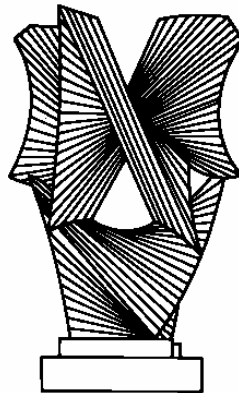


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China As a Test Case: Is the Rule of Law Essential for Economic Growth?

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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. Some commentators predict that China's economy will surpass the size of the U.S. economy some time in the second decade of this century (albeit at a much lower per capita income level). For most purposes, these predictions are quite misleading.¹ Yet 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

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1. The predictions of total Chinese GDP soon surpassing U.S. GDP are based on purchasing power parity comparisons. Whatever their value for certain purposes, these comparisons are almost surely unjustified for any inference about China's influence on global national security and foreign policy issues. 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 current 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 intended to "bring our GDP up to around 4 trillion U.S. dollars and per capita GDP to around 3,000 U.S. dollars within the next 15 years" (www.gov.cn/english/2005-10/16/content_78589.htm). That Chinese GDP figure for 2020 would still be equal to only about one-third of 2005 U.S. GDP and obviously much smaller still on a 2005 U.S. per capita GDP basis. (The

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 and through the outsourcing to China of research and development activities from some of the world's most accomplished high-technology firms.

Yet the level of China's adherence to the rule of law is frequently criticized.²

How does China's growth rate fit with its rule-of-law profile? Does the coexistence of high economic growth and lax adherence to the rule of law mean that institutions are not important to economic growth after all? Does it mean, 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, 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," they write.⁴

China's Ranking on a Law and Finance Scale

In arguing that China is a counterexample to the legal institutional approach, Allen, Qian, and Qian gave China scores on corporate and creditor rights law following the methodology developed by La Porta and his colleagues in their seminal 1998 Law and Finance article.⁵ In corporate law China earned a shareholder rights score of 3 (out of 6) and a creditors rights score of 2 (out of 4). In both cases China's shareholder rights score fell below the average for countries whose law originated in English common law but above the average for those whose law originated in French civil law. 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. China's creditor rights score, while higher than the 1 scored by Australia, Canada, and the United States, was

estimates cited in this note should be adjusted to reflect the one-time upward adjustment of Chinese GDP by about one-sixth announced by the Chinese government at the end of 2005. See note 15.)

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, pp. 462–63).

4. Allen, Qian, and Qian (2005a, p. 57).

5. Allen, Qian, and Qian scores are found at Allen, Qian, and Qian (2005a, p. 65, table 2A, and p. 66, table 2B). The LLSV scores are found at La Porta and others (1998, pp. 1130–31, table 2, and 1136–37, table 4).

nonetheless far below many of its neighbors: Hong Kong, India, Indonesia, and Malaysia all scored a 4.

Though one might think that these comparisons leave China in a reasonably strong position, Allen, Qian, and Qian decided on a different comparison (based on the number of countries above and below a given sample mean) that made China's results appear weaker than the LLSV methodology would have. Abandoning LLSV averages, Allen, Qian, and Qian emphasized that "almost 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."⁶ Although China's shareholder rights score of 3 was exactly the same as the average score of the forty-nine countries in the LLSV sample, Allen, Qian, and Qian chose to emphasize that 65 percent of the LLSV countries had a score "higher or equal to three."⁷

Nonetheless, if one takes the LLSV analysis as giving a reliable insight into corporate and creditors rights law (despite the skepticism expressed in earlier chapters about their choice of substantive law provisions), 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 midpoint of the middle 50 percent of countries for both shareholder and creditors rights.⁸ Nonetheless, the real question is how well the substantive law is enforced.⁹ According to a report from the Organization for Economic Cooperation and Development (OECD), surveys show that "China is still seen as comparing unfavourably to its Asian competitors" with regard to "actual corporate governance practices."¹⁰

6. Allen, Qian, and Qian (2005a, p. 64).

7. Allen, Qian, and Qian (2005a, p. 66, table 2B). The authors do not state what percentage of the LLSV countries had a score "lower or equal" to 3, a category obviously overlapping with "higher or equal."

8. See La Porta and others (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 in regulatory quality among transition countries.

9. Allen, Qian, and Qian (2005a, p. 68, table 2C) not only make the same point about enforcement but also attempt to measure enforcement in China. However, their measures, taken from La Porta and others (1998), are mostly about issues such as risk of expropriation, risk of contract repudiation, and accounting standards, matters that do not bear on judicial enforcement of substantive law, or about issues such as corruption and the rule of law, matters that are much too general to be able to measure judicial enforcement. In any case, Allen, Qian, and Qian do not attempt to rate China on most of their enforcement measures.

10. OECD (2002, p. 36).

World Bank Rankings

A second way to rank China is to use the World Bank's *Doing Business* studies. Some of their categories are analogous to rule-of-law indicators and correspond roughly to legal areas studied in earlier chapters of this book. For example, for "contract enforcement," a measure of the performance of the judiciary in contract litigation between private parties, the World Bank ranks China as 47th best out of the 155 countries ranked. China ranks higher than the average country in both the East Asian and South Asian regions, though well below the average of OECD member countries.¹¹

"Registering property" shows that China's land registration system is especially strong, even though the nature and quality of China's protection of real property is still limited (since land belongs to the state and occupants normally have only user rights).¹² Despite this substantive shortcoming, all three of the procedural aspects of registration—the number of procedures, the time in days, and the cost of registration as a percentage of property value—rank above the OECD average. In fact, whatever the substantive land property rights (which are not measured or ranked in the study), China's procedures are efficient, allowing China to rank 24th of the 155 countries.

"Protecting investors" is a different story, however. China ranks 100th. The main reason for this poor showing lies not on the substantive law side, where China ranks high, but rather on the enforcement side: China ranks 1 on a scale of 1 to 10 with regard to director liability for self-dealing and 2 on the same scale for shareholder's ability to sue officers and directors for misconduct. (On this scale a ranking of 1 is the worst score; 10 the best.)

"Getting credit" is concerned with both legal rights and credit information registries. On a legal rights index, which measures the degree to which collateral and bankruptcy laws facilitate lending,¹³ China scores 2 on a scale of 10, well below the East Asia and the South Asia average scores of 5.3 and 3.8, respectively, and even further

11. The discussion of China in the World Bank *Doing Business* studies is to be found online in a substantial number of different (and changing) documents (last accessed by this author on May 11, 2006), which are best accessed through the following web address (from which one can click on individual topics or countries): (doingbusiness.org/ExploreEconomies/).

12. See discussion of China's land system in chapter 7 and later in this chapter. For the World Bank *Doing Business* view of Chinese substantive land law, see (doingbusiness.org/Documents/Registering-Property/42.pdf).

below the OECD average score (6.3). Nor does China make up for legal deficiencies through credit information registries, where its score is 3. This score is higher than the two surrounding regions' rankings, but that is only because the credit information index refers to formal rules; in fact, only 0.4 percent of adults in China are covered by a public registry and none (0.0 percent) are covered by a private registry.

For "closing a business," the World Bank study uses a methodology based on law firm responses to a hypothetical case to assess the time and cost of bankruptcy.¹⁴ Here China ranks 59th, with scores on time, cost, and recovery rate being better than the average of East Asian countries but well below the average of South Asian countries (even though China's procedures take less time). And China ranks far below the OECD average on all three dimensions.

From these various World Bank *Doing Business* rankings it is apparent that China's rule-of-law profile, much as in the Allen, Qian, and Qian study, is somewhere in the middle range of developing countries as a group. It is noteworthy that China is well below the average, however, in a few crucial financial sectors, notably in equity markets where, despite reasonable substantive corporate law, China's enforcement measures for protecting investors, as noted above, rank quite low.

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 China is well on its way to becoming a developed country. Nothing could be further from the truth!

