of the labor force was gainfully employed in modern industrial and service industries, there was no longer much additional labor to be usefully deployed in increasing the growth rate.

Can such a slowdown be expected in Chinese growth? Alwyn Young, one of the economists on whose work Krugman based his article, has more recently gone deeply into Chinese statistics to determine whether Chinese growth is also explained by China’s ability to mobilize labor resources and by China’s high rate of investment.³⁹ He noted that, in the context of increased labor force participation rates and disproportionately large increases in the working age population, a movement in the proportion of the population employed in agricultural labor relative to nonagricultural labor had taken place. While the agricultural labor force had hardly grown (less than one percent per annum from 1978 to 1988), the nonagricultural labor force grew rapidly: 4.5 percent per annum.⁴⁰ In a lengthy complex analysis that cannot be adequately summarized in a few sentences, he concluded that the disproportionate increase in the nonagricultural labor force coupled with its increased educational attainment and the increased labor force participation accounted for most of the well-publicized high growth rate. (Put in laymen’s terms, Young was analyzing the economic result of the shift in the relative proportion of Chinese workers from farm to factory and from the rural West to the more dynamic eastern and southern coastal areas.)

The Young analysis has two important implications for Rule of Law issues. First, China is growing, but its growth is much like that of the Asian Tigers and therefore at some point one should expect a slowdown. However, with tens of millions of unemployed and underutilized labor, especially in rural Western China,⁴¹ the period before slowdown may well be longer. Further, there have apparently been large numbers of underutilized workers in China’s State Owned Enterprises (“SOEs”) and tens of

³⁸ Krugman (1994, p. 70).

³⁹ Young (2003).

⁴⁰ Young (2003, p. 1235, Table 6 and p. 1237, Table 8).

⁴¹ Wu (2005, p. 133-138).

millions have been laid off—11.5 million in 1997 alone.⁴² On the other hand, China has a rapidly aging labor force due to its one-child policy and therefore there is not a massive army of young adults (relative to its 1.3 billion population) ready to join the labor force. In fact, China's population is one of the oldest on average in Asia.⁴³

Second, Young found that China had experienced growth in TFP, though his estimate of TFP growth was lower than that found by others, who using different periods have found different results. Bosworth and Collins found that TFP growth in China was higher than the rest of East Asia as a whole and the developing world as a whole.⁴⁴ Improvement in institutional quality appears in growth accounting exercises under the TFP account, and although China's absolute level of institutional quality may still be low, it is now growing faster than during the Cultural Revolution.

Heystens and Zebregs, surveying the literature, found that Chinese "TFP growth was ... particularly high following the liberalization of the agricultural sector in the early 1980s, and in the early 1990s after market-oriented reforms were accelerated, and to have been well above that of the prereform period (1952–78)."⁴⁵ Hence, even when capital and labor resources are plentiful, growth appears to be dependent on TFP growth, and institutional reform has fed TFP growth in China in the past. An OECD study found that the growing private sector in China had a higher TFP than the state-owned sector; and this was true even though the state sector had higher labor productivity due to the fact that the state sector was able to apply three times the capital that was utilized by the private sector (which, as shown below, has little access to bank lending or the corporate bond market in the present stage of Chinese institutional reform).⁴⁶ Whether China can avoid a growth slowdown therefore depends in substantial measure, as the experience of China's Asian neighbors suggests, on whether it can successfully address institutional issues, including Rule of Law issues.

Enforcement and the Chinese Judiciary

The Chinese government and society have been placing increasing importance on

⁴² See Qian (2000a). See also Wu (2005, p. 198).

⁴³ "At the outset of reform in the late 1970s, over 70 percent of China's labor force was employed in agriculture. By 2000, China's agriculture labor force had already declined to below the 50 percent mark, which is impossible without successful development outside the agricultural sector." Qian (2003, p. 301).

⁴⁴ Bosworth and Collins (2003).

⁴⁵ Heytens and Zebregs (2003, p. 12).

⁴⁶ Organization for Economic Cooperation and Development (2005a, p. 86-87).

law:

Judicial caseloads are averaging nearly 5 million per year nationwide, while the number of additional disputes resolved through mediation and arbitration is burgeoning. Bookstores in Beijing, Shanghai, and other major cities are well stocked with books on law, and crowded with prospective purchasers. Law faculties are filled to capacity with many of China's best students, driven by the prospect of lucrative employment to study a field that for all intents and purposes did not exist 25 years ago. Law firms have multiplied—more than 5,000 have been established since 1990, bringing the total to more than 9,000.⁴⁷

An interest in, and even an emphasis on law, does not, however, mean that enforcement is of high quality. To address that issue, it is useful to break the issue down into two parts: the relationship of the state to the actors in the economy and the quality of the judiciary.

Despite the explosion in the size of the Chinese private sector, the remaining size of the state-owned and collective enterprise sectors, coupled with the influence of the government, the Chinese Communist Party (“CCP”), and those allied with government and the party suggest that the central issues are likely to involve the problem of the predatory ruler. In China the potential problem is much greater than a sixteenth or seventeenth century Tudor or Stuart King seizing property or welshing on his debts; as powerful as the Crown might have been, most of England was untouched by what was a tiny government and public sector.⁴⁸ In China the issues arise from the large role of government and the influence of the CCP.

As for the role and quality of the Chinese judiciary and, more broadly, the legal system as a whole, a few striking aspects of Chinese history play an important role. China had essentially no legal system when the economic reforms began in 1978. With the creation in 1949 of the People's Republic of China in 1949 (“PRC”), even the notion of law was in flux and with the onset of the Cultural Revolution under Mao's leadership, law was subordinated to party policies.⁴⁹ As Clarke points out, a “legal vacuum” was created that “ultimately had to be filled by whatever authoritative materials decisionmakers had at hand, including Party newspaper editorials, policy documents, and

⁴⁷ Potter (2004, p. 466).

⁴⁸ See discussion of the conflicts involving the Crown in England in Kenneth W. Dam, *Institutions, History, and Economic Development*, U. Chicago Law and Economics, Olin Working Paper No. 271, available at <http://ssrn.com/abstract=875026>.

⁴⁹ Peerenboom (2002, p. 44–46).

leaders' speeches."⁵⁰

Even during the Imperial period (ending in 1911) the legal system was largely a penal system, and (though a good deal of academic controversy exists on the point⁵¹) the use of law to settle private disputes was less common than in other countries.⁵² Chow summarizes the traditional view of Imperial law on this subject:

Citizens viewed law as being administered vertically, from the state upon the individual, as opposed to being used horizontally to resolve disputes between actors with one another.... [T]he use of law as a form of state administered power upon individuals also struck fear in most of the general population with good reason. Ordinary subjects who had disputes resolved them through informal means and mediation by various customary and unofficial channels such as through the use of craft or merchant guilds or through the intervention of village elders. The aversion to using the legal system among the general populace meant that China did not develop a civil law system useful in resolving civil disputes. Formal law only served the public interests of the state and was not viewed by ordinary Chinese as a tool to resolve private disputes.⁵³

It is, nonetheless, the case that in 1904, near the end of the Imperial period, a company law was passed, but it had few favorable economic consequences and, in any event, did not provide for private dispute settlement.⁵⁴

In the first half of the Republic of China period (which ran from the end of the Empire in 1911 to the creation of the PRC in 1949), various attempts to introduce statutory law to govern disputes between private parties were made. But the technique of using legal transplants from Western systems did not find fertile soil, and private disputes continued to be dealt with primarily through customary mediation techniques.⁵⁵ Perhaps one reason that the transplants did not take root is that China, never having been a colony, did not have a foreign legal system as a base of departure.⁵⁶ Indeed, the idea of a court had been foreign to Chinese Imperial law, which had “no special, differentiated

⁵⁰ Clarke (2005).

⁵¹ Diamant et al. (2005, p. 4); Scoggins (1990).

⁵² For a general discussion on the Rule of Law during the Imperial period, see Peerenboom (2002, p. 36–43).

⁵³ Chow (2003, p. 52–53). Between the Imperial and Mao periods attempts were made to adopt Western-type codes but these codes “had little effect on Chinese life, especially outside the cities,” in part because the codes “were often too complex and irrelevant to Chinese conditions and were adopted and studied in an abstract and mechanical spirit.” Lubman (1999, p. 31).

⁵⁴ Wei (2003, p. 27–29).

⁵⁵ Lubman (1999, p. 31–32).

⁵⁶ Clarke (2005).

institution (‘court’) before which disputing parties advance legal claims.”⁵⁷ In any event, legal reform efforts were cut short by civil war. And Western laws and institutions evaporated with the 1949 creation of the PRC.

