

**Rule of Law in China: Chinese Law and Business**

# China: Suffering from Growth Pains or Doomed to Stagnation?

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## Executive Summary

This brief presents an alternative view to Minxin Pei, arguing that while China faces daunting challenges, it has also undertaken significant institutional reforms.<sup>1</sup>

- Arguments about China's reforms centre on the role and transformation of the Chinese state. The 'developmental school' sees strong state involvement as a positive influence on the economy. In contrast, the 'distorted-market school' considers the Chinese state to be an obstacle to further market-oriented reforms.
- Minxin Pei highlights China's 'governance deficits', and predicts that China is 'doomed to stagnation'. His argument is in line with the 'distorted-market school'. It rests on the notion that the current ruling elites have a vested interest in perpetuating the existing authoritarian order.
- China does face significant challenges. But the country has made remarkable progress in social development and economic change. Pessimists offered dire predictions for the banking sector; but China has since tackled the issue of non-performing loans and listed the largest banks on the stock markets.
- China has made major efforts to construct a modern regulatory state. Its institutions were born with serious flaws. The case of securities regulation, however, suggests that the state has helped investors regain confidence through increased transparency and accountability.
- Pei refers to the number of industrial and traffic accidents as an indicator of poor governance. These numbers are uncomfortably high, but there has been a downward trend recently.
- China's success, so far, is partly based on the ability of its leaders to learn and borrow in order to adapt to a changing environment. Myriad institutional reforms have improved state transparency, efficiency, and fairness. As the Chinese per capita gross domestic product (GDP) rises to higher levels, growth will likely slow. But China is not destined to stagnation.

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1. Pei, M. (2006) *China's Trapped Transition. The Limits of Developmental Autocracy*. Cambridge (MA): Harvard University Press.

## China: Suffering from Growth Pains or Doomed to Stagnation?

The history of the modern world is littered with failed reform attempts. Alexis de Tocqueville's famous statement comes to mind: 'The most dangerous moment for a bad government is when it begins to reform'. It is thus no surprise that ever since China's post-Mao reform era began, reformers have had to contend with sharply divided opinions and analyses of the prospects for further reforms.

### *The state and economic growth in China: two divergent views*

Behind the different views of China's reform prospects lies the central concern with the role of the Chinese state, which is still dominated by the Communist Party. For the reformation of socialist economies led by Leninist parties presents special challenges. Rather than building state capacity to take care of the markets, the daunting task of market reform in socialist economies not only involves the introduction of markets, but also the transformation of the state, from an institution populated by party bureaucrats with vested interests, to one that is qualitatively different and compatible with a free market.

There have been two diametrically opposed assessments of the role of the Chinese state and its relationship with business. One account, which I call the 'developmental school', sees strong state involvement in China as a crucial ingredient of economic success. Accordingly, the Chinese state, particularly the local state, has played a positive developmental role in the economy, in the same way as their counterparts in China's neighbouring economies, at least prior to the Asian financial crisis. Under the decentralizing reforms, local governments in China, ranging from villages through provinces to central government ministries, have become deeply engaged in bureaucratic, government, or state entrepreneurship. They have not only forged alliances with business, but have frequently been the investors

themselves. The bonds between government and business thus bring about a kind of corporatist arrangement in China that some have called socialist corporatism; and, in the case of local governments, local state corporatism. High growth rates became the justification for existing institutional practices. Some economists developed theories to prove that local government ownership in China helped curb state predation, increase local public goods provision, and reduce costly revenue hiding.

Unlike proponents of the developmental school, many other scholars and analysts, who, for lack of a more appropriate appellation, may be referred to as the 'distorted-market school', have highlighted the market-distorting aspects of state entrepreneurship and the obstacles it poses to further market-oriented reforms. At the turn of the 1990s, the World Bank noted that China's post-Mao reforms were caught between planning and the market. A number of economic commentators based in China, notably He Qinglian and Yang Fan, have been especially outspoken about the dangers of state agents combining with businesses, and even organized crime, at a time of sharply rising income inequalities.<sup>2</sup> The union between officialdom (*guan*) and business (*shang*), they argue, has not only become a breeding ground for corruption and self-aggrandizement, but has also provided a powerful rent-seeking block against reforms. Put simply, bureaucratic entrepreneurialism in China has become the main obstacle to the market economy the nation wants to build.