The Chinese economy is well down the list of developing countries in per capita income. In 2004 per capita income (according to official Chinese statistics) was \$1,500 (U.S.) at current exchange rates. (This figure received a one-time upward adjustment for 2004 of about one-sixth simply by adding services to the GDP account.¹⁵) Using purchasing power parity (PPP), per capita GDP was \$7,634 in that year. For North American readers, it may be helpful to compare China with Mexico, since those readers

13. This legal rights index with respect to facilitating lending is based on Djankov and others (2005).

14. See discussion of this case in chapter 9 on credit markets.

15. "Revised GDP for 2004 Up By 16.8%," *China Daily*, December 21, 2005. See also Giles and Guerrero (2005).

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 2004 was \$6,790, four times as great as per capita income in China; and Mexico's per capita income on a PPP basis was \$9,168, substantially greater than China's.¹⁶

One can argue about the right measure to use for comparisons—purchasing power parity 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, there is every reason to be skeptical of the PPP figures for Chinese GDP. Albert Keidel, who prepared a 1994 World Bank report casting doubt on the technical basis for PPP estimates of Chinese GDP, reaffirmed the inadequacy of those approximations in 2004, stating: “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.”¹⁷

Similarly, Richard Cooper argues: “Even if one were inclined to a purchasing power parity ... [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.”¹⁸ Two Washington think tanks concluded that they “did not believe that World Bank estimates of China's

16. World Bank (2006b) (data in current international dollars). However, according to the Economist Intelligence Unit (2006b, pp. 22–23), the newly discovered services output came largely from price increases in services and did not change the fact that “China's economy remains centered on manufacturing, and is relatively energy-inefficient and increasingly unequal in terms of the distribution of wealth.”

17. Statement of Albert Keidel at an IMF Economic Forum on China in the Global Economy: Prospects and Challenges. Washington, October 19, 2004 (imf.org/external/np/tr/2004/tr041019.htm).

18. Cooper (2002, p. 788).

GDP measured in terms of PPP should be taken seriously.”¹⁹

A reason for being cautious about past Chinese growth rates is that, as Alwyn Young points out, China has used a different method from 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.²⁰ Young also cautions that even assuming the correctness of Chinese nominal national income statistics, inflation was underestimated by Chinese authorities so that real GDP growth in the 1986–98 period was overstated by 3.0 percentage points a year.²¹ Using Young’s analysis, the real growth in GDP during that period was 6.2 percent rather than 9.2 percent. Annual growth of more than 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 twenty-four years, the compounding of 9 percent growth yields an eightfold increase in total growth; compounding of 6 percent growth would yield only a fourfold increase—resulting in a Chinese economy only half as much larger than the base year.

The policy question is not what the exact Chinese growth rate is, but whether it can be sustained. One reason for doubt derives from the recent history of China’s neighbors. The uncontroversial fact that China is currently at a much lower level of per capita GDP than those neighbors 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 current Chinese level. In that sense China is no outlier in East Asian growth statistics. Moreover, 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.”²²

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

19. Bergsten and others (2006, p. 163, n. 2).

20. Young (2003, p. 1224, n. 5). See also Holz (2006). On the weaknesses of the Chinese statistical system, see OECD (2005a, pp. 169–96).

21. Young (2003, p. 1232). See also World Bank (1997, p. 3, box 1.1).

22. Naisbitt (1997, p. 14).

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.²³

The important point about the comparison with China's neighbors is that the spurts of growth Wolf refers to (lasting from twenty-three years for Japan to twenty-nine 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 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 Indonesia, Malaysia, South Korea, and Thailand 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, resulting in a permanent loss in cumulative GDP.²⁴ Data for later years shows, moreover, that after the turn of the millennium, the growth rate continued to be substantially below that of the period leading up to 1997. Those countries have recently grown more rapidly than in the 2001–03 postcrisis period, but this is a period in which the world economy as a whole has been growing at a higher rate than in the period before the onset of the Asian crisis; in 2004, *The Economist* noted that the world economy was “growing at its fastest rate for almost 30 years.”²⁵

Thailand grew at rates between 6.8 and 11.2 percent from 1990 to 1996, with 1997 marking the beginning of a recession. But between 2000 and 2004, Thailand managed only 5.4 percent average growth and is expected to grow by only 5.0 percent in 2006. Indonesia grew at rates between 7.2 and 9.0 percent between 1990 and 1996, but averaged only 4.6 percent average growth from 2000 to 2004 and is predicted to grow by

23. Wolf (2005). To be sure, China's growth rate has been in the 9–10 percent range recently, but China produced considerably lower growth in some earlier reform periods.

24. Cerra and Saxena (2005).

5.0 percent in 2006. Some pundits claimed Malaysia did not suffer much from the Asian financial crisis because it fenced off its financial sector with capital controls. It nevertheless was unable to replicate its 8.9 to 10.0 percent growth of the 1990–96 period, achieving only an average of 4.4 percent during the 2000–2004 period, with the 2006 prediction being 5.5 percent.²⁶

The reasons for this marked slowdown, especially after the recession, among China’s neighbors are controversial and multiple. One reason is 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 with Japan, which reached West European levels several decades ago. Moreover, some of the slowdown was 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 some analysts blame for the subsequent slowdown, and which might have been avoided or lessened by different economic policies. Some analysts attribute the 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 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, as well as a perceived implicit government guarantee to banks and poor banking supervision facilitating “crony capitalism.”²⁷ An important study by Simon Johnson and colleagues showed that although poor 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

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

26. World Bank (2006b, table 4.1). The predictions were released by the International Monetary Fund in April 2006 (in other words, well into the year in question, 2006); see IMF (2006, p. 35, table 1.6).

27. For a journalistic review of corporate governance failings and abuse of minority shareholders leading to the Asian financial crisis, see Vines (2000, pp. 141–60). See also “Six Deadly Sins,” *The Economist*, March 5, 1998; and “On the Rocks,” *The Economist*, March 5, 1998. On implicit guarantees, see Bai and Wang (1999, pp. 436–37); and Krugman (1998). On bank supervision, see Pomerleano (1999).

shareholders.²⁸ A statistical study found significant results for Thailand and Indonesia (the two countries perhaps worst hit by the Asian crisis), suggesting a high degree of expropriation of minority shareholders.²⁹

In Indonesia much of the banking system proved to be insolvent, in large part because of connected and directed lending. As one study put it: “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 related to its weak banking sector, which in turn was related to the insistence of the government, 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 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

28. See Johnson and others (2000) and Claessens, Djankov, and Lang (2000) on the shareholding structure that made minority shareholders vulnerable.

29. Claessens and others (1999).

30. Srinivas and Sitorus (2004, pp. 153–55).

31. “Six Deadly Sins,” *The Economist*, March 5, 1998.

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. This examination can be conducted using growth accounting, an approach that 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 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, as Alwyn Young puts it, “represents the proportional increase in output that would have occurred in the absence of any input changes.”³⁴

Young has explored Chinese statistics to determine whether Chinese growth, like the growth of the Asian Tigers in the precrisis period, can be explained primarily by China's ability to mobilize labor resources and by China's high rate of investment. He noted that, in the context of increased labor force participation rates and

32. Slide presentation by David Dollar: “Improving the Efficiency of China's Growth Is Important for the Whole World” (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 given 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.

disproportionately large increases in the working age population, a change 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 1 percent a year from 1978 to 1988), the nonagricultural labor force grew rapidly: 4.5 percent a year.³⁵ In a lengthy, complex analysis, which 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 primarily 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.)

A possible conclusion is that while China is currently growing rapidly, its growth is much like that of the Asian Tigers and therefore at some point a Chinese slowdown should be expected. Of course, over the very long run, as China approaches a per capita income level similar to that of the developed world, its growth likely would gradually decline to that of the developed world. The opportunities to catch up with the capital depth and technological know-how of the developed world will have been exhausted, and in that case China is no different from any developing country and at some point its rate of growth must naturally slow.³⁶ The question now, however, is whether there will be an unnatural slowdown such as that experienced by the Asian Tigers.

