

China's Legal and Institutional Infrastructure

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Comparison of Major Economies: GDP and Growth

GDP in 2005			GDP in 2005 on PPP basis*		Annual growth rate of GDP using PPP (1990 - 2005)	
Rank	Country	GDP (US \$ bil.)	Country	GDP (Int'l \$ bil.)	Country	Growth rate (%)
1	US	12,452	US	12,332	China	11.8
2	Japan	4,672	China	8,092	India	7.9
3	Germany	2,800	Japan	4,009	Korea	7.6
4	UK	2,197	India	3,603	Taiwan (China)	7.4
5	France	2,113	Germany	2,498	Thailand	6.9
6	China	1,910	UK	1,826	Iran	6.8
7	Italy	1,719	France	1,812	Indonesia	6.2
8	Spain	1,124	Italy	1,695	Turkey	5.7
9	Canada	1,106	Russia	1,585	US	5.2
10	Korea	800	Brazil	1,553	Mexico	5.1

* The PPP conversion factor is obtained from The World Bank Development Indicator (Table 5.6, World Bank. For details on how to calculate the indicator, see "Handbook of the International Program," United Nation, New York 1992.

Why is China's economy so successful?

- Conventional wisdom is that what is needed for a successful economy and a high growth rate is:
 - Good legal system
 - Good financial system
 - Good corporate governance

See LLSV (1997, 1998), King and Levine (1993), Levine (1999) and many others

Why is China's economy so successful?

- Allen, Qian, and Qian (2005, JFE) show
 - Legal system is not good
 - Banks and stock markets do not work well
 - Corporate governance in listed sector is poor
 - Corruption

Why is China's economy so successful? (cont.)

Three sectors:

- State Owned Enterprises (SOE's)
- Listed Companies (mostly former SOE's)
- Private/Hybrid Sector

Why is China's economy so successful? (cont.)

Growth rates for Industrial Output 1990-2004:

- State and Listed Sectors: 5%
- Private/Hybrid Sector: 14%

Shares of Industrial Output 2004:

- State and Listed Sectors: 35%
- Private/Hybrid Sector: 65%

Reason for China's success

Private/Hybrid sector has been extraordinarily successful

Counterexample to conventional wisdom

- Standard mechanisms in terms of the legal system, financial system, and corporate governance as bad or worse than in the State and Listed sectors

How does Private/Hybrid Sector function?

- Historically, China did not use the legal system in commerce
- However, it had a highly commercialized society
- How did this operate?
- Other systems for dispute resolution were used instead

Alternatives to the legal system in 19th Century China

Dispute resolution (see Kirby 1995):

- Longstanding custom
- Regulation of Guilds and Families
- Local notables

We need to understand the modern equivalents

What should China do going forward?

“The modern corporation on a Western model would be the essential vehicle for *private* economic development”

What should China do going forward?

- This was not written today but rather was the view of the drafters of China's first Company Law in 1904 (*Gongsilu*)
- It turned out to be very wide of the mark (Kirby 1995)
- Chinese firms on the mainland and later in Taiwan did not use the provisions of the law but again conducted commerce outside the legal system

Comparison to India

- Allen, Chakrabarti, De, Qian, and Qian (2006) do a similar study on India
- India has been successful in terms of growth despite
 - Formal (excellent) laws and institutions being of limited importance in practice
 - Financing depending mostly on internal and alternative sources and not very much on banks and stock markets
 - Corruption

Research Agenda

- How does finance work in the Private/Hybrid Sector in China with such a poor legal system?
- Why don't these mechanisms work for the financial markets?
- Can these mechanisms be superior to Western notions of law-based governance and commerce?
- Large countries versus small countries