Beginning in 1978, with the ascent to Communist Party leadership of Deng Xiaoping, a legal reform effort was launched. Its purpose was an announced shift “from class struggle and political campaigns to economic development and modernization.”⁵⁸ The 1982 Constitution struck a Rule of Law theme by stating that the Constitution “is the fundamental law of the state and has supreme legal authority.... No organization or individual is privileged to be beyond the Constitution or the law.”⁵⁹ And that theme was generalized in the 1999 amendments to the Constitution calling for the country to “be built into a socialist country based upon the rule of law.”⁶⁰ In 2004 the Constitution was further amended to protect property; the amendment stated that “citizens’ lawful private property is inviolable,” that the “State, in accordance with law, protects the rights of citizens to private property and to its inheritance,” and that the State “shall make compensation for the private property expropriated or requisitioned.”⁶¹

If enforcement even more than substantive law is the key to the Rule of Law, then the first place to focus is on the Chinese judiciary. No power of judicial review with regard to the constitutionality of statutes exists. Moreover, there is little evidence that the Constitution has any direct effect at all in litigation; legislation determines the law and the legislature is thus sovereign (the role of the Party aside).⁶² One can object that British courts have no power of judicial review either. But of course the British have no single written document known as a constitution (and Chinese judges occupy a completely different role and societal position than British judges do).

Even more important than the absence of judicial review is the fact that there is little pretense that the Chinese judiciary is independent in the Western sense. One Chinese view of independence is that it is the judiciary as a whole that is to be independent, not the individual judge.⁶³ Hence, judges may and often do consult with other judges, especially higher level judges, in reaching decisions—just as a bureaucrat

⁵⁷ Clarke (2005).

⁵⁸ Chow (2003, p. 75).

⁵⁹ Quoted in Chow (2003, p. 77–78).

⁶⁰ Quoted in Chow (2003, p. 78).

⁶¹ Constitution of the People’s Republic of China, as amended in 2004, Article 13.

⁶² Lin (2003, p. 275–276) and Gewirtz (2001, p. 208).

⁶³ Lubman (1999, p. 262).

would naturally consult with superiors before reaching important decisions.⁶⁴ This practice reflects a bureaucratic culture pervading the Chinese judicial system.

Bureaucratic consultation leads to unusual judicial practices. Higher courts sometimes act on their own initiative, without hearing parties or counsel, to instruct lower courts how to decide cases.⁶⁵ Another bureaucratic practice is the use of adjudicative committees,⁶⁶ which sometimes discuss cases before trial, leading to the assertion that “those who try the case do not decide it, and those who decide the case do not try it.”⁶⁷ The bureaucratic culture results in a situation, according to the President of the highest Chinese court, where “courts have often been taken as branches of the government, and judges viewed as civil servants who have to follow orders from superiors, which prevents them from exercising mandated legal duties.”⁶⁸ The 2005 Supreme People’s Court Five Year Plan for court reform called attention to the need for reform of adjudication committees, but the nature of that reform remained under consideration.⁶⁹

Corresponding to the lack of judicial independence is the absence of any doctrine of separation of powers:

The PRC also rejects the notion of horizontal separation of powers between different branches of the government (for example, the traditional troika of legislative, executive, and judicial branches). A necessary separation of functions is acknowledged, but constitutionally speaking the National People’s Congress (in form, a legislature) sits at the apex of China’s political power structure. In reality, that position is occupied by the Standing Committee of the Politburo of the Chinese Communist Party, but both form and reality share the rejection of multiple power centers.⁷⁰

The fact that judges are regarded as bureaucrats leads to unusual consequences when the litigation involves the government. Some government offices of equal or higher bureaucratic rank than that of a judge see no reason to consider themselves bound by that judge’s orders; on the contrary, government officeholders tend to consider themselves

⁶⁴ Hung (2004, p. 99–104) and Lubman (1999, p. 263).

⁶⁵ Chow (2003, p. 219).

⁶⁶ Peerenboom (2002, p. 323–325).

⁶⁷ Quoted in Lubman (1999, p. 261).

⁶⁸ Quoted in Hung (2004, p. 52).

⁶⁹ Congressional-Executive Commission on China (2004, p. 79-81). See also Yan (2004).

⁷⁰ Clarke (2005).

bound only by orders issued by their superiors.⁷¹ And judgments can be reopened long after they are rendered, just as a government bureaucracy can always change its mind; in short, the concept of finality plays much less of a role than in most Western systems.⁷²

The interaction between the courts and the government bureaucracies is also affected by “local protectionism.”⁷³ Federalism has been carried, especially on a *de facto* basis, much further in China than in most countries. As will be discussed below, this has beneficial aspects, but it is not an unmitigated blessing where the legal system is concerned given that the court system is supposedly national. Trial courts and judges are heavily dependent on local governments (and local people’s congresses) for funding, salaries, and even continued employment. Courts are thus often unsympathetic with plaintiffs from other provinces, especially where the defendant is a locally based state-owned enterprise.⁷⁴ Civil judgments rendered in other provinces are often refused enforcement.⁷⁵

Perhaps the largest question of judicial independence involves the role of the CCP.⁷⁶ Interference by Party members is probably more common in administrative rather than judicial bodies. Although judicial review of abstract rule-making by administrative bodies for compliance with the constitution and with legislation is not available, judicial review of administrative decisions to determine whether legislation has been complied with in particular cases involving particular parties (sometimes called legality review) is in principle available. But it is generally conceded that judicial control of administrative decisions leaves a good deal to be desired.⁷⁷

The early practice under which courts would ask for instructions from the Party’s political-legal committee at the court’s level has become less common, except perhaps in exceptional cases involving politically sensitive or controversial litigation.⁷⁸ Because the role of the Party is not set out clearly in law, the techniques of interference take many forms. Hung recounts that in the period 1989-2000 a basic court in Jiangxi province

⁷¹ Chow (2003, p. 223–224).

⁷² Clarke (1996, p. 41–49); Chow (2003, p. 213–215).

⁷³ Peerenboom (2002, p. 311–312).

⁷⁴ Peerenboom (2002, p. 311–312, 472); Chow (2003, p. 221).

⁷⁵ Chow (2003, p. 221–224).

⁷⁶ For a general discussion on the Party’s influence on the judiciary, see Peerenboom (2002, p. 302–309, 319–320). For a Chinese reform view, see Wu (2005, p. 427–428).

⁷⁷ For a detailed review, see Peerenboom (2001).

⁷⁸ Chow (2003, p. 198–199).

handled 200 first-instance administrative cases but the administrative defendants simply failed to appear in 95 percent of the cases.⁷⁹ Hung also states that lawyers are reluctant to take cases challenging administrative acts for fear of losing their license to practice law.⁸⁰ She observes that the Party tries to propagate the notion that judges should rely on Party leadership in administrative litigation, pointing to an article published on the official web site of Chinese courts:

The handling of many [administrative] cases involves the overall working situation of the party and the state and involves social stability and economic development [and] therefore, [judges] must tightly rely on the party committee's leadership ... to ensure the orderly development of administrative litigations....⁸¹

She also notes that courts even “boast in their annual reports about their efforts in ‘taking the initiative’ to get support from the party” in connection with administrative cases.⁸² Hung also notes other kinds of interference by administrative bodies, such as harassing witnesses, pressuring plaintiffs to withdraw cases, and *ex parte* approaches to judges to “inquire” about cases and to “exchange” views, something which may be initiated by both administrative and Party officials.⁸³

In 2004 the President of the Supreme People's Court conceded that the “difficulty of executing civil and commercial judgments has become a major ‘chronic ailment’ often leading to chaos in the enforcement process.”⁸⁴ According to his statement, “China's courts lack the authority and stature to command obedience to their decisions, especially where such decisions affect other government branches and officials.”⁸⁵

Lawyers from common law countries, where judges often make law, should perhaps be reminded that the influence of the Party in legislation has traditionally been so dominant that the Party can simply change legislation to achieve its ends. The National People's Congress, which is the legislature, and its Standing Committee “have generally

⁷⁹ Hung (2004, p. 91).

⁸⁰ Hung (2004, p. 88–89).

⁸¹ Quoted in Hung (2005, p. 10).

⁸² Hung (2005, p. 11).

⁸³ Hung (2004, p. 92–93). See Hung (2005, p. 12) for an example of *ex parte* communications by an administrative official.

⁸⁴ Enforcement of Civil Judgments: Harder than Reaching the Sky, China Law and Governance Review (2004, June No. 2).

⁸⁵ Enforcement of Civil Judgments: Harder than Reaching the Sky, China Law and Governance Review (2004, June No. 2).

been viewed as docile, rubber-stamp bodies that routinely approve by unanimous or near unanimous vote legislation already approved by the [Party].”⁸⁶ Hence, direct influence on courts is not always essential in order to shape the way the law develops; influence does become important, however, in actual enforcement of the law.