China is far from reaching that point of natural slowdown. With tens of millions of unemployed and underutilized workers, especially in rural western China, the period before slowdown may well be longer than in the Asian crisis countries.³⁷ Further, tens of millions of underutilized workers in China's state-owned enterprises (SOEs) have been laid off, and the shift of the workforce out of SOEs is apparently continuing.³⁸ Finally, Chinese emphasis on education, including higher education, may enable continued growth through what Robert Fogel calls "factor enhancement."³⁹ At the same time, China

34. Young (2003, p. 1223).

35. Young (2003, p. 1235, table 6; p. 1237, table 8).

36. See the same point as applied to the Asian Tigers in Radelet and Sachs (1997).

37. Wu (2005, pp. 133–38).

38. According to Fishman (2005, p. 74), 53 million people working in China's state sector lost their jobs between 1996 and 2001. See also Qian (2000a) and Wu (2005, p. 198).

39. Fogel (2006).

has a rapidly aging labor force because of 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.⁴⁰

The influx of rural workers into the modern commercial and industrial economy is not the only significant factor in China's economic growth. An extremely high investment rate in China has led to speculation that an investment bubble is occurring.⁴¹ Investment rates have grown to 45 percent of GDP, leaving consumers with less than half of GDP (the remainder going to government noninvestment expenditures).⁴² Since the very word *bubble* suggests an unfortunate ending, the question whether one exists not only is important, but also raises the further question whether legal institutions are implicated. After all, the use of the word in this sense dates back in England to a speculative mania leading to the collapse of the South Sea Company in 1719–20. The collapse was followed by enactment of the Bubble Act of 1720 (prohibiting the formation of joint stock companies without royal charters), giving rise to the notion that changes in law may arrest the formation of bubbles.⁴³

The South Sea incident involved financial investment, as opposed to real investment—say, in plant and equipment—and that has been true of nearly all bubble incidents, including the tech stock bubble in the United States and the rapid growth and then collapse of Germany's Neuer Markt at the dawn of the twenty-first century.⁴⁴ Not only has there been relatively little financial speculation in China since 2000 (even though the Chinese stock market began to rise rapidly in the first half of 2006), but investment in China has been heavily in physical infrastructure—roads, airports, and the like. Still, there has been a great deal of investment in real estate, some taking on

40. According to Qian (2003, p. 301), “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.”

41. “Struggling to Keep the Lid On,” *The Economist*, April 27, 2006.

42. IMF (2005b, pp. 96–97, box. 2.1; Kuijs (2005). The Economist Intelligence Unit (2006c, p. 5) reports that private consumption has been growing more slowly than GDP. Meanwhile, investment in fixed assets has been growing much faster than GDP, increasing by 27 percent, year over year, in the first quarter of 2006.

43. The classic descriptions of the South Sea incident, as well as to the contemporaneous bubble involving John Law's Mississippi Company in France, are Mackay (1841, pp. 1–88) and the successive editions of Kindleberger's *Manias, Panics, and Crashes*. See Kindleberger and Aliber (2005). See also Garber (2000).

44. On the Neuer Markt, see Burghof and Hunger (2003).

speculative dimensions analogous to stock market speculation.⁴⁵ One worrisome aspect of the investment surge in real estate (and to some extent in physical infrastructure) is the involvement of political officials for their private gain, a key feature of the South Sea bubble.⁴⁶ The involvement of local governments with private housing contractors led a prominent Chinese business columnist to attack government “manipulation” of the property market, observing that a “profit-driven local government cannot ensure the stable development of the sector.”⁴⁷ Nonetheless, the bubble question will not be addressed here because, corruption aside, any speculative element does not appear closely related to institutional failings in China of the kind examined in this book. In any event, even if the bursting of an investment bubble were to derail Chinese growth, the slowdown would likely prove temporary if one is to judge by U.S. experience where panics leading to sharp recessions were experienced five times in the nineteenth century. Indeed, the panic of 1873 was set off by an investment bubble in Chicago following the great Chicago Fire in 1871. An investment boom took place in which, according to a contemporary observer, “every other man and every fourth woman had an investment in house lots.”⁴⁸

In addition to its high investment rate and its ability to mobilize labor resources for some time to come, China has also shown an ability thus far to increase total factor productivity. 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 [was] well above that of the prereform period (1952–78).”⁴⁹ Thus even when capital and labor resources are plentiful, rapid growth is at least partly 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 rate of TFP increase than the state-owned sector, and this was true even though the state sector had higher labor productivity because it was able to apply three times the capital that was used by the private sector (as shown below, the private sector has relatively little access to bank

45. For a view on whether a real estate bubble exists in China, see Lau (2006).

46. Garber (2000, pp. 111–12), on what he calls “The Purchase of Parliament.”

47. McGregor (2006), quoting Hu Shuli.

48. On the five panics, see Kindleberger and Aliber (2005, p. 259–62). The quotation regarding the Chicago investment boom is a paraphrase of an earlier source; see Kindleberger and Aliber (2005, p. 101).

lending or a corporate bond market in the current stage of Chinese institutional reform).⁵⁰

The pressure on the Chinese leadership to force rapid growth in overall Chinese GDP growth may have been based on the need to provide jobs for an expanding population, especially migrants to the cities, and an increase in the number of university graduates. But this need is expected to decline somewhat, in part because the one-child policy has led to a decline in the rate of population growth and therefore in the need to provide additional jobs. The result is that the leadership may be able in the coming decades to devote increased resources to institutional reform, including legal reforms such as an expanded and better-trained judiciary.

The leadership can, if it so chooses, turn to foreign borrowing to finance institutional reform. Not only does it have massive foreign exchange reserves, but governmental external debt is remarkably low.⁵¹ Moreover, domestic debt is also low, even though there are huge implicit liabilities for future cleaning up of nonperforming loans of banks and other nonperforming obligations of state-owned enterprises. Further financial flexibility is provided by a fiscal deficit that is relatively modest compared with other countries; China's budget deficit was only 1.5 percent of GDP in 2005.⁵² Despite its financial flexibility, though, China's ability to avoid a growth slowdown 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 law. According to Potter:

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.

49. Heytens and Zebregs (2003, p. 12).

50. OECD (2005b, pp. 86–87).

51. The Economist Intelligence Unit (2006b, p. 5) has estimated total external debt at \$263 billion in U.S. dollars with a debt service ratio (debt service to current account surplus) of only 5.2 percent.

52. Economist Intelligence Unit (2006c, p. 3).

Law firms have multiplied—more than 5,000 have been established since 1990, bringing the total to more than 9,000.⁵³

An interest in, and even an emphasis on law does not, however, mean that enforcement is of high quality. It is useful to break the issue of enforcement quality 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, and those allied with government and the party, suggest that the central issues are likely to involve the problem discussed in earlier chapters—the predatory ruler. In China the potential problem is much greater than a sixteenth or seventeenth century Tudor or Stuart King seizing property or reneging 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.⁵⁴ In China the issues arise from the large role of government and the influence of the Chinese Communist Party.

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, 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.⁵⁵ As Donald 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 leaders’ speeches.”⁵⁶

Even during the Imperial period (ending in 1911) the legal system was largely a penal system, and although a good deal of academic controversy exists on the point, the use of law to settle private disputes was less common than in other countries.⁵⁷ Chow

53. Potter (2004, p. 466).

54. See discussion of the conflicts involving the Crown in England in Dam, Kenneth W., "Institutions, History, and Economic Development" (January 2006), U. Chicago Law & Economics, Olin Working Paper No. 271 Available at SSRN: <http://ssrn.com/abstract=875026>.

55. Peerenboom (2002, pp. 44–46).

56. D. Clarke (2005).

57. Diamant, Lubman, and O’Brien (2005, p. 4); Scoggins (1990). For a general discussion on the rule of law during the Imperial period, see Peerenboom (2002, pp. 36–43).

summarizes the traditional Western view of Imperial law:

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.⁵⁸

Nonetheless, in 1904, near the end of the Imperial period, a company law was passed, but it had few favorable economic consequences and did not provide for private dispute settlement.⁵⁹

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 People's Republic of China, or 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.⁶⁰ 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. Indeed, the modern idea of a court had been foreign to Chinese Imperial law, which, Clarke reported, had “no special, differentiated institution (‘court’) before which disputing parties advance legal claims.”⁶¹ In any event, legal reform efforts were cut short by civil war and the Japanese invasion, and Western laws and institutions evaporated with the 1949 creation of the PRC and especially the Cultural Revolution.