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2. He Qianlian's representative work is Qinglian, H. (1998) *Xiandaihua de xianjing: dangdai zhongguo de jingjin shehui wenti* ('The Pitfalls of Modernization: Economic and Social Problems in Contemporary China'). Beijing: Jinri zhongguo chubanshe.

Given these arguments, it is not surprising that analysts belonging to the 'distorted-market school' are pessimistic about China's reform and growth prospects. In an article published in the *China Reform News*, Zhong Guoxing wrote apocalyptically that the combination of markets and corruption would lead to economic retardation, distortions, bubbles, and social unrest.

Against the background of the Asian financial crisis and the fall of corrupt leaders, such as Indonesia's Suharto, scholars in the West have become especially sensitive to the predatory aspects of China's 'developmental state' and symptoms of crony capitalism. Writing in 1999, Minxin Pei asked 'will China become another Indonesia?'<sup>3</sup> Xiaobo Lü notes that China has evolved into a sort of 'booty socialism' in which 'bureaucratic discipline is low, while policy implementation and rule enforcement remain problematic'.

### **Pei's trapped in transition theory**

Minxin Pei's *China's Trapped Transition*, building on his long-standing concern about China's governance, is the latest addition to the literature counselling pessimism regarding China's reform prospects and future. While he recognizes that China has made unprecedented achievement in economic development and social change over more than a quarter of a century, he chooses to highlight a range of weaknesses and problems in China's governance.

The logic of Pei's model rests on the self-interest of the ruling elite in perpetuating the existing authoritarian order. In this political framework, the default economic reform strategy is gradualism, which allows the ruling elite to defend its political and economic interests, and contain the political risks of reform. So far, China has been lucky with its gradualist reform path and has achieved rapid growth. For Pei, however, such rapid growth has merely provided the ruling elite with greater

resources to preserve the status quo. Given China's system of governance, the rapid growth will necessarily not be sustained.

Much of Pei's book is devoted to enumerating the costs of gradual reforms and what Pei calls China's 'governance deficits'. Among these are the well-known problems of the state-dominated commercial banking sector and the state grain procurement system. Also noted are problems with public and workplace safety, basic education, public health, the environment, the countryside, and employment. He claims that 'the build-up of governance deficits is an inevitable product of the transition strategy and policies adopted by the CCP' (p. 204). Now these deficits threaten the very sustainability of China's development.

Moreover, Pei believes that the Chinese state has evolved into 'a decentralized predatory state' (p. 132). Except for pockets along the coast, the Chinese state is suffering the symptoms of a figurative bank-run, with insiders engaged in 'unrestrained predation' (p. 206). 'Doubtless', Pei asserts, 'China's state capacity will continue to erode ... sustainable economic development will be put at risk.' (p. 166). According to this prognosis, China's developmental autocracy is doomed to stagnation.

### **Trapped in stagnation or suffering from growth pains?**

With all the costs, pitfalls, deficits, and institutional dynamics of a bank-run afflicting the Chinese Communist Party (CCP) state, it is surprising that Pei does not predict the imminent collapse of the Party. For, as Steven Solnick argues in the case of the Soviet Union, it was opportunism from within that caused the Soviet state to suffer from the organizational equivalent of a colossal bank-run and eventually to collapse.<sup>4</sup>

3. Pei, M. (1999) 'Will China Become Another Indonesia?' *Foreign Policy Institute Wire Report*, 7:8, July.

4. Solnick, S. (1999) *Stealing the State: Control and Collapse in Soviet Institutions*. Cambridge (MA): Harvard University Press.

Given a similar dynamic; Pei's own, earlier insightful analysis and comparison of Chinese and Soviet reforms; and the symptoms Pei reports to have observed, we may wonder why the outcome in China should be so different. Indeed, Pei asserts that the probability of the collapse of the CCP is low, unless it fractures from within. Instead, he suggests that China may be stuck in political and economic stagnation for a long time to come, with neither 'the development of a true market economy' (p. 206), nor the emergence of liberal democracy. It is highly likely that China's rise will fizzle out (p. 213).

Pei's analysis and prognosis might be assessed conceptually. What exactly is his definition of stagnation? If there is indeed stagnation, how would we be able to tell? If not, would he let us know?

Nobody, including China's own leaders, would deny China faces serious problems and daunting challenges; and, of course, the same can be said of quite a few other countries. A few years ago, I would have agreed with much of Pei's description and empirical facts, including citation of fraud and waste in the state granary system; the sorry state of the commercial banks; the massive problems in public safety; rising inequality and associated challenges in education, health care, and so on.