The Party’s influence on enforcement can thus take various forms. Where adjudication committees are used, for example, they “usually make their decisions after consultation with the CCPs political-legal committees at corresponding levels.”⁸⁷ In addition, Party influence is partly exercised through the power of local people’s congresses over judicial budgets, salaries and tenure. Moreover, as Alford reports, “virtually all significant legal personnel are Party members or have been closely vetted by the Party prior to assuming office [and] this is particularly the case with regard to the judiciary.”⁸⁸ Judges, especially at the trial level, are thus not necessarily behaviorally independent, especially because they frequently lack the education and competence necessary to command societal prestige⁸⁹ and because administrative officials (who are often Party members) tend to lack respect for legal knowledge and law.⁹⁰

Moreover, Party influence can be said to be partly structural because of the particular type of federalism in China where the trial-level judiciary is not in practice shielded by the prestige of higher-level appellate courts; trial courts in that sense, not having independence and not benefiting from a notion of separation of powers, are forced to show some deference to local government and hence to the Party:

Bifurcation between a people’s congress on the one hand and a day-to-day government on the other hand is replicated several layers down into local government. In each case, the government organization is responsible not to the government organization the next level up, but rather to the people’s congress at the same level. Again this is the formal structure. In practice, the Communist Party organization at any given level of government has a monopoly on political power. This monopoly, of course, does not mean absolute power to do whatever the Party organization wishes. There are always constraints on capacity, whether economic, political, or social.⁹¹

⁸⁶ Chow (2003, p. 178). Chow acknowledges some attenuation in the unanimity of legislative voting, but points to only two instances where a Party-backed proposal was blocked. Chow (2003, p. 179–184).

⁸⁷ Hung (2005, p. 10).

⁸⁸ Alford (2003, p. 134–135).

⁸⁹ Hung (2004, p. 100–101). Chen (2003, p. 454) points out that “a large number of judges, especially in less developed provinces, are former military officers who had no formal legal training prior to being a judge.” See also Peerenboom (2002, p. 14).

⁹⁰ Hung (2004, p. 93).

⁹¹ Clarke (2005).

Efforts to meet this structural problem by creation of intermediate appellate courts with jurisdiction over more than one province have failed; hence, China has no equivalent of U.S. Courts of Appeal that normally have federal trial courts located in several U.S. states within their territorial jurisdiction.⁹²

Behavioral independence depends heavily on the tenure of judges and their salaries. A version of life tenure on good behavior was introduced by a 2001 amendment to the Judge's Law; it limits the grounds for dismissal, but those grounds involve such broad criteria as "to be unqualified for the present post and decline to accept other assignments."⁹³ Also, the appointment and removal of chief judges of particular courts can be made by the corresponding legislative body.⁹⁴ Judicial salaries are comparatively low. Judges' education and training leave much to be desired,⁹⁵ though the educational attainment of Chinese judges is improving; in 2003 some 40 percent had earned a four-year university degree, a 21 per increase since 1998.⁹⁶ Corruption appears to be common.⁹⁷ Finally, a 1998 rule issued by the highest court made judges subject to being held liable for intentional or negligent violation of any law or regulation; some 2000 judges were held to have violated the rule in the 1999–2000 period and the consequences of violation were potentially substantial.⁹⁸ Behavioral independence is thus questionable, despite the limitations on dismissal in the Judges Law. This is probably a problem largely in the review of administrative acts, where the interests of both the Party and the bureaucracy are more likely to be directly engaged than in ordinary civil litigation.

Substantive Law

Although enforcement may be as important as substantive law, poor enforcement is more likely to be a hindrance to growth than weak substantive law in developing

⁹² Peerenboom (2002, p. 328); Wu (2005, p. 428).

⁹³ Article 40, Judges Law of the People's Republic of China, 2001.

⁹⁴ Lubman (1999, p. 256).

⁹⁵ Peerenboom (2002, p. 320–322).

⁹⁶ Congressional-Executive Commission on China (2005, p. 88).

⁹⁷ Peerenboom (2002, p. 322–323); Hung (2004, p. 105–108); Organization for Economic Cooperation and Development (2005b, p. 107 (Box 3.1)).

⁹⁸ Hung (2004, p. 104–105). Efforts have been made by the Supreme People's Court to limit the application of court responsibility systems. Congressional-Executive Commission on China (2004, p. 78–79).

countries, Chinese officials have begun to recognize publicly that the substantive legal system presents a major risk to the Chinese financial system.⁹⁹

China faced a particular challenge during the Deng Xiaoping reform era at the end of the Cultural revolution. All property having a function in the economic system belonged to the state. Agricultural land belonged directly to the state. Non-agricultural economic activities, especially in industry, were carried on within companies, but these companies were not legal persons but rather were more like units of the government, often local government. State-owned corporations (“SOEs”) in the sense of legal persons with the legal qualities of Western corporations did not yet exist.¹⁰⁰ In fact, the transfer of such activities from the earlier companies to distinct legal entities with shares owned by the state—a process sometimes called corporatization—was considered at the time a major reform.¹⁰¹ The separation of management from control was considered a step forward because it made possible, at least in theory, professional management that could be responsive to economic considerations rather than bureaucratic whim or fashion. However, the executives of state enterprises were still bureaucrats at heart, even to the extent of retaining their rank as state or provincial officials.¹⁰²

The enactment of a company law made the corporate form (and hence limited liability) also available to private enterprises and led in time to a decline in the market share of “SOEs.”¹⁰³ In any event, the move to SOEs was far from a solution and did not give China a market economy. An SOE was still prone to bureaucratic interference. The ultimate owner—the Chinese people—could not act as an ultimate owner, exercising residual control rights; in fact, even if one is prepared to say that the state is the agent of the people with respect to governance of an SOE, the state itself was not able to fulfill that function.¹⁰⁴ Legislation in 2003, however, created a State Assets Supervision and Administration Commission (SASAC) to monitor and supervise central government controlled SOEs.¹⁰⁵ Parallel institutions were formed at provincial and local levels. Despite this legislation intended to concentrate the state’s ownership responsibilities,

⁹⁹ See Speech by Junbo Xiang, Deputy Governor of the People’s Bank of China, Improve the Legal System to Prevent Financial Risk, at the 2005 High-level Forum of China’s Financial Reform, Shanghai, April 26, 2005.

¹⁰⁰ Wu (2005, 154-156)

¹⁰¹ Clarke (2003, p. 496); Osgathorpe (1995-1996).

¹⁰² Tenev and Zhang (2002, p. 82).

¹⁰³ Zhang (2004, p. 2032, including Table 1).

¹⁰⁴ Clarke (2003).

¹⁰⁵ Organization for Economic Cooperation and Development (2005b, 301-322). This change took the Ministry of Finance largely out of the line of responsibility for non-financial SOEs.

SOEs may nonetheless remain subject to conflicting demands and preferences, particularly of local Party and local government officials. And the Party often appoints the managers.¹⁰⁶

These problems are particularly acute in the financial sector where government allocations of capital to enterprises were replaced in the 1980s by loans from four state-owned commercial banks (SCBs).¹⁰⁷ These SCBs tended to use government and Party criteria to allocate loans,¹⁰⁸ and at the very least were sensitive to government and Party priorities for the promotion of particular industries and regions.¹⁰⁹ Local bank branches were likely to be heavily influenced by local governments in making their credit allocation decisions. As a result of these pressures as much as 90 percent of SCB loans went to SOEs.¹¹⁰ The SCBs were further handicapped in pursuing purely market considerations in lending decisions by what the Financial Times editorially called “large-scale fraud, embezzlement and other misdeeds, from branch offices all the way up to the boardroom.”¹¹¹

Given the role of the government and the Party, it is little wonder that SOEs acted, initially at least, more like government agencies than true private sector enterprises and even after various reforms, the state-dominated financial system did not produce satisfactory mobility of capital across China. Even to the extent capital was mobile, there was a tendency “to allocate capital systematically away from the more productive regions towards less productive ones.”¹¹² For one reason, the SCBs concentrated on funding SOEs.¹¹³

Meanwhile, the four large SCBs were supplemented by other state-owned financial institutions such as joint-stock banks (“JSBs”).¹¹⁴ Unlike the original four SCBs, whose operations reflected the national perspective of their origin in a central

¹⁰⁶ Tenev and Zhang (2002, p. 20–28).

¹⁰⁷ Naughton (1995, p. 255–257); Wu (2005, p. 219).

¹⁰⁸ McGregor (2005b).

¹⁰⁹ Tenev and Zhang (2002, p. 55–65).

¹¹⁰ Cull and Xu (2000, p. 2 and 8, Figure 1). See also Dyer (2005c).

¹¹¹ Chinese Corruption: Deeper Reforms Are Needed to Stop the Rot. Financial Times. March 28, 2005. p. 14. For details on the banking scandals, see Barboza (2005); Personal Banking, China Construction Bank. The Economist (U.S. Edition March 26, 2005); and Lague (2005).

¹¹² Boyreau-Debray and Wei (2004).

¹¹³ Cull and Xu (2000, p. 2); Lardy (1998, p. 83).