Beginning in 1978, with Deng Xiaoping's ascent to party leadership, a legal reform effort was launched. Its purpose was an announced shift “from class struggle and

58. Chow (2003, pp. 52–53). Between the Imperial and Mao periods, attempts were made to adopt Western-type codes, but according to Lubman (1999, p. 31), 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.”

59. Wei (2003, pp. 27–29).

60. Lubman (1999, pp. 31–32).

61. D. Clarke (2005).

political campaigns to economic development and modernization.”⁶² 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.” That theme was generalized in the 1999 amendments to the constitution, which called for the country to “be built into a socialist country based upon the rule of law.”⁶³ In 2004 the constitution was further amended to protect property; the amendment provided 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.”⁶⁴

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. What is striking is how few of the requisites discussed in chapter 5 on the judiciary are to be found in China, even today. The judiciary has no power to review the constitutionality of statutes. 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).⁶⁵ 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 lack of judicial independence 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.⁶⁶ Hence, judges may and often do consult with other judges, especially higher-level judges, in reaching decisions—just as a bureaucrat would naturally consult with superiors before reaching important decisions.⁶⁷ This practice reflects a bureaucratic culture pervading the Chinese judicial system.

62. Chow (2003, p. 75).

63. Quoted in Chow (2003, pp. 77–78).

64. Constitution of the People’s Republic of China, as amended in 2004, Article 13. A follow-on proposal to unify Chinese law on property rights, however, failed to pass in 2006; see Kahn (2006).

65. Lin (2003, pp. 275–76) and Gewirtz (2001, p. 208).

66. Lubman (1999, p. 262).

67. Hung (2004, pp. 99–104); Lubman (1999, p. 263).

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.⁶⁸ Another bureaucratic practice is the use of adjudicative committees, 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.”⁶⁹ 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.”⁷⁰ 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.⁷¹

Corresponding to the lack of judicial independence is the absence of any doctrine of separation of powers. As Clarke described it:

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.⁷²

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 bound only by orders issued by their superiors.⁷³ 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 in litigation in China than in most

68. Chow (2003, p. 219).

69. Quoted in Lubman (1999, p. 261); see also Peerenboom (2002, pp. 323–25).

70. Quoted in Hung (2004, p. 52).

71. Congressional-Executive Commission on China (2005, pp. 85-86). See also the March 2006 report by Xiao Yang, president of the Supreme People’s Court, who simply states on this point that “we must perfect the adjudication committee system.” (X. Yang 2006).

72. D. Clarke (2005).

Western systems.⁷⁴

The interaction between the courts and the government bureaucracies is also affected by “local protectionism.”⁷⁵ Federalism has been carried, especially on a de facto basis, much further in China than in most countries. As is discussed later, this has beneficial aspects, but it is not an unmitigated blessing where the legal system is concerned, especially 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 to plaintiffs from other provinces, especially where the defendant is a locally based state-owned enterprise. Civil judgments rendered in other provinces are often refused enforcement.⁷⁶

Perhaps the largest question of judicial independence involves the role of the Communist Party.⁷⁷ 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.⁷⁸

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.⁷⁹ 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 1989–2000 period, a basic court in Jiangxi province handled 200 first-instance administrative cases, but the administrative defendants simply failed to appear in 95 percent of the cases. Hung also states that lawyers are reluctant to

73. Chow (2003, pp. 223–24).

74. D. Clarke (1996, pp. 41–49); Chow (2003, pp. 213–15).

75. Peerenboom (2002, pp. 311–12).

76. Peerenboom (2002, pp. 311–312, 472); Chow (2003, pp. 221–24).

77. For a general discussion on the party’s influence on the judiciary, see Peerenboom (2002, pp. 302–09, 319–20). For a Chinese reform view, see Wu (2005, pp. 427–28).

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

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; as evidence Hung points 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 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.” 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.”⁸⁴

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. As Chow notes, the National People’s Congress, which is the legislature, and its standing committee “have generally been viewed as docile, rubber-stamp bodies that routinely approve by unanimous or near unanimous vote legislation already approved by the [party].”⁸⁵ Hence, direct influence on courts is not always essential for shaping the way that substantive law develops; influence does become important, however, in actual enforcement of the law.

79. Chow (2003, pp. 198–99).

80. Hung (2004, pp. 88–89, 91).

81. Quoted in Hung (2005, p. 10).

82. Hung (2005, p. 11).

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

84. China Law and Governance Review (2004).

85. Chow (2003, p. 178). Chow (2003, pp. 179–84) acknowledges some attenuation in the unanimity of legislative voting but points to only two instances where a party-backed proposal was blocked.

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 CCP's political-legal committees at corresponding levels."⁸⁶ 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."⁸⁷ 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 prestige and because administrative officials (who are often party members) tend to lack respect for legal knowledge and law.⁸⁸

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. Clarke describes the situation:

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.⁸⁹

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

86. Hung (2005, p. 10).

87. Alford (2003, pp. 134–35).

88. Hung (2004, pp. 93, 100–01). Z. 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).

89. D. Clarke (2005).

within their territorial jurisdiction.⁹⁰

As noted in chapter 5 on the judiciary, behavioral independence depends heavily on the tenure of judges and their salaries. Since the adoption of an amendment to the Judges Law, China has had a version of life tenure on good behavior; the grounds for dismissal are limited, but they involve such broad criteria as “unqualified for the present post and decline to accept other assignments.”⁹¹ Also, the appointment and removal of chief judges of particular courts can be made by the corresponding legislative body.⁹² Judicial salaries are comparatively low. Judges’ education and training leave much to be desired, although educational attainment is improving; in 2003 some 40 percent of Chinese judges had earned a four-year university degree, a 21 percent increase since 1998.⁹³ Corruption appears to be common.⁹⁴ Finally, a 1998 rule issued by the highest court made judges liable for intentional or negligent violation of any law or regulation; some 2,000 judges were held to have violated the rule in the 1999–2000 period, and the consequences of violation were potentially substantial.⁹⁵ Behavioral independence is thus questionable, despite the limitations on dismissal in the Judges Law. Lack of independence is most likely 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.

The Transition in China’s Economic and Legal Structure

Although enforcement may be as important as substantive law and poor enforcement is more likely than weak substantive law to be a hindrance to growth in developing countries, Chinese officials have begun to recognize publicly that the substantive legal system presents a major risk to the Chinese financial system.⁹⁶

China faced a particular challenge during the reform era at the end of the Cultural

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

91. Article 40, Judges Law of the People’s Republic of China, 2001.

92. Lubman (1999, p. 256).

93. Peerenboom (2002, pp. 320–22); Congressional-Executive Commission on China (2005, p. 88).

94. Peerenboom (2002, pp. 322–23); Hung (2004, pp. 105–8); OECD (2005a, p. 107 box 3.1).

95. Hung (2004, pp. 104–5). Efforts have been made by the Supreme People’s Court to limit the application of such court responsibility systems; see Congressional-Executive Commission on China (2004, pp. 78–79)

96. 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 (www.pbc.gov.cn/english/detail.asp?col=6500&ID=75).