Nonetheless, despite and, to some extent, because of all the predictions of gloom and doom, there is no denying that China has sustained one of the most impressive records of economic growth for more than a quarter of a century, bringing millions of Chinese out of abject poverty.<sup>5</sup> In fact, Pei himself recognizes that for more than a quarter of a century, China has made unprecedented achievement in economic development and social change.

Thus it behoves us to consider the implications of Pei's thesis empirically assuming the following pertain:

- The Chinese government dramatically reduces the percentage of non-performing loans in the commercial banking sector, and brings about substantial reforms of the banks, in terms of governance, internal risk controls, and external monitoring.
- For example, by augmenting the banking supervisory authority, by listing the banks on international stock markets, and by bringing in strategic investors that have strong interests in seeing the Chinese banks improve their performance.
- The Chinese government itself exposes problems in the state granary system and undertakes reforms in the sector.
- The Chinese government works hard to bring down crime rates and reduces the number of traffic accidents and public safety incidents.
- The Chinese government begins to significantly increase investment in rural education and health care.

There have been improvements in all these areas and others. Over the past two decades or so, the Chinese state has weathered some fairly severe tests, including the Tiananmen crisis of 1989, the fall of Communism in the former Soviet Union and Eastern Europe, the Asian Financial Crisis of the late 1990s, and, most recently, the crisis of SARS in 2003. The regime's ability to survive these crises and continue delivering has confounded some of its critics.

Rather than pointing to areas to which Pei has not attended,<sup>6</sup> we might consider a number of specific areas Pei gives prominence to considering what has occurred in recent years.

In the case of the non-performing loans in the banking sector, for example, Gordon Chang predicted that 'China's banks are doomed', and would fail, along with the Chinese state.<sup>7</sup> Pei cites this sector

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5. Ravallion, M. and S. Chen, 'Learning from Success: Understanding China's (Uneven) Progress Against Poverty', *Finance and Development*, 41, No. 4: 16-19.

6. Yang, D. L. (2004) *Remaking the Chinese Leviathan: Market Transition and the Politics of Governance in China*. Stanford (CA): Stanford University Press.

7. Chang, G. L. (2001) *The Coming Collapse of China*. New York: Random House.

as a prime example of how reform in China has lost momentum. As of early 2007, however, the dire predictions about China's banking sector have failed to pass. Instead, the authorities have put quite a few banking leaders behind bars, including Wang Xuebing, Liu Jinbao, Zhu Xiaohua, and Zhang Enzhao.

The major banks have all undertaken serious internal reforms to lower operating costs, including the closure of unprofitable branches writing off non-performing loans, enhancing accounting standards, strengthening risk management, and improving corporate governance. As the internal reforms began to bear fruit, the Chinese leadership took the decisive step of recapitalizing the top three banks with funds from the country's ballooning foreign exchange reserves. It allowed strategic investors such as the Bank of America, Goldman Sachs, Temasek Holdings, and the Royal Bank of Scotland to take out stakes in these banks. Certainly, the Chinese banks still need to do much more to catch up with the major international banks such as HSBC or Citicorp, which are themselves not without areas of weakness. But few today would predict the collapse of the Chinese banking system, unless the Chinese economy plunges into deep recession.

It is hard to agree with Pei that all the governance deficits he cites are 'an inevitable product of the transition strategy'. Even a brief stop-over in India would disabuse such an idea. Nonetheless, it is worthwhile to note that China's leaders have begun to make serious efforts in the past few years to invest in rural education and improve access to health care.

Then, there are the dreaded statistics on traffic accidents, as well as deaths from industrial accidents, including mining. While these rising numbers could in the past have been interpreted as symptoms of growth pains, I agree with Pei that they are far too high. Yet, we also know that the Chinese leadership has launched significant initiatives to improve mine safety, curb industrial accident, and reduce the number of traffic deaths. These initiatives have started to yield some results. Even though the

number of motor vehicles continues to increase dramatically, in 2006 the number of people who died from road accidents was 89,455, down by 9283 on 2005; and fewer than 90,000 for the first time since 2000. Meanwhile, the State Administration of Work Safety reported that overall safety also showed improvement, with the number of deaths down by 11.2 per cent in 2006.