¹¹⁴ Wu (2005, p. 233).

planning period, the 11 JSBs have been more focused on the business of banking.¹¹⁵ In addition, some 1000 or more “city” banks owned by municipalities have emerged. Still other publicly owned banks have been created for agricultural and non-business purposes.¹¹⁶ Only in 1995 was the first private sector bank licensed, and the few private banks in operation have a tiny percentage of the commercial-industrial market.¹¹⁷ Most state-owned financial institutions continue to focus their lending on keeping afloat SOEs, many of which are in parlous financial conditions:

Bank loans appear to have been channeled to provinces with heavy concentrations of SOEs. These provinces have, at the same time, also been the ones that have tended to grow relatively slowly, suggesting that the productivity of lending was relatively low.... The banking system has been used to keep inefficient state enterprises afloat so as not to produce excessive layoffs and raise the cost of transition to levels where social stability might be threatened.¹¹⁸

The result of the dominance of state banks compared to private banks is that the private commercial and industrial sector in China has had relatively little access to formal credit.¹¹⁹ Private sector enterprises, which outperform public sector enterprises,¹²⁰ are financed almost entirely by retained earnings and private savings, although informal credit markets do exist:

Between 1990 and 1997, the new jobs created in the private sector accounted for 56 percent of new formal employment in urban areas. This rapid growth has occurred with relatively few resources from the financial sector: in the period 1991–97, the share of private investment in the national total was in the range of 15–27 percent, with little recourse to formal bank loans (less than 1 percent of working capital loans went to the private sector).¹²¹

Foreign direct investment has been a supplementary source of capital for private sector enterprises.¹²² Moreover, China has increasingly turned to foreign investment to stimulate reform in state-owned enterprises. Recently the Chinese government has encouraged minority investment (so-called strategic investment) by foreign banks in

¹¹⁵ Organization for Economic Cooperation and Development (2005b, p. 384).

¹¹⁶ Cull and Xu (2000, p. 6, 7, Table 1); Lardy (1998, p. 61–76, 80).

¹¹⁷ Cull and Xu (2000, p. 6, 7, Table 1).

¹¹⁸ Aziz and Duenwald (2002). On FDI in the form of minority interests in SOEs, see Wu (2005, p. 302).

¹¹⁹ Wu (2005, p. 232–234).

¹²⁰ Clarke (2003, p. 494–495, n. 2 and sources cited therein).

¹²¹ Aziz and Duenwald (2002).

¹²² Aziz and Duenwald (2002).

state-owned banks. The rationale for this foreign investment reflects the Chinese economic leadership's frustration with state-owned commercial banks. As explained by the China Banking Regulatory Commission:

It should be recognized that transforming the Chinese state-owned commercial banks into real commercial ones would be an arduous task....Such an ownership structure makes it easy for banks to depart from market principles, but difficult for them to set up a sound corporate governance structure or an efficient operation mechanism. Consequently, it makes it hard for the banking supervisor to implement scientific and sound standards, resulting in both the high and accumulating impaired assets and low business performance. Such circumstances could not only block the banks from achieving sustainable development, but also have a direct impact on the control and mitigation of risks as well as the efficient allocation and safety of the funds in the whole society. Therefore, it has long been imperative for China to carry out in-depth banking reform, so as to be better adapted to the development of the socialist market economy and in particular to meet the urgent needs of all-round opening up of the Chinese financial sector after the WTO entry. To this end, the purpose of introducing experienced and qualified overseas strategic investors is an effective method to promote as well as enhance the reform.¹²³

The willingness, indeed apparent eagerness to bring in strategic bank investors was apparently linked in Chinese leadership thinking to making initial public offerings (IPOs) in the Hong Kong market of minority interests in state-owned banks.¹²⁴ Neither the interest in strategic investors nor the IPOs were necessarily driven by the need for more capital. In a revealing statement, the chairman of SASAC asserted in December 2005 that IPOs in overseas markets (in which he apparently included Hong Kong) was justified because “overseas markets are more regulated and Chinese companies can benefit and learn to fine-tune corporate structure and governance.”¹²⁵

The SCBs, which were carrying out government (and Party) policies in extending loans to the SOEs, not only had massive holdings of non-performing loans but also tended to earn negative returns on assets.¹²⁶ “According to Chinese government statistics, as of the end of 2002, China’s four major state-owned commercial banks collectively had recorded a bad asset ratio of 25 percent.”¹²⁷ This figure does not include

¹²³ China Bank Regulatory Commission (2005).

¹²⁴ China Bank Regulatory Commission (2005). See Dolven et al. (2004).

¹²⁵ Geoff Dyer (2005d).

¹²⁶ Lardy (2003, p. 67).

¹²⁷ Wu (2005, p. 382). See also Lardy (2004, p. 108 and 109, Table 5-2).

nonfinancial institutions; state-owned corporations, for example, had NPLs equal to half of their total assets as of 1996.¹²⁸

Although official figures for SCB NPLs more recently began to decline as a percentage of assets, the decline was apparently caused in part by a rapid increase in the volume of lending (the base for calculating that ratio).¹²⁹ Moreover, it is likely that NPLs would have risen since 2003, not fallen, if it had not been for the infusion of capital from the state.¹³⁰ This infusion continued with the contribution in 2005 of \$60 billion in capital by the central bank (taken from foreign currency reserves) through the Huijin Investment Company, which thereby became a major stockholder of several SCBs.¹³¹ A Bank of Spain study estimated that total injections of governmental capital into the Chinese banking system from 1998 to 2005 was equal to a total of 20 to 25 percent of Chinese 2004 GDP, a truly huge subsidy that could easily account for the decline in the NPL ratio.¹³²

The Rise of Stock Exchanges and Securities Regulation

A transformed corporate landscape was thus created by the reforms of the 1980s and 1990s in which (1) loans by state-owned commercial banks and later by other state-owned financial institutions replaced capital allocations from the state coupled with (2) the conversion of state enterprises into corporations owned by the state—that is, SOEs. These two changes soon led to further changes. The reason was that the SOEs were no longer able to generate enough profits to fund their own growth, even when coupled with bank loans from SCBs. Indeed, additional loans from the SCBs to the SOEs seemed to generate steadily increasing portfolios of NPLs for the SCBs.¹³³

¹²⁸ Lardy (2003, p. 71).

¹²⁹ García Herrero and Santabárbara (2004, p. 22-24); Organization for Economic Cooperation and Development (2005a, p. 149).

¹³⁰ According to Jinglian Wu, Standard and Poor's reported in September 2003 that even with the "substantial increase in total outstanding loans," the NPL ratio was 40 to 45 percent. (Wu 2005, p. 382).

¹³¹ Browne (2005).

¹³² García Herrero et al. (2005). To illustrate the costs to the Chinese government of cleaning up NPLs, a proportionately large series of bank bail-outs in the United States would cost between \$2 and \$3 trillion in total.

¹³³ AQQ (2005b, p. 35, Table 2). As noted earlier in the text, NPLs for SCBs declined later, because state bodies, including asset management companies, bought loans in default or otherwise put additional funds into SCBs. García Herrera and Santabarbara (2004, p. 15, Table 5).

A partial answer to this financing quandary was to create stock exchanges in Shanghai and Shenzhen in 1990, and thereby generate a climate that would induce Chinese citizens to use some of their savings to purchase stock of the SOEs in IPOs. It is important to stress that one effect, and perhaps a prime purpose, of the move to public issuance of securities was to tap private savings to finance the SOEs.¹³⁴ According to Jinglian Wu, a leading Chinese economist who served as an advisor to the State Council, the “administrative authorities...adopted the policy that ‘the stock market should serve the SOEs.’” Private savings were going to the same ultimate use before through the intermediation of state-owned financial institutions, but expansion of that route was plagued by the steady rise of NPLs and by the low interest rates paid on savings deposits.

In retrospect, one can see that the creation of the stock exchanges was designed not just to support the issuance of stock to the public by providing venues for secondary trading but also to stimulate the desire to invest by implicitly promising greater returns to savers. What resulted was an enthusiastic search by the public for riches and indeed a new kind of gambling for many Chinese citizens; Wu observes that “the government boosting the stock market and SOEs grabbing the money” created a “casino without rules.”¹³⁵ Between 1990 and 2001 the Shanghai stock market composite index went up approximately twentyfold.¹³⁶ As the market rose (with price-earnings ratios reaching a “ridiculously high level of 100 to 200 in the early 1990s),”¹³⁷ the amount of money raised by the SOEs through IPOs and further stock issuances (seasoned equity offerings) increased, reaching 1.7 percent of GDP in 2000. This was almost as high a percentage as in the United States during the Internet bubble and a far higher percentage than Japan ever reached.¹³⁸

The popularity of stock issuance created a new set of Rule of Law problems. The SOEs’ demand for new capital continued to grow and with it all kinds of stratagems to convince savers to buy what in many cases were financially weak companies. Market manipulation¹³⁹ and even outright fraud became a path for that purpose—“creating fake

¹³⁴ The “stock market has failed to ... improve resource allocation. Rather it provided SOEs with unprecedented access to cheap direct finance.” Zhang (2004, p. 2044). See also Green (2004, p. 11) and Green (2003, p. 22–24, 26).

¹³⁵ Wu (2005, p. 243-244). Similarly, the head of the China State Council’s Development Research Council called the stock market “worse than a casino” because at least in a casino there were rules. Green (2003, p. 165).

¹³⁶ Chen (2003, p. 460, Figure 1).

¹³⁷ Wu (2005, p. 244).

¹³⁸ Chen (2003, p. 459, Table 2).