Revolution. All property having a function in the economic system belonged to the state. Agricultural land belonged directly to the state. Nonagricultural 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 in the sense of legal persons with the legal qualities of Western corporations did not yet exist.⁹⁷ 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 a major reform at the time.⁹⁸ The separation of management from control was regarded as a step forward because it made possible, at least in theory, professional management that could respond to economic considerations rather than to bureaucratic whim or fashion. The executives of state enterprises were still bureaucrats at heart, however, even to the extent of retaining their rank as state or provincial officials.⁹⁹

The enactment of a company law made the corporate form (and hence limited liability) available to private enterprises as well and led in time to a decline in the market share of SOEs.¹⁰⁰ 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.¹⁰¹ Legislation passed in 2003, creating a State Assets Supervision and Administration Commission to monitor and supervise SOEs controlled by the central government, was intended to concentrate the state's ownership responsibilities.¹⁰² Parallel institutions were formed at provincial and local levels. Despite this legislation, SOEs may nonetheless remain subject to conflicting demands and preferences, particularly of local party and local government officials. And the party often appoints

97. Wu (2005, 154–56).

98. Clarke, D. (2003, p. 496); Osgathorpe (1995–96).

99. Tenev and Zhang (2002, p. 82).

100. L-Y. Zhang (2004, p. 2032, including table 1).

101. D. Clarke (2003).

102. OECD (2005a, pp. 301-22). This change took the Ministry of Finance largely out of the line of responsibility for nonfinancial SOEs.

the managers.¹⁰³

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).¹⁰⁴ These SCBs tended to use government and party criteria to allocate loans and at the very least were sensitive to government and party priorities for the promotion of particular industries and regions.¹⁰⁵ Local governments were likely to heavily influence local bank branches in making their credit allocation decisions. As a result of these pressures, as much as 90 percent of SCB loans went to SOEs.¹⁰⁶ 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.”¹⁰⁷

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. Even after various reforms, the state-dominated financial system did not produce satisfactory mobility of capital across China. To the extent capital was mobile, there was a tendency “to allocate capital systematically away from the more productive regions towards less productive ones,” in part because the SCBs concentrated on funding SOEs.¹⁰⁸

Meanwhile, the SCBs were supplemented by other state-owned financial institutions such as joint-stock banks, although at the end of 2004 SCBs still accounted for nearly 60 percent of banking system assets.¹⁰⁹ Unlike the original four SCBs, whose operations reflected the national perspective of their origin in a central planning period, the eleven joint-stock banks have been more focused on the business of banking.¹¹⁰ In addition, some 1,000 or more “city” banks owned by municipalities have emerged. Still other publicly owned banks have been created for agricultural and nonbusiness

103. Tenev and Zhang (2002, pp. 20–28).

104. Naughton (1995, pp. 255–57); Wu (2005, p. 219).

105. McGregor (2005a); Tenev and Zhang (2002, pp. 55–65).

106. Cull and Xu (2000, pp. 2, 8, figure 1). See also Dyer (2005d).

107. “Chinese Corruption: Deeper Reforms Are Needed to Stop the Rot,” *Financial Times*, March 28, 2005. For details on the banking scandals, see Barboza (2005); “Personal Banking, China Construction Bank,” *The Economist*, March 26, 2005; and Lague (2005).

108. Boyreau-Debray and Wei (2004); Cull and Xu (2000, p. 2); Lardy (1998, p. 83).

109. Wu (2005, p. 233); Podpiera (2006), p. 3).

purposes.¹¹¹ 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.¹¹² According to the Economist Intelligence Unit, “entrepreneurs in various parts of China have tried for years to establish private banks, although the pace has been glacial, [reflecting] government’s disposition for private investment in existing state-controlled banks rather than the emergence of newcomers that will add to the pressure piled on the state-owned banking sector.”¹¹³ Most state-owned financial institutions continue to focus their lending on keeping afloat SOEs, many of which are in parlous financial conditions. As Aziz and Duenwald report:

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.¹¹⁴

More generally, as a 2006 IMF report states, “The pricing of credit risk [by SCBs] remains rather undifferentiated, and bank lending does not appear to take enterprise profitability into account when making lending decisions.”¹¹⁵

The dominance of state banks results in the private commercial and industrial sector in China having had relatively little access to formal credit.¹¹⁶ Yet private sector enterprises outperform public sector enterprises.¹¹⁷ But, as Aziz and Duenwald note, retained earnings and private savings are the dominant sources of private sector financing, 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

110. OECD (2005a, p. 384).

111. Cull and Xu (2000, pp. 6, 7, table 1); Lardy (1998, pp. 61–76, 80).

112. Cull and Xu (2000, pp. 6, 7, table 1).

113. Economist Intelligence Unit (2005, pp. 6–24). According to this report, China’s first private bank, China Minsheng Banking Corp., became a listed company on the Shanghai stock exchange in 2000 and was the ninth largest bank in China in 2004. This bank, however, has many “state owned” shareholders and therefore “strictly speaking” is “not a private bank.” The report counts only two private banks in China but notes that more than ten foreign private banks operate in the country.

114. Aziz and Duenwald (2002). On foreign direct investment in the form of minority interests in SOEs, see Wu (2005, p. 302).

115. Podpiera (2006, p.3).

116. Wu (2005, pp. 232–34).

117. D. Clarke (2003, p. 494–95, n. 2 and sources cited therein).

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).¹¹⁸

Foreign direct investment has been a supplementary source of capital for private sector enterprises.¹¹⁹ 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 state-owned banks. The rationale for this foreign investment reflects the Chinese economic leadership's frustration with the SCBs. As the China Banking Regulatory Commission explained:

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.¹²⁰

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.¹²¹ 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 the State Assets Supervision and Administration Commission asserted in December 2005 that IPOs in overseas markets (in

118. Aziz and Duenwald (2002). It appears that city-controlled and other local banks have begun to make loans to local private companies in order to promote local economic activities.

119. Aziz and Duenwald (2002).

120. China Bank Regulatory Commission (2005).

121. China Bank Regulatory Commission (2005). See Dolven, Winn, and Murphy (2004).

which he apparently included Hong Kong) were justified because “overseas markets are more regulated and Chinese companies can benefit and learn to fine-tune corporate structure and governance.”¹²²

The SCBs, which were carrying out government (and party) policies in extending loans to the SOEs, not only had massive holdings of nonperforming loans but also tended to earn negative returns on assets.¹²³ Wu reported that “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.”¹²⁴ This figure does not include nonfinancial institutions; state-owned corporations, for example, had nonperforming loans equal to half of their total assets as of 1996.¹²⁵

Although official figures for SCB nonperforming loans 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).¹²⁶ Moreover, it is likely that nonperforming loans would have risen since 2003, not fallen, were it not for the infusion of capital from the state.¹²⁷ 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.¹²⁸ A Bank of Spain study estimated that total injections of governmental capital into the Chinese banking system from 1998 to 2005 was equal to 20 to 25 percent of China’s 2004 GDP, a truly huge subsidy that could easily account for the decline in the nonperforming loan ratio.¹²⁹

The Rise of Stock Exchanges and Securities Regulation

122. Dyer (2005c).

123. Lardy (2003, p. 67).

124. Wu (2005, p. 382). See also Lardy (2004, pp. 108–09, table 5-2).

125. Lardy (2003, p. 71).

126. García Herrero and Santabábara (2004, pp. 22–24); OECD (2005b, p. 149). Economist Intelligence Unit (2005, p. 20), cites the Chinese central bank as giving a nonperforming loan figure of 15 percent in March 2005 but states that in the past “official statements suggested that 20-25% of all loans were nonperforming, with 6-7% being unrecoverable.”

127. According to Jinglian Wu, Standard and Poor’s reported in September 2003 that even with the “substantial increase in total outstanding loans,” the nonperforming loan ratio was 40 to 45 percent. (Wu 2005, p. 382). See also “A Muffled Report,” *The Economist*, May 20, 2006.

128. Browne (2005).

A transformed corporate landscape was created by the reforms of the 1980s and 1990s in which loans by state-owned commercial banks and later by other state-owned financial institutions replaced capital allocations from the state coupled with the conversion of state enterprises into corporations owned by the state—that is, SOEs. These two changes soon led to further changes, in large measure because 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 nonperforming loans for the SCBs.¹³⁰

A partial answer to this financing quandary was to create stock exchanges in Shanghai and Shenzhen in 1990, thereby generating a climate that would induce Chinese citizens to use some of their savings to purchase stock of the SOEs in IPOs. One important effect, and perhaps a prime purpose, of the move to public issuance of securities was to tap private savings to finance the SOEs.¹³¹ 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 nonperforming loans 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; Jinglian Wu, a leading Chinese economist who served as an adviser to the State Council, observes that “the government boosting the stock market and SOEs grabbing the money” created a “casino without rules.”¹³² Between 1990 and 2001, the Shanghai stock market composite index went up

129. García Herrero, Gavilá, and Santabábara (2005). To illustrate the costs to the Chinese government of cleaning up nonperforming loans, a proportionately large series of bank bailouts in the United States would cost between \$2 and \$3 trillion in total.