The coal-mining industry has received special attention in recent years. In 2006, the number of coal-mining accidents was down by 11 per cent and the number of deaths down 20 per cent. Since Pei takes deterioration in the statistics as signs of growing governance deficits, it would appear reasonable to take improvement as an indication of improving governance. It is also worth mentioning the dramatic improvement in China's airline safety: it is now safer to fly in China than in Europe, though China remains behind the US in this regard.

### ***Crisis, learning, and reforms***

The above review, cursory though it may be, suggests that China's governance may not be stagnating, as Pei suggests. We could undoubtedly peek into various forms of stagnation here and there; but these must be examined alongside the vistas of dynamic change palpably felt. There may be an inclination to agree with Pei that China's strong growth rates should be discounted on account of the low quality of such growth. However, I would suggest that China's continuing growth is not only reflected in improved living standards and competitiveness. It also provides the foundations for further growth and for tackling a host of the problems and challenges.

Fundamentally, the story of China's relative success is based on the ability of its leaders, institutions, businesses, and society to continue adapting to changing circumstances. Elsewhere I have provided a broad review of the governance reforms China has undertaken since the early 1990s.<sup>8</sup> These include the substantial streamlining of government; the

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8. Yang, D. L. (2004), op. cit.

simplification and rationalization of administrative approvals, including the establishment of one-stop administrative service centres; the divestiture of businesses operated by the armed forces and other Party and state organs; the establishment and enhancement of regulatory agencies, especially for banking, securities, and insurance; the ongoing reforms of the government budget and financial management; and the introduction of competitive mechanisms: bidding and tendering, for government procurements and land allocation.

I would suggest that such reforms have helped improve the efficiency, transparency, and fairness of the administrative state; strengthened the regulatory apparatuses; removed various institutional incentives and loopholes for corrupt practices; and improved the environment for business. Certainly, China continues to rank fairly low on various international indicators, such as Transparency International's Corruption Perceptions Index. Nonetheless, if a statistical regression analysis on this index is performed, and its relationship to the level of per capita GDP examined, China's ranking tends to exceed the rank that would be predicted from the level of its nominal per capita GDP.

Several mechanisms are at work in propelling China's leaders to adopt various institutional reforms. They have borrowed from others, for example in areas of budget management reforms; and the reconfiguration of the People's Bank of China in the image of the Federal Reserve System. Importantly, many of the reforms have a ratcheting effect. Once the prices for most goods are freed up, no right-minded national leader would want to go back to the regime of planned prices. Land auctions and the reforms in government financial management, once introduced, tend to become established practices and procedures.

China's leaders have generally pursued major reforms in response to urgent needs and crises, real or perceived. In 1993–4, the Chinese leadership, fearing the political consequences of its weakening fiscal prowess, pushed through a comprehensive overhaul

of the tax and fiscal systems, which came into effect on 1 January 1994. The Asian Financial Crisis of the late 1990s became the catalyst for a range of new reforms. Topping the list was the divestiture of businesses operated by the armed forces, judicial institutions, and other Party and state institutions, many of which had flouted their extra-legal privileges and contributed to rampant smuggling. Worried about financial stability, the Chinese leadership also restructured the People's Bank of China in the mode of the regional Federal Reserve Banks of the United States by establishing regional branches, and by strengthening other financial regulators.

Meanwhile, alarmed by the fall of governments in several Asian countries, the leadership began to introduce a variety of institutional mechanisms to mitigate corruption in specific sectors. More recently, growing social protests about land requisitions from rural areas and urban relocations have moved the government to respond with improved terms for affected rural communities and urban dwellers, thus reducing the number of 'mass incidents'. Major corruption scandals involving the management and use of social welfare funds have prompted the Ministry of Labour and Social Security to tighten supervision of the management of such funds in the provinces and cities.

### ***Building a modern regulatory state***

It is not possible to cover in this policy brief the many adaptations and innovations, as well as the temporizing mechanisms that China's leadership has introduced. It is nonetheless useful to briefly review China's continuing efforts to construct a modern regulatory state. It is now generally recognized that a modern regulatory state is essential to help overcome certain problems of coordination and collective action, and thus maintain market order.<sup>9</sup>

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9. Polanyi, K. (1944) *The Great Transformation*. New York: Rinehart and Co.

Sunstein, C. R. (1990) *After the Rights Revolution: Reconceiving the Regulatory State*. Cambridge (MA): Harvard University Press.