¹³⁹ Wu (2005, p. 242).

receipts and fake contracts to make up whatever profits that are needed to meet IPO requirements.”¹⁴⁰ Chen gives the illustration of splitting an SOE into a “good” entity and a “bad” entity, selling shares to the public in the good entity but arranging for the bad entity to end up with the controlling interest in the now public entity.¹⁴¹ Efforts of regulatory authorities to assure that only healthy companies issued stock by imposing minimum profit regulations simply led, in Chen’s words, to companies adapting their “accounting manipulation schemes” to the new regulations.¹⁴²

Efforts to commence shareholder securities cases to attack such fraud and manipulation was quite a strain for the Chinese judicial system, which had no idea how to manage mass tort litigation—that is, how to handle a massive number of individual claims against the same defendant for exactly the same alleged wrongdoing. The Supreme People’s Court, apparently panicking at the prospect, issued a notice in 2001 directing lower courts not to accept private securities lawsuits for the time being, despite the existence of the underlying 1999 securities act providing supporting substantive legal standards.¹⁴³ But subsequently, in a complex and rapid evolution, rules were worked out in consultation with many private sector experts, interpreting the underlying statute and creating the basis for actions by shareholders acting jointly.¹⁴⁴ However, class actions (in which one or more shareholders sue jointly on behalf of shareholders as a class) are apparently still not feasible in China.¹⁴⁵ Moreover, private class actions require, as a predicate, a prior adjudication in favor of the government with respect to the underlying violation.¹⁴⁶ Nonetheless, the intention of Chinese leaders to empower shareholders is reflected in the 2005 company act (effective in 2006) providing explicitly for shareholder derivative actions against controlling shareholders and corporate officials violating a fiduciary duty.¹⁴⁷

As a result of the selling of shares in SOEs to the public and their listing on

¹⁴⁰ Chen (2003, p. 457). See Wu (2005, p. 251); Green (2003, p. 24, 135–139).

¹⁴¹ Chen (2003, p. 457).

¹⁴² Chen (2003, p. 458).

¹⁴³ Chen (2003, p. 464).

¹⁴⁴ For a general discussion, see Hutchens (2003) and Chen (2003, p. 464–467).

¹⁴⁵ Lu (2003, p. 798–801) and Hutchens (2003, p. 640–645). Hutchens surmises that class actions were seen as a threat to SOEs and perhaps as a threat to the CCP by fomenting class struggle. Hutchens (2003, p. 644–645). But see, IIF Equity Advisory Group (2004, p. 4), which refers to the first class action shareholder lawsuit pending in a Beijing Court.

¹⁴⁶ Hutchens (2003, p. 634, 640).

¹⁴⁷ Company Act 2005, Article 152. The statute follows on a 2001 rule of the Chinese Securities Regulatory Commission on fiduciary duties.

exchanges, a structure resulted in which an average of about one-third of the shares of an SOE (“A shares” for Chinese citizens buying with local currency plus “B shares” for foreign currency purchasers) are held by the public with about another one-third held by the state (state shares) and the last one-third (legal person shares) held by a variety of institutions, in many instances state-related entities including provinces and municipalities.¹⁴⁸ State shares and legal person shares, unlike shares held by the public, are in principle not tradable on exchanges. However, many nontradable shares have in fact been bought and sold off the exchanges for a variety of reasons.¹⁴⁹

At the turn of the millennium Chinese leaders broached their interest in selling state shares to the public—a policy known as “reduction of state-owned shares.” In 2001 the China Securities Regulatory Commission issued a notice to that effect.¹⁵⁰ Although the notice was often thought to be a move toward making SOEs true private sector enterprises, a more powerful motive may have been to raise still more funds to finance SOEs, which were consuming vast amounts of capital in expansion and in covering losses. These demands for capital could not be entirely met by SCBs and other state-owned financial enterprises, which were weighed down with large quantities of NPLs and hence were not well placed or strongly motivated to meet these demands.

The news of these intentions coincided with a downturn in the Chinese stock market and, while perhaps not causing the downturn, certainly exacerbated it.¹⁵¹ This development might not have surprised a more sophisticated financial community. Shareholdings (including shares held indirectly through SOEs) by government – state, provincial and local – were larger than shareholdings in the hands of the public and therefore constituted a huge overhang of potential supply, leading potentially to at least a doubling (or if legal person shares were also sold, a tripling) of the number of tradable shares outstanding.¹⁵² (At the end of 2002, only 34.7 percent of shares in listed

¹⁴⁸ Li and An (2004); Zhang (2004, p. 2035). The one-third, one-third, one-third breakdown conventionally used for expository purposes ignores an underlying variation among industries and companies. See, for example, Li and An (2004, p. 385, Table 1). showing that many listed companies have over 50 percent of their stock in state share form. See for detail on different kinds of shares, Schipani and Liu (2002, p. 65, Table 1). H shares, which are traded in Hong Kong, composed about 5 percent of all Chinese shares in 1998. Schipani and Liu (2002, p. 65, Table 1). See also Tenev and Zhang (2002, p. 76–77).

¹⁴⁹ The complexity of motives for such transactions is explored in Green (2005).

¹⁵⁰ Li and An (2004, p. 378).

¹⁵¹ Dyer (2005c).

¹⁵² Hangover Cure. *The Economist* (May 5, 2005) and Dyer (2005b).

companies were tradable on Chinese stock markets.¹⁵³) By mid-2005 the Shanghai stock exchange index, which once traded above 2200,¹⁵⁴ was at a five-year low, trading near 1000.¹⁵⁵ In August 2005 the China Securities Regulatory Commission announced that all listed companies' shares would be made tradable, though at the discretion of the companies. However, in order to encourage the change, holders of domestic shares (A shares) were promised compensation, thereby discriminating against foreigners who hold other classes of shares and against even Chinese who later acquired shares originally issued in foreign currency.¹⁵⁶

Coexisting with these issues involving SOE shareholdings is an absence of ready financing, other than by retained earnings and private savings, for true private sector enterprises, despite some informal credit markets. Outstanding corporate domestic currency debt securities constitute less than one percent of GDP (in contrast to Malaysia at 50 percent, South Korea at 28 percent and emerging markets as a whole at more than 5 percent).¹⁵⁷ As for primary markets in equities, public issuance and listing of non-SOE shares (that is, shares of purely private sector companies) are far from the norm:

The chance for nonstate firms becoming listed is extremely slim. Indeed, the first public company with a private background did not appear until 1998, on the Shanghai Stock Exchange.¹⁵⁸

According to the *Financial Times* reporting in 2005, “only between 30 and 130 of the 1,300 companies listed on the Chinese market have a private-sector background—and even some of those are in reality controlled by branches of the state.”¹⁵⁹

Moreover, true private sector firms are only in exceptional cases able to raise money by selling shares to the public, but state-owned financial firms may not always have the willingness and the ability to lend. Chinese businesses, including SOEs, relied in the first quarter of 2005 on banks for 99 percent of their funding, but, according to the

¹⁵³ Wu (2005, p. 165)

¹⁵⁴ Wu (2005, p. 250).

¹⁵⁵ Areddy (2005) and Dyer (2005a)

¹⁵⁶ Dyer and Guerrero (2005a).

¹⁵⁷ Eichengreen and Luengnaruemitchai (2004, Table 1). See also Barnett (2004). Even government enterprises find difficulties in issuing bonds. See Mingli and Liu (2001) published by the Asian Development Bank.

¹⁵⁸ Zhang (2004, p. 2035). However, Zhang (2004, p. 2035) also states somewhat contradictorily that “80% of the listed companies were state-controlled,” implying that as much as 20 percent of the companies were not state-controlled. However, some companies are controlled by provincial and local governments.

¹⁵⁹ Dyer and Guerrero (2005b); Zhang (2005).

Financial Times, “private companies—the motors of growth in the modern Chinese economy—borrow money for start-up finance from ‘underground’ banks that charge high interest rates.”¹⁶⁰ According to one review of the evidence:

There is a wealth of data illustrating the extreme financial constraints facing the domestic private firms. A number of international surveys shows that [China’s] private firms are more financially constrained than private firms in other countries.¹⁶¹

How can one explain, under conditions that so favor the financing of SOEs over private companies, the fact that the SOE share of GDP is nevertheless falling, accounting in 2002 for only 44 percent of Chinese GDP and only 41 percent of gross industrial output?¹⁶² One possible answer is that state-owned industry is highly inefficient and wasteful of capital. For China as a whole, an important measure of capital efficiency, the incremental capital-output ratio (“ICOR”)—which is the ratio of investment (as a percentage of GDP) to real economic growth (as a percentage of GDP)—was 5-1; this ratio “was comparatively higher than that for Japan, South Korea and Taiwan when they were experiencing high economic growth.”¹⁶³ Because of the very high Chinese savings rate and the high level of FDI, China is apparently able to waste capital,¹⁶⁴ but an inefficient and inadequately reformed financial sector could prove to be a barrier to continued rapid growth if a crisis, say of the nature of the Asian financial crisis, should erupt.

Corporate Governance

The larger problem created by the existing SOE shareholding structure with the state retaining control is not just inefficiency, but the creation of a built-in corporate governance problem, leaving the public shareholders locked in the position of minority shareholders. The public shareholders are thus vulnerable to expropriation by management and/or by state bureaucrats responsible for the firm or the industry in

¹⁶⁰ Francesco Guerrera and Richard McGregor (2005). See also Tsai (2002); Organization for Economic Cooperation and Development (2005a, p. 159-160). Some mainland private firms also borrow through Hong Kong affiliates. For an example of the obstacles to bank borrowing, see Huang (2005, p. 31).