130. Allen, Qian, and Qian (2005b, p. 35, table 2). As noted earlier in the text, nonperforming loans 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 Santabarbará (2004, p. 15, table 5).

131. L-Y. Zhang (2004, p. 2044) reports that the “stock market has failed to ... improve resource allocation. Rather it provided SOEs with unprecedented access to cheap direct finance.” See also Green (2004, p. 11) and Green (2003, pp. 22–24, 26).

132. Wu (2005, pp. 243–44). 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).

approximately twentyfold, although the rate of increase slowed after 1996.¹³³ As the market rose (with price-earnings ratios reaching, in Wu’s words, a “ridiculously high level of 100 to 200 in the early 1990s),” 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 2000.¹³⁴ 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.¹³⁵

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 manipulation and even outright fraud became a path for that purpose—“creating fake receipts and fake contracts to make up whatever profits that are needed to meet IPO requirements.”¹³⁶ Zhiwu 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 company. Efforts of regulatory authorities to ensure 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.¹³⁷

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.¹³⁸ Subsequently, in a complex and rapid evolution, rules were worked out in consultation with many private sector experts, interpreting the underlying statute and

133. Z. Chen (2003, pp. 459, 460, figure 1); Gao (2002, p. 7, chart 1).

134. Wu (2005, p. 244); Z. Chen (2003, p. 458).

135. Z. Chen (2003, p. 459, Table 2).

136. Wu (2005, p. 242); Z. Chen (2003, p. 457). On fraud, see also Wu (2005, p. 251); Green (2003, p. 24, 135–39).

137. Z. Chen (2003, pp. 457–58).

138. Z. Chen (2003, p. 464).

creating the basis for actions by shareholders acting jointly.¹³⁹ 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.¹⁴⁰ Moreover, private class actions apparently require, as a predicate, a prior adjudication in favor of the government with respect to the underlying violation.¹⁴¹ As a result of the sale of shares in SOEs to the public and their listing on exchanges, a structure resulted in which, very roughly, an average of one-third of SOE shares (“A shares” for Chinese citizens buying with local currency, plus “B shares” for foreign currency purchasers) are held by the public with about another third held by the state (state shares) and the last third (legal person shares) held by a variety of institutions, in many instances state-related entities including provinces and municipalities.¹⁴² 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.¹⁴³

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.¹⁴⁴ Although the notice was thought by many to have been 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 for expansion and for 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 nonperforming loans and hence were not well placed or strongly motivated to meet these demands.

139. For a general discussion, see Hutchens (2003) and Z. Chen (2003, pp. 464–67).

140. Lu (2003, pp. 798–801) and Hutchens (2003, pp. 640–45). Hutchens surmises that class actions were seen as a threat to SOEs and perhaps as a threat to the party by fomenting class struggle. But see IIF Equity Advisory Group (2004, p. 4), which refers to the first class-action shareholder lawsuit pending in a Beijing Court.

141. Hutchens (2003, pp. 634, 640).

142. Li and An (2004); L-Y. 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 more than 50 percent of their stock in state share form. For detail on different kinds of shares, see 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. See also Tenev and Zhang (2002, pp. 76–77).

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

144. Li and An (2004, p. 378).

The news of these intentions coincided with a downturn in the Chinese stock market and, while perhaps not causing the downturn, certainly exacerbated it.¹⁴⁵ 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.¹⁴⁶ (At the end of 2002, only 34.7 percent of shares in listed companies were tradable on Chinese stock markets.¹⁴⁷) By mid-2005 the Shanghai stock exchange index, which once traded above 2200, was at a five-year low, trading near 1000.¹⁴⁸ 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. To encourage the change, holders of domestic shares (A shares) were promised compensation; this policy discriminated against foreigners who hold other classes of shares and against even Chinese who later acquired B shares originally issued to foreigners against foreign currency.¹⁴⁹

Coexisting with these issues involving SOE shareholdings is an absence of ready debt securities market financing. Outstanding corporate domestic currency bonds constitute less than 1 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).¹⁵⁰ 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. According to Le-Yin Zhang, “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.”¹⁵¹ In 2005 the *Financial Times* reported that “only between 30 and 130 of

145. Dyer (2005d).

146. “Hangover Cure,” *The Economist*, May 5, 2005; Dyer (2005b).

147. Wu (2005, p. 165)

148. Wu (2005, p. 250); Areddy (2005); Dyer (2005a)

149. Dyer and Guerrero (2005a).

150. Eichengreen and Luengnaruemitchai (2004, table 1). See also Barnett (2004). Even government enterprises find difficulties in issuing bonds; see Mingli and Liu (2001).

151. L-Y. Zhang (2004, p. 2035). However, Zhang 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.

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.”¹⁵²

Moreover, private sector firms are not always able to borrow money because state-owned financial firms may not always be willing or able 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 *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.”¹⁵³ 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 show that [China’s] private firms are more financially constrained than private firms in other countries.”¹⁵⁴

Under conditions that so favor the financing of SOEs over private companies, how can one explain the declining SOE share of GDP? In 2002 SOEs accounted for only 44 percent of Chinese GDP and only 41 percent of gross industrial output?¹⁵⁵ 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 is the incremental capital-output ratio, or the ratio of investment (as a percentage of GDP) to real economic growth (as a percentage of GDP). At 5 to 1, this ratio “was comparatively higher than that for Japan, South Korea, or Taiwan when they were experiencing high economic growth.”¹⁵⁶ Because of the very high Chinese savings rate and the high level of foreign direct investment, China is apparently able to waste capital, but an inefficient and inadequately reformed financial sector could prove to be a barrier to continued rapid growth if a crisis of the nature, say, of the Asian financial crisis, should erupt.¹⁵⁷

152. Dyer and Guerrera (2005b); J. Zhang (2005).

153. Guerrera and McGregor (2005). See also Tsai (2002); OECD (2005b, p. 159–60). Some mainland private firms also borrow through Hong Kong affiliates. For an example of the obstacles to bank borrowing, see Huang (2005, p. 31).

154. Huang (2005, p. 27).

155. L-Y. 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).

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

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

Corporate Governance

The existing SOE shareholding structure with the state retaining control is not just inefficient; it also creates 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 or by state bureaucrats responsible for the firm or the industry in question.¹⁵⁸ The risk of such expropriation is heightened by the weaknesses of the Chinese judiciary. As Clarke has observed, “Chinese courts are not politically powerful and are hence reluctant to take cases involving large sums of money and politically powerful defendants.”¹⁵⁹

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 Commission, 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.”¹⁶⁰ Individual accounts of outright fraud and asset stripping by majority shareholders abound. Schipani and Liu cite one 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.”¹⁶¹ In 2001, Bai and colleagues reported, “Sanjiu Pharma’s largest shareholder extracted US \$301.9 million, 96% of the listed company’s total equity.”¹⁶²

Two new regulatory provisions imposed in recent years indicate that Chinese leaders recognize the need for corporate governance reforms. One provision requires independent directors; the other imposes a fiduciary duty upon directors.¹⁶³ 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, where the state owns, directly or indirectly, the majority of the shares, controls senior personnel appointments, and

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

159. D. Clarke (2003, p. 503).

160. IIF Equity Advisory Group (2004, p. 3). The data apparently became available because the Chinese Securities Regulatory Commission adopted additional requirements to attempt to deal with these problems.

