China’s Legal and Institutional Infrastructure

Franklin Allen
University of Pennsylvania

Corporate Governance in East Asia:
Culture, Psychology, Economics and Law
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### Comparison of Major Economies: GDP and Growth

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* 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