¹⁶¹ Huang (2005, p. 27).

¹⁶² Zhang (2004, p. 2036). Wu (2005, p. 29 (Table 2.5) shows that the combined share of the nonstate and noncollective sector (that is, the private or nonpublic sector) has been above 40 percent since 1998. Similarly, the share of urban employment of the private sector has been above 50 percent since 1999, and above 60 percent since 2001. Wu (2005, p. 199 (Table 5.1).

¹⁶³ Kwan (2004). See also comment on ICOR in Wu (2005) and Wolf (2003).

¹⁶⁴ See the analysis of savings and investment in Rawski (2005).

question.¹⁶⁵ The risk of such expropriation is heightened by the previously reviewed weaknesses of the Chinese judiciary, especially because, as Clarke observes, “Chinese courts are not politically powerful and are hence reluctant to take cases involving large sums of money and politically powerful defendants.”¹⁶⁶

The abuse by the majority is not just a theoretical possibility. A Report by a task force of the Institute of International Finance found, based on data from the Chinese Securities Regulatory Committee, that “about 75 percent of listed companies have seen their IPO proceeds channeled back to the parent company and/or have experienced other forms of asset stripping via transfer pricing following the IPO.”¹⁶⁷ Individual accounts of outright fraud and asset stripping by majority shareholders abound. For example, “the 1999 annual report of Daqing Liyani Co. revealed that the largest majority shareholder stole RMB 620 million Yuan from this corporation, accounting for 50% of its total corporate assets.”¹⁶⁸ In 2001, “Sanjiu Pharma’s largest shareholder extracted US \$301.9 million, 96% of the listed company’s total equity.”¹⁶⁹

That Chinese leaders recognize the need for corporate governance reform is shown by two new regulatory provisions imposed in recent years, one requiring independent directors and--as previously mentioned--another imposing a fiduciary duty upon directors.¹⁷⁰ The real question, of course, is how these requirements are to be given specific content and actually enforced in view of the weakness of the Chinese judiciary and the elusiveness of the legal concepts involved. In the Chinese context, what does independence of directors mean, and what exactly is a fiduciary duty and to whom is it owed, where the state owns, directly or indirectly, the majority of the shares, controls senior personnel appointments,¹⁷¹ and supports the actions taken?

SOE managers have learned how to engage in self-dealing even without the connivance of state officials, especially through gaining “additional autonomy from their supervising agencies” by transactions with private sector companies under their own

¹⁶⁵ A corollary is that no market for corporate control exists. Zhang (2005, p. 2035).

¹⁶⁶ Clarke (2003, p. 503).

¹⁶⁷ IIF Equity Advisory Group (2004, p. 3). The data apparently became available because the CSRS adopted additional requirements to attempt to deal with these problems.

¹⁶⁸ Schipani and Liu (2002, p. 61).

¹⁶⁹ Bai et al. (2003). For examples of self-dealing by SOE managers, see Wu (2005, p. 395-396).

¹⁷⁰ On fiduciary duties (or the lack thereof) in China, see Wu (2005, p. 169-170). On the independent director requirement, see Wu (2005, 174-175) and Shen et al. (2005).

¹⁷¹ McGregor (2005b).

control or influence:

With the rapid development of the nonstate sector, managers or their relatives and friends often have their own businesses, which provides opportunities for diverting state assets to private benefits. A large body of anecdotal evidence indicates that asset stripping, or siphoning resources into structures where the controller has both majority control and income rights, is widespread. Furthermore, the “grafting” of nonstate property onto the state sector also offers opportunities for asset stripping, for instance, by using the appraisal and valuation process to form joint ventures....¹⁷²

Similarly, managers of SOEs having subsidiaries that are listed, and hence having many small shareholders, can use their SOE’s control of listed companies to transfer wealth through:

soft loans from listed companies on a long-term basis; the use of listed companies as guarantors to borrow money from banks; and the sale of assets to listed companies at unfair prices, usually without an appraisal by an independent evaluator.¹⁷³

Even bankruptcy has become a convenient occasion for self-dealing by corporate groups: a “common practice was to move most of the productive assets to other firms before bankruptcy.”¹⁷⁴

Credit Markets

In contrast to capital markets, which play a small role in the Chinese economy except for raising capital for SOEs through the sale of shares, credit markets provide the great majority of funds for enterprise. In fact, China has the dubious distinction of having the largest banking sector relative to GDP of any big economy in the world.¹⁷⁵ But the credit system has its own weaknesses. Aside from the poor financial condition of the banking system, plagued with NPLs, that has required state “bail-out” subsidies of

¹⁷² Tenev and Zhang (2002, p. 22).

¹⁷³ Tenev and Zhang (2002, p. 101).

¹⁷⁴ Ma et al. (2001, p. 60, n. 15); see Wu (2005, p. 160).

¹⁷⁵ A Great Big Banking Gamble, *The Economist* (Oct. 27, 2005). China has a particularly large financial sector compared to most countries at its present stage of development. Organization for Economic Cooperation and Development (2005a, p. 138, Fig. 3.1).

SCBs¹⁷⁶ and the use of asset management companies to take NPLs off the banks' books,¹⁷⁷ the credit system has legal problems.

The core of these problems lies in the uncertainty about secured debt. This uncertainty is tied up with the absence of a bankruptcy system appropriate to an economy so dependent on a large financial sector. In the early reform years, the very concept of bankruptcy was resisted since officials thought it

unfair to punish enterprises that could not make profits because of external, "objective" ... causes beyond their control (prices, demands of planners, fixed assets, etc.) [and] because the burden would fall mostly on a few actors (coal, steel, heavy machinery) and the inland provinces where these sectors were concentrated.¹⁷⁸

Nonetheless, a bankruptcy law for SOEs became effective in 1988 and the 1991 Law of Civil Procedure "introduced rudimentary provisions for the bankruptcy of legal persons."¹⁷⁹ A more adequate bankruptcy law has been under consideration for some years.¹⁸⁰ The biggest stumbling block has apparently been the question of absolute priority for secured creditors.¹⁸¹ The principal issue has been the relative priority of secured creditors versus employee claims for past wages, pensions, and social welfare payments. This issue has had to be addressed in every country, but in China it appears to have been a question of ideology favoring workers' rights versus the needs of the economy for putting secured creditors first in priority to assure a steady flow of secured credit to key enterprises.¹⁸² Another bankruptcy issue has been the uncertain status of land pledged as security,¹⁸³ particularly land that has been "allocated" by administrative authorities.¹⁸⁴ The new bankruptcy bill has been delayed, apparently due primarily to the

¹⁷⁶ A \$45 Billion Shot in the Arm. *The Economist*. (January 6, 2004). See also discussion of the use of foreign exchange reserves for investment in SOEs in text, *supra*.

¹⁷⁷ *Failing to Perform*, *The Standard* (June 20, 2005).

¹⁷⁸ Shirk (1993, p. 132).

¹⁷⁹ Tenev and Zhang (2002, p. 15).

¹⁸⁰ Organization for Economic Cooperation and Development ((2005a, p. 91-93).Booth (2004, p. 95). See Speech by Junbo Xiang, Deputy Governor of the People's Bank of China, Improve the Legal System to Prevent Financial Risk, at the 2005 High-level Forum of China's Financial Reform, Shanghai, April 26, 2005. See also Rogoff et al. (2004).

¹⁸¹ Organization for Economic Cooperation and Development (2005a, 91-93)..

¹⁸² Lardy (2003, p. 72-73). See Speech by Junbo Xiang, Deputy Governor of the People's Bank of China, Improve the Legal System to Prevent Financial Risk, at the 2005 High-level Forum of China's Financial Reform, Shanghai, April 26, 2005.

¹⁸³ Barale (2005).

¹⁸⁴ Traditionally, and certainly in the Mao period, all land was owned by the state, and the status of land remains a major economic issue going far beyond the question of bankruptcy law. In the Chinese countryside the land issue has been so important, particularly when cities expand over agricultural land,

employee versus secured creditors priority issue.¹⁸⁵ Meanwhile, the great preponderance of all credit continues to be provided by advances from state-sector banks, and the corporate bond market has remained small.¹⁸⁶

Legal and Institutional Reform

The foregoing review of China's financial sector points to deep flaws in equity and credit markets, and especially in corporate governance. Yet attitudes in the business and financial communities abroad toward China's economic future remain optimistic, especially compared to attitudes toward much of the rest of the developing world. Is this unjustified euphoria derived from extrapolation of past growth? Or can one find in Chinese institutional reform a basis for optimism?