161. Schipani and Liu (2002, p. 61).

162. Bai and others (2003). For examples of self-dealing by SOE managers, see Wu (2005, pp. 395–96).

supports the actions taken, what does independence of directors mean, what exactly is a fiduciary duty, and to whom is it owed?¹⁶⁴

One common practice is to steer SOE business into transactions with private sector companies under their own control or influence. Tenev and Zhang describe the situation:

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....¹⁶⁵

Similarly, Tenev and Zhang write, managers of SOEs with subsidiaries that are listed and hence have 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.”¹⁶⁶ 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,” Ma, Mok, and Cheung write.¹⁶⁷

Credit Markets

In contrast to capital markets, 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.¹⁶⁸ But the credit system has its own weaknesses. Aside from the poor financial condition of the banking system, which

163. On fiduciary duties (or the lack thereof) in China, see Wu (2005, p. 169–70). On the independent director requirement, see Wu (2005, pp. 174–75), Shen and Jia (2005), and D. Clarke (2006).

164. On senior personnel appointments, see McGregor (2005a).

165. Tenev and Zhang (2002, p. 22).

166. Tenev and Zhang (2002, p. 101).

167. Ma, Mok, and Cheung (2001, p. 60, n. 15); see Wu (2005, p. 160).

168. “A Great Big Banking Gamble,” *The Economist*, Oct. 27, 2005. China has a particularly large financial sector compared with most other countries at its present stage of development. OECD (2005b, p. 138, figure 3.1).

has required state bailout subsidies of state-owned commercial banks and the use of asset management companies to take nonperforming loans off the banks' books, the credit system has legal problems.¹⁶⁹

The core of these problems lies in the uncertainty about secured debt. This uncertainty is tied to 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, Shirk explains, because 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.”¹⁷⁰ 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.”¹⁷¹ A more adequate bankruptcy law has been under consideration for some years.¹⁷² The biggest stumbling block has apparently been the question of absolute priority for secured creditors. 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.¹⁷³ Another bankruptcy issue has been the uncertain status of assets pledged as security, particularly land that has been “allocated” by

169. “A \$45 Billion Shot in the Arm,” *The Economist*, January 6, 2004; “Failing to Perform,” *The Standard*, June 20, 2005.

170. Shirk (1993, p. 132).

171. Tenev and Zhang (2002, p. 15).

172. OECD (2005b, pp. 91–93); Booth (2004, p. 95); World Bank Office Beijing (2005). 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 (www.pbc.gov.cn/english/detail.asp?col=6500&ID=75). See also Rogoff, Bag, and Wang (2004).

173. Lardy (2003, pp. 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 (www.pbc.gov.cn/english/detail.asp?col=6500&ID=75). After this working paper was prepared, the Chinese legislature in August 2006 passed a bankruptcy law that favors secured creditors over employee claims, except for bankruptcies of some 2000 state-owned enterprises. Guerrera and McGregor (2006).

administrative authorities.¹⁷⁴

Meanwhile, the great preponderance of all credit continues to be provided by advances from state-sector banks. The corporate bond market has remained small, with outstanding bonds constituting only 0.7 percent of GDP in China in 2004, compared with 11.8 percent in Thailand, 21.1 percent in Korea, and 38.2 percent in Malaysia.¹⁷⁵

Legal and Institutional Reform

This review of China's financial sector points to deep flaws in equity and credit markets and especially in corporate governance. Yet in the business and financial communities abroad attitudes toward China's economic future remain optimistic, especially compared with 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—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 removing price controls, was to act quickly before political opposition could arise.¹⁷⁶ The second strategy was to adopt the best Western substantive statutes—world “best-practice” legislation. For the reasons reviewed generically in earlier chapters of this book (notably a failure to improve enforcement commensurately and societal resistance to

174. Barale (2005). 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, that it has produced violent conflicts. See “Turning Ploughshares into Staves,” *The Economist*, June 25, 2005 (U.S. edition). See also Peerenboom (2002, p. 482) and McGregor (2005b) concerning land disputes as a major source of unrest. For a general discussion on land in China, see Ho (2001) and Brandt and others (2002). In 2003, a change of law granted farmers thirty-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. UNDP (2005, p. 4). See chapter 7 for a general discussion of the role of land rights in economic development, including a brief description of the evolution of Chinese land law.

175. IMF (2005a, p. 107, table 4.2). See Green (2003, pp. 41–44). Corporate bonds of more than one year maturity apparently cannot legally be issued; see Kuo (2006).

176. Hoffman (2002, p. 183).

legal transplants), the record in those transition countries, especially in the former Soviet Union (aside from the Baltic states), has not been encouraging.

China adopted a different reform strategy—one that can be characterized as incremental, selectively adaptive, or more perceptive.¹⁷⁷ (Deng Xiaoping called it “crossing the river by feeling for stones.”) However it is characterized, China’s approach was certainly different and arguably more intelligent. Because legal reform was needed to enable economic reform, legal reform had to take on some of the same incremental characteristics. Lichtenstein mentions “gradualism, experimentation, regional differences” and “piecemeal and sometimes unconnected approaches and early vagueness supplemented by later detail.”¹⁷⁸ Most of all, both economic and legal reforms were evolutionary in character. Although the Chinese reform was more centrally directed and had a fundamental impact in only a few decades, it is nonetheless reminiscent of the evolutionary developments over centuries in the English legal and political system that culminated in the Glorious Revolution.¹⁷⁹

Why was China able, or perhaps forced, to carry out a different strategy from the Eurasian transition countries? One explanation is the considerable continuity in Chinese leadership, despite changes in leadership after Mao’s death. No post-Mao revolution of the type that could permit a completely new leadership to assume power occurred, in contrast to the experience in most of the Eurasian transition countries. In China the old leadership, below the very top, was still partially in power but knew that change was necessary. Yingyi Qian explains one reason the leadership 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. No appetite was left for messianic transformations.¹⁸⁰

Three early reforms illustrate the Chinese approach: the dual track, the township-village enterprises (TVEs), and fiscal federalism.¹⁸¹ All three involved the necessity of taking into account the predictable opposition of established economic power centers. As

177. See Wu (2005, pp. 43, 57–74) on a strategy of incrementalism.

178. Lichtenstein (2003, pp. 275, 287).

179. See discussion in Dam, Kenneth W., "Institutions, History, and Economic Development" (January 2006), U. Chicago Law & Economics, Olin Working Paper No. 271 Available at SSRN: <http://ssrn.com/abstract=875026>.

180. Qian (2000b, p. 169).

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

a corollary, the reforms were based on a political recognition that not everything could be reformed at once—that it was hopeless to attempt to change from a totally socialist society to a market economy in just a few years. In addition, all three reforms were an intelligent harnessing of a key insight of both neoinstitutional economics and classical microeconomics—the importance of incentives. To be sure, this explanation is 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 in a political world the fastest route between two points is not necessarily a straight line. Recognition of a goal does not automatically make clear the means for achieving the goal, as experienced policymakers throughout the world are well aware.

The Dual Track System

The dual track reform of the mid-1980s was the path chosen to exit from both from state planning (in the mandatory socialist sense) and from 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 and selling their product at designated prices. The dual track system effectively bought off both sets of beneficiaries 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. In this instance, existing firms and political power centers were “grandfathered” as part of a consensus decision system. But the rules were different for additional production, either by expansion of existing firms or by entry of new firms. For additional production, firms were allowed to buy inputs at whatever price they could and to sell their outputs at whatever price they could.¹⁸²

Not only were the incentives to expand production and to establish new firms strong, but the new inputs and outputs would be traded in what was a market economy. The reform was economically efficient because it harnessed the economic insight that what counts for efficiency is marginal prices, not average prices. GDP in China’s industrial sector, for example, began expanding at double digit rates in 1983 and (except

182. See generally Shirk (1993), and on the dual track reform, see Wu (2005, pp. 68–71); and Lau, Qian, and Roland (2000).

for 1989 and 1990) continued at those higher rates. 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.¹⁸³ At the consumer level, retail level transactions at plan prices “declined from 97 percent in 1978 to only 30 percent in 1990” and the decline continued thereafter.¹⁸⁴