Certainly China has not pursued the same strategy of reform as the Eurasian transition countries of Central Europe and the former Soviet Union. Reform in those countries tended to involve two strategies, the first to make large and quick changes—at the limit, a Big Bang approach of moving from a past of state dominance, state planning, and comprehensive price control to a Western-style market economy. The idea, particularly for price controls, was to remove them quickly before political opposition could arise.¹⁸⁷ The second strategy was to adopt the best Western substantive statutes—world “best practice” legislation. For a number of reasons, notably a failure to improve enforcement commensurately and societal resistance to legal transplants, the record in those transition countries, notably in the former Soviet Union (aside from the Baltic states), was not encouraging.

that it has produced violent conflicts. Turning Ploughshares into Staves. *The Economist* (U.S. Edition, June 25, 2005). See also Peerenboom (2002, p. 482) and McGregor (2005a) concerning land disputes as a major source of unrest. For a general discussion on land in China, see Ho (2001) and Brandt et al. (2002). In 2003, a change of law granted farmers 30 year land use rights, but still did not give them legal title or the power to mortgage the land for farm improvements or other uses. As many as 40 to 50 million farmers have lost land through expropriation. United Nations Development Program (2005). UNDP (2005, p. 4). See for a general discussion of the role of land rights in economic development, including a brief description of the evolution of Chinese land law, Kenneth W. Dam, *Land, Law and Economic Development*, U. Chicago Law & Economics, Olin Working Paper No. 272, available at <http://ssrn.com/abstract=876659>.

¹⁸⁵ World Bank Office Beijing (2005).

¹⁸⁶ Green (2003, p. 41–44).

¹⁸⁷ “Gaidar and Chubais believed that gradualism was akin to death; it would strengthen the vested interests and doom any real chance at reform. Chubais said it was only an illusion that change could be done ‘gently, slowly, and painlessly, so that everybody should be happy.’” Hoffman (2002, p. 183).

China adopted a different reform strategy. One can characterize it as incremental,¹⁸⁸ selectively adaptive, or more perceptive. (Deng Xiaoping called it “crossing the river by feeling for stones.”) But it was certainly different and arguably more intelligent. Since legal reform was needed to enable economic reform, legal reform had to take on some of the same characteristics; Lichtenstein mentions “gradualism, experimentation, regional differences” and “piecemeal and sometimes unconnected approaches and early vagueness supplemented by later detail.”¹⁸⁹ Most of all, both economic and legal reform was evolutionary in character; although Chinese reform was more centrally directed and took only a few decades to make a fundamental difference, it is reminiscent of the evolutionary developments over centuries in the English legal and political system culminating in the Glorious Revolution.¹⁹⁰

Why was China able, or perhaps forced, to carry out a different strategy from the Eurasian transition countries? One reason was that, despite some changes in leadership after the death of Mao, there was also considerable continuity in leadership. In China there was no post-Mao revolution of the type that could permit (despite the relative absence of violence) a completely new leadership to assume power as in most of the Eurasian transition countries. Thus, the old leadership, below the very top, was still partially in power but knew that change was necessary. Yingyi Qian explains one reason they did not opt for a big bang transformation: China had had two of them before—the Great Leap Forward of 1958 and the Cultural Revolution from 1966 to 1976—and both had ended disastrously. There was no appetite left for messianic transformations.¹⁹¹

Three of the early reforms illustrate the Chinese reform approach: the dual track, the township-village enterprises (TVEs), and fiscal federalism.¹⁹² All three involved the necessity of taking into account the predictable opposition of established economic power centers. As a corollary, the reforms were based on the political recognition that it was not feasible to attempt to reform everything at once. (That is, it was hopeless to attempt to transition in a few years from a totally socialist society to a market economy.) In addition, all three reforms were an intelligent harnessing of a key insight of neoinstitutional economics, an insight that is also part of classical microeconomics—the

¹⁸⁸ Wu (2005, p. 43, 57-74).

¹⁸⁹ Lichtenstein (2003, p. 275, 287).

¹⁹⁰ See discussion in Kenneth W. Dam, *Institutions, History, and Economic Development*, U. Chicago Law and Economics, Olin Working Paper No. 271, available at <http://ssrn.com/abstract=875026>.

¹⁹¹ Qian (2000b, p. 169).

¹⁹² The discussion of Chinese reform draws heavily on Wu (2005) and Qian (2003).

importance of incentives. This explanation is, to be sure, a backward-looking rationale of the Chinese reforms. At the beginning, there was no leadership announcement of a market economy goal. Even after the market economy goal came into clear sight, ideology and politics required the goal to be articulated as a “socialist market economy.” In sum, Chinese reforms recognized that the fastest route between two points is not, in a political world, necessarily a straight line. Recognition of a goal does not automatically make clear the way to achieve the goal, as experienced policymakers throughout the world are well aware.

The dual track system. The dual track reform was the path chosen to exit from both from state planning (in the mandatory socialist sense) and its concomitant comprehensive price control. This control system had powerful proponents: the bureaucrats who administered it and the producers that enjoyed a guaranteed margin, buying their inputs at designated prices and selling their product at designated prices. Both sets of beneficiaries were, in effect, bought off by the dual track system because plan quantities remained the same as under past rules and the beneficiaries were able, as economists would say, to enjoy the “rents” from this noncompetitive system. But for additional production, either by expansion of existing firms or by entry of new firms, the rules would be different; with respect to the additional production, firms were allowed to buy inputs at whatever price they could, and to sell their outputs at whatever price they could. In this instance, and in others, existing firms and political power centers were “grandfathered” as part of a consensus decision system.¹⁹³

The incentives to expand production and to establish new firms were strong. And the new inputs and outputs would be traded in what was a market economy. The move was economically efficient because it harnessed the economic insight that what counts for efficiency is marginal prices, not average prices. GDP in the industrial sector, for example, began expanding at double digit rates in 1983 and (except for 1989 and 1990) continued at those higher rates.¹⁹⁴ The evolutionary character of the dual track is best seen in the steel industry. By 1988, with economic expansion being stimulated by the market as opposed to the plan, production in the steel industry was far greater than the plan quota.¹⁹⁵ At the consumer level, retail level transactions at plan prices “declined

¹⁹³ See generally Shirk (1993), and on the dual track reform, see Wu (2005, p. 68-71) and Lau et al. (2000).

¹⁹⁴ Qian (2003, p. 302, Table 11.2).

¹⁹⁵ Qian (2003, p. 309, Table 11.3).

from 97 percent in 1978 to only 30 percent in 1990” and the decline continued thereafter.¹⁹⁶

Township-Village Enterprises: TVEs were an adaptation of the Mao period commune and brigade enterprises. The leadership used them because they already existed, having been “on the fringe of the central planning” system,¹⁹⁷ but were renamed TVEs, and were harnessed to provide additional production. One way of looking at TVEs is to think of them as being a *de facto* alliance of local government and small collective enterprises.¹⁹⁸ In the absence of any system of private property, local government would have been the prime predator for a local firm to fear (since Beijing was far away¹⁹⁹ and the central government was in no position to exercise direct power in the country as a whole). Putting the local government in business as the owner of the TVEs was a way of protecting entrepreneurial firms in the face of insecure and ill-defined property rights.²⁰⁰ As owners, local governments had a stake in making the TVEs successful because if their profits grew, there would be more money available to local government owners for their own function—the provision of local public goods. Moreover, these public goods—such as law enforcement, public health services, and infrastructure—were beneficial to the central government, and hence the center was disinclined to intervene. The TVE reform thus worked because of its effect on the incentives of the firm, the local government, and the central government.

Over time the TVEs began to compete with each other both in the product market and in the market for capital. By 1993 these local government-owned firms were providing 27 percent of all industrial output.²⁰¹ In a further evolution, the government began privatizing TVEs, usually by management buy-outs.²⁰² Meanwhile, many TVEs, especially older ones in rural areas, are being displaced by private firms,²⁰³ and TVEs no longer appear to be a favored part of China’s economic reform.

¹⁹⁶ Lau et al. (2000, p. 139, 140, Table 4).

¹⁹⁷ Qian (2003, p. 314).

¹⁹⁸ Chen (2000, p. 7).

¹⁹⁹ A Chinese proverb, “The mountains are high and the Emperor is far away,” thus has a contemporary meaning.

²⁰⁰ McDonnell (2004).

²⁰¹ Roland (2000, p. 281).

²⁰² Laixiang (2005, p.102).Moreover, in the 1990s the growth of TVEs began to give way to the growth of private firms. McDonnell (2004, p. 977–982).

²⁰³ Fishman (2005, p. 74–75) and Peerenboom (2002, p. 486).

Fiscal Federalism: Reform of intergovernmental fiscal relationships started in 1980 with a fiscal contracting system that, although varying regionally and evolving over time, had the characteristic of a compact between lower and higher levels of government within China's decentralized system.²⁰⁴ As between provinces and the central government, for example, each province divided its tax and other revenue into several categories, normally budgetary and extra-budgetary funds. Budgetary funds were to be shared between central and provincial governments according to a previously set formula.²⁰⁵ A formula might, in the case of provincially raised revenues, for example, call for a fixed proportion to be remitted upward—perhaps with an annual adjustment—and the rest retained by the provincial government. A pre-set formula had the advantage that the more revenue a government was able to collect, the more it could devote to its own purposes. Extra-budgetary funds, which were derived from such special sources as locally owned SOE retained profits, were to be entirely retained by the level of government that raised them.