Township-Village Enterprises

TVEs were an adaptation of the commune and brigade enterprises of the Mao period. The leadership used them because they already existed “on the fringe of the central planning” system, but renamed them TVEs, and harnessed them to provide additional production.¹⁸⁵ One way of looking at TVEs is to think of them as being a de facto alliance of local government and small collective enterprises.¹⁸⁶ In the absence of any system of private property, the prime predator for local firms to fear would have been the local government (since Beijing was far away, and the central government was in no position to exercise direct power in the country as a whole).¹⁸⁷ 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.¹⁸⁸ 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

183. Qian (2003, p. 302, table 11.2; p. 309, table 11.3).

184. Lau, Qian, and Roland (2000, pp. 139, 140, table 4).

185. Qian (2003, p. 314).

186. H. Chen (2000, p. 7).

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

188. McDonnell (2004).

providing 27 percent of all industrial output.¹⁸⁹ In a further evolution, the government began privatizing TVEs, usually by management buyouts.¹⁹⁰ Meanwhile, many TVEs, especially older ones in rural areas, are being displaced by private firms, and TVEs no longer appear to be a favored part of China's economic reform.¹⁹¹

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.¹⁹² Each province for example, 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.¹⁹³ 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 preset 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 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.¹⁹⁴ Thus, to use the Chinese slogan of the time, the center and the local governments were to “eat in separate kitchens.”¹⁹⁵

189. Roland (2000, p. 281).

190. Laixiang (2005, p.102). Moreover, in the 1990s the growth of TVEs began to give way to the growth of private firms; see McDonnell (2004, pp. 977–82).

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

192. The description of the fiscal contracting system draws heavily on Wu (2005, pp. 259–81) and Montinola, Qian, and Weingast (1995). Details vary from province to province (Wu 2005, pp. 258–63), and no attempt is made here to describe the fiscal contracting system in any detail.

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

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

195. Shirk (1993, pp. 149–78). Sometimes the Chinese slogan is translated as “eating from separate pots.”

The segregation of extra-budgetary funds was a particular success in the sense that by the early 1990s these revenues had grown to be about equal to budgetary revenues.¹⁹⁶

In the mid-1990s Weingast popularized the notion that Chinese fiscal federalism, as a form of “market-preserving federalism,” promoted economic growth.¹⁹⁷ It should not be thought, however, that the federalism was of a constitutional kind. As Dali Yang has explained, “unlike federalist systems in developed Western economies,” Chinese federalism does “not rest on any form of constitutional protection or explicit binding agreement,” but rather, “again and again, local authorities are reminded that the Center calls the shots and can rewrite the rules in its own favor.”¹⁹⁸ Moreover, the fiscal system proved unstable and had to be revised frequently to specify taxes the central government and the provincial governments each would be responsible for collecting. The fiscal arrangements illustrate the recurring phenomenon that each stage of reform created its own perverse incentive and roadblocks, which required adjustments introduced by the leadership.¹⁹⁹

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 that 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, at best, economic development would be slow.

The Chinese experience suggests, however, that China’s leaders, beginning with Deng Xiaoping, have been following what might be called a “guided” evolutionary approach. Thoroughgoing reform, especially of the Big Bang type, was not an available

196. Montinola, Qian, and Weingast (1995, p. 64).

197. 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; see Lieberthal (2004, pp. 253–54).

198. D. Yang (2006, pp. 146–47).

option for Deng. 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 outwaited. Many of the steps taken in the early reform years correspond to this interpretation.²⁰⁰

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 an adequate legal structure 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. Coffee, reviewing the U.S. experience and a comparable U.K. experience, observes that the political constituency necessary for the legal reforms was not in place earlier but resulted from the desire 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.²⁰¹

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.²⁰²

199. Wu (2005, pp. 269–90); D. Yang (2006).

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

201. Coffee (2001, p. 80).

202. Shirk (2003, pp. 123–24) makes the point that reform was slowed down when the CCP leadership was divided or at least perceived as divided by the bureaucracy.

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.²⁰³ (However, SOEs have been able to downsize by shedding almost 40 percent of employees between 1998 and 2003.²⁰⁴) The shareholding structure of SOEs has seriously delayed further expansion of securities markets and has discouraged investors (if one is to judge by market averages). The Chinese leadership can apparently manage political and ideological barriers, but not always and not indefinitely.

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 facing the current Chinese leadership has been created in large measure by recent Chinese political, economic, and ideological history, which has left the leadership to deal with 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.²⁰⁵ The Chinese have no doubt been wise to avoid a legal transplantation strategy 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. In that light, such adaptations as TVEs and the dual track system can be interpreted as wise efforts to adapt existing Chinese

203. One chronicle of Chinese reform calls SOE reform a “miserable failure”; see Qian (2003, p. 306).

204. Fishman (2005, p. 74) reports that “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.” According to other data, employment in the state controlled industrial sector fell by 40 percent from 1998 to 2003; see OECD (2005b, p. 95).

205. In his Internet autobiography Douglass North notes 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 (nobelprize.org/economics/laureates/1993/north-autobio.html).

institutions rather than to attempt to transplant alien institutions. 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, but there may be limits to how fast and successfully evolution can be force-fed.

In a book edited by Dani Rodrik and devoted to a review of the economic growth history of several developing countries, Rodrik drew the following two overall conclusions. First, he concluded that “the onset of economic growth does not require deep and extensive institutional reform.” 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.”²⁰⁶ This is a precept that the Chinese leadership seems to understand. What is not yet known is whether they will be able to continue to implement the necessary institutional reforms .

The econometric evidence examined in earlier chapters showing that causation runs from institutions to growth rather than vice-versa may be interpreted to say that *on balance* the causation runs from institutions to growth but that to some extent increasing wealth helps to build institutions. This more nuanced interpretation of institutions and economic growth makes practical sense. If, for example, low pay for judges makes for a weak, even corrupt, judiciary, then a willingness to use new revenues derived from economic growth to strengthen the judiciary can help to create the institutional basis for further economic growth. In that light, it is significant that while the first ten years of transition in Eastern Europe were marked by poor institutions, by the end of the 1990s institutional improvement was becoming relatively rapid—more rapid than could have been predicted by the absolute level of economic development at the outset of reforms.²⁰⁷ More generally, Johnson, Ostry and Subramanian studied developing countries with initially weak institutions that experienced an acceleration in growth—usually through a surge in exports of manufactures—and were able to sustain that growth for fifteen or more years. They found that a “preponderance” of those countries “saw the quality of their broad economic institutions improve during growth episodes.” This result suggests,

206. Rodrik (2003, pp. 15, 16).

207. Murrell (2005).

they say, “the potential for a virtuous circle through which growth and the policy levers used to achieve growth lead to positive institutional change.” The authors hypothesize that “growth in manufactured exports benefits a cross-section of the population (in a way that natural resource growth does not), creating a constituency for improving institutions more broadly.”²⁰⁸

One interpretation therefore is that economic growth can lead eventually to a surprisingly strong improvement in institutions when supported by strong political leadership intent on achieving institutional reform and where a constituency for reform is engendered by the initial growth. Indeed, one view of the Asian Tigers’ rapid growth followed by crisis is precisely that those countries achieved very rapid growth despite weak institutions so long as they were still at a relatively low level of economic development, but that they failed to invest their growing incomes in improvement of institutions and eventually the failure to do so led to the Asian financial crisis.

That is why it is crucial to understand that China is still a poor country, well below the per capita income of the Asian (former) Tigers when their growth slowdown began. China is still short of the point where it has to overcome the type of challenges, institutional and macroeconomic, that led to the Asian crisis. In China the current 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. Rather, the Chinese experience is consistent with Rodrik’s view that considerable development is possible without strong legal institutions but sustainable growth to higher per capita levels requires considerable development of legal institutions.²⁰⁹ While a definitive conclusion will not be able to be drawn for several decades, it is nonetheless

208. Johnson, Ostry, and Subramanian (2006).

209. Rodrik (2003, pp. 15. 16).

clear that little thus far in the Chinese experience leads to the conclusion that rule-of-law issues are not important in economic development.

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