The system, to the extent it worked as planned, provided a strong incentive to lower levels of government to maximize its revenues by promoting rather than preying on local business since they no longer had as much reason to fear that any increases would be taken away by a higher level organ of government.²⁰⁶ Thus, to use the Chinese slogan of the time, the center and the local governments were to “eat in separate kitchens.”²⁰⁷ The segregation of extra-budgetary funds was a particular success in the sense that by the early 1990s extra-budgetary revenues had grown to be about equal to budgetary revenues.²⁰⁸ Weingast popularized the notion that Chinese federalism, as a form of “market-preserving federalism,” promoted economic growth.²⁰⁹ The fiscal system was, however, unstable and had to be revised frequently to make clearer what taxes the central government and the provincial governments would be responsible for.²¹⁰ The fiscal arrangements illustrate the recurring phenomenon that each stage of reform created its

²⁰⁴ The description of the fiscal contracting system draws heavily on Wu (2005, p. 259-281) and Montinola et al. (1995). Details vary from province, Wu (2005, p. 258-263), and no attempt is made here to describe the fiscal contracting system in any detail.

²⁰⁵ The central government also collects revenues, such as tariffs and taxes on enterprises subject to central control. Wu (2005, p. 260).

²⁰⁶ Qian and Weingast (1997). Compare the experience in China with that in Russia where annual negotiations were necessary between the provinces and the center. Roland (2000, p. 280).

²⁰⁷ Shirk (1993, p. 149–178). Sometimes the Chinese slogan is translated as “eating from separate pots.”

²⁰⁸ Montinola et al. (1995, p. 64).

²⁰⁹ Weingast (1995). In 1994 the fiscal federalism system was reformed so that the provinces separately collected taxes for the central government and for themselves, with the center deciding on forms and rates of taxation. Lieberthal (2004, p. 253–254).

²¹⁰ Wu (2005, p. 269-290).

own perverse incentive and roadblocks, which required adjustments introduced by the leadership.²¹¹

Guided Evolution?

Much of the economic research on the institutional determinants of economic development has wrestled with the econometric problem of showing causation. One of the reasons has been that many opponents of the thesis that institutions (and particularly legal institutions) have to precede faster economic development have argued that such institutions are expensive and only a wealthier society can afford them. The economists' response has been that their econometric studies ran from institutions to development, rather than the other way around; in this view, to wait for development to generate the wealth necessary for better institutions would simply mean that economic development would never occur.

The Chinese experience suggests, however, that an evolutionary approach—let us say, a “guided” evolutionary approach—has been the path China's leaders, beginning with Deng Xiaoping, have been following. Thoroughgoing reform, especially of the Big Bang type, was not an available option for Deng Xiaoping. He evidently felt that he had to feel his way (feeling for stones on the way across the river to development). Political, ideological, and especially bureaucratic obstacles had to be overcome, circumvented, or sometimes perhaps simply out-waited. Many of the steps taken in the early reform years correspond to this interpretation.²¹²

That such a hand-in-hand relationship in the progress of economies and law can be found, as John Coffee has documented, in the growth of the U.S. securities markets. Those markets developed rapidly in the United States in the nineteenth century without the legal structure adequate for deterring fraud and self-dealing (although the New York Stock Exchange listing standards constituted a self-regulatory approach to investor protection). But it was not until after the 1929 crash that the Securities Act of 1933 and the Securities Exchange Act of 1934 were enacted, creating the legal structure for today's U.S. securities markets.²¹³ Coffee, reviewing the U.S. experience and a comparable U.K.

²¹¹ Wu (2005, p. 282-290).

²¹² For an excellent review of early Chinese reform consistent with this interpretation, see Shirk (1993). See also Baum (1994, p. 15–18) for a critical view of the Deng Xiaoping reform approach, noting that “some of Deng's stepping stones became millstones.”

²¹³ Coffee (2001).

experience, observes that the political constituency necessary for the legal reforms was not in place earlier but was created by financial developments that they were enacted to support and safeguard the expansion of already existing markets:

Although there is little evidence that strong legal rules encouraged the development of either the New York or London Stock Exchanges ..., the reverse does seem to be true: Strong markets do create a demand for stronger legal rules. Both in the United States and the United Kingdom, as liquid securities markets developed and dispersed ownership became prevalent, a new political constituency developed that desired legal rules capable of filling in the inevitable enforcement gaps that self-regulation left.²¹⁴

This is a comforting notion and does seem to describe how Chinese leaders unleashed rapid growth in the post-Mao period, filling in the chinks and gaps in the legal infrastructure to support further development as they went forward. In fact, unlike Coffee's securities markets example, the Chinese experience seems to be less purely reactive to scandal than the U.S. depression-period legislative reform. Chinese reform seems to be more thought out and even guided by the leadership of the CCP.²¹⁵

However, although this kind of "feeling for stones" evolution put China on the path to rapid economic development, the momentum of reform appears to have slowed over the last decade, at least in the financial sector. Stock exchanges were well accepted when they helped finance SOEs, but the SOEs themselves seem to have resisted further reform.²¹⁶ (However, SOEs have been able to "downsize" by shedding almost 40 percent of employees between 1998 and 2003.²¹⁷) The shareholding structure of SOEs has seriously delayed further securities market expansion and has discouraged investors (if one is to judge by market averages). Political and ideological barriers can apparently be managed by the Chinese leadership, but not always and not indefinitely.

²¹⁴ *Id.* at 80.

²¹⁵ Shirk (2003, p. 123–124) makes the point that reform was slowed down when the CCP leadership was divided or at least perceived as divided by the bureaucracy.

²¹⁶ One chronicle of Chinese reform calls SOE reform a "miserable failure." Qian (2003, p. 306).

²¹⁷ "From 1996 to 2001, 53 million people working in China's state sector lost their jobs. That is 7 million more people than the total employment rolls of 46 of the five hundred largest corporations in the world. Or, to state the numbers another way: in the four years beginning in 1998, state-owned companies fired 21 million. That's more than all the Americans who work in manufacturing." Fishman (2005, p. 74). According to other data, employment in the state controlled industrial sector fell by 40 percent from 1998 to 2002. Organization for Economic Cooperation and Development (2005a, p. 95).

Still, it is noteworthy that each generation of Chinese leaders appears increasingly comfortable with the notions that market influences should determine the direction of the economy, that the Rule of Law deserves at least verbal support as an objective, and that incentives play a crucial role in economic growth. A key problem faced by the current Chinese leadership is created in large measure by recent Chinese political, economic, and ideological history, which has left the leadership to face a multitude of stumbling blocks, ranging from underperforming state-owned industrial and financial enterprises to state bureaucracies and local governments that enjoy de facto autonomy in many spheres and that therefore have strong incentives to resist change.

The fact that Chinese leaders and thinkers have expressed an interest in Douglass North and his work suggests that they know that their institutions are not sufficiently strong for indefinite sustained growth.²¹⁸ The Chinese have no doubt been wise to avoid a legal transplantation strategy (transplanting advanced country law) in view of the distinctive social norms and culture that China's long history, its relative isolation from outside influences, and its internal twentieth century upheavals have produced. But evolution has its limits too. Evolution toward the Rule of Law in Western Europe, including England, took centuries. In China the evolution is more controlled from the center than anyone could claim about the earlier evolution in Europe.

In a book edited by Dani Rodrik that was devoted to a review of the economic growth history of a number of developing countries, Rodrik drew the following two overall conclusions. First: "The onset of economic growth does not require deep and extensive institutional reform."²¹⁹ China certainly presents powerful evidence in support of that conclusion. But Rodrik's second conclusion raises squarely the China case: "Sustaining high growth in the face of adverse circumstances requires ever stronger institutions."²²⁰ This is a principle that the Chinese leadership seems to understand. What we do not yet know is whether they will be able to continue to implement the institutional reforms implied in that principle.

That is why it is crucial to understand that China is still a poor country, well

²¹⁸ In his Internet autobiography Douglass North points to the fact that after his Nobel Prize, he had been asked to elaborate his views, "particularly in China, where there is much enthusiasm about the implications of the new institutional economics applied to solving problems of the Chinese political economic future." See Douglass C. North—Autobiography. Available at [<http://nobelprize.org/economics/laureates/1993/north-autobio.html>].

²¹⁹ Rodrik (2003, p. 15)

²²⁰ Rodrik (2003, p. 16)

below the per capita income of the Asian (former) Tigers when their growth slowdown began. As the Asian Crisis illustrated, China still is short of the point where the Asian Crisis type of challenges will have to be addressed, recognizing that the Asian Crisis was as much an institutional as a macroeconomic crisis. In China the present difficulties and dilemmas in the financial sector illustrate the complexities resulting from earlier compromises and half measures. And the leadership's inability thus far in the strictly legal arena to overcome such challenges as local protectionism and lack of judicial independence illustrates the heights still to be scaled.

All of these circumstances recall Zhou Enlai's famous answer to a question about the consequences of the French Revolution, "It is too early to tell." It is certainly too early to accept the notion that recent Chinese experience is a counterexample to the need for a focus on institutions in the developing world and, indeed, for a Rule of Law in China itself. While we will not know for certain for several decades exactly what conclusion to draw, we can still say with considerable confidence that there is little thus far in the Chinese experience to lead to the conclusion that Rule of Law issues are not important in economic development.

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