As China has made the transition from planning to market, most industrial ministries inherited from the pre-reform central planning era have been eliminated; while a long list of regulatory commissions, administrations, and bureaus have been established or reinforced. In addition to the regulatory commissions for banking, insurance, and securities, the list of regulatory agencies also includes: the State Environmental Protection Administration; the State Administration of Industry and Commerce; the State Administration of Quality Supervision, Inspection and Quarantine (formerly the State Administration of Technical and Quality Supervision prior to its merger with China Inspection and Quarantine); the State Intellectual Property Office (formerly the State Patent Bureau); the State Administration of Press and Publications (National Copyright Administration); the State Food and Drug Administration; and the State Administration of Workplace Safety. Working alongside the powerful National Development and Reform Commission and government ministries such as the Ministry of Finance, the regulatory agencies are charged with the enforcement of state laws to protect, as required, the rights of consumers, workers, and investors.

For the regulatory agencies to function well as modern regulators, they must be designed properly, such that they would be focused on the intended mission and be equipped with the appropriate resources: personnel and funds, as well as enforcement authority, to carry out their mission.

A review of Chinese regulatory developments in the reform era suggests that the regulatory institutions are often born with serious congenital flaws. The effects of these flaws are magnified by a volatile socio-psychological environment, which has made many officials incapable of resisting the urge to seek self-enrichment, at the expense of public interest. As a result, the regulatory agencies have not only found it difficult to be effective regulators, but have succumbed to widespread corruption. The history of Chinese regulatory developments in the reform era is thus about the struggle to cope

with and to overcome the various institutional flaws, and to curb regulatory corruption.

Perhaps the most glaring case of bad institutional design occurred in connection with China's emerging stock markets. Until fairly recently, the Chinese securities markets had the following characteristics:

- For the first decade, post-Mao, of China's stock markets (a period covering approximately the first 1000 firms listed) the right to list was administratively rationed. In order to be able to make an initial public offering (IPO), a company has to first obtain an IPO quota.
- Influence over the power to grant the right to an IPO was not centralized in the China Securities Regulatory Commission, but widely dispersed among the securities commission, the reform commission, other government agencies, and different levels of government.
- As the government gradually phased out grants to state enterprises, government agencies, including different levels of government, were eager to gain access to alternative sources of funds. They had fairly short time frames, and largely used the stock markets to collect money from the public to bail out under-performing state firms.
- China's accountants, auditors, and lawyers were generally not independent, and were lacking in professional standards and ethics.
- The amount of money that could be raised through an IPO was large, and considered to be easy money. Shareholders until recently had few rights.
- There was little punishment for the misuse of funds raised through IPOs.

Given these characteristics, it is not surprising that China's stock listing process became infested with corruption. Getting a quota or the permission to list on the stock markets was licence to gather money from eager investors, without having to be accountable to shareholders. To obtain the right to list, enterprising managers bribed gatekeepers. They had accountants falsify company accounts in order to get listed. Many regulators and government officials

with access to IPO quotas received bribes in cash as well as stock. As a result, China's listed companies acquired the reputation of 'changing face'. Within a year of a company's listing with glowing numbers, the company's performance would suddenly deteriorate, leaving shareholders holding the bag.

By the mid- to late 1990s, millions of Chinese had become stock investors. Having witnessed stock-related riots, the Chinese leadership became seriously worried about the political consequences of China's casino-like stock markets. It began to promote reforms of the IPO process and of securities regulation generally. In connection with these reforms, a few officials were arrested or disgraced for securities-related corruption, including Xu Penghang, vice-minister of the State Economic and Trade Commission, and later of the Commission on National Defense, Science, Technology, and Industry and alternate member of the Central Committee; and Wu Wenying, former minister of the National Council of Textile Industry, and later Member of the Standing Committee of the Chinese People's Political Consultative Conference.

To curb corruption and win back investor confidence, the China Securities Regulatory Commission (CSRC), armed with the Securities Law and more centralized authority, changed the administrative approval system (*shenpi zhi*) for stock-listing to a market-oriented US-style registration system (*zhuce zhi*). Applications for initial public offerings were vetted by expert committees, whose names were known to the public. The underwriters, law firms, and auditors, all of which have also undergone profound reforms to enhance professionalism, can be severely penalized if they are found to have provided false information. Strict rules concerning disclosure and corporate governance have been introduced for listed companies. Accounting standards have been raised. Non-tradable state shares were unlocked in processes that gave power to individual shareholders, who would otherwise have been in the minority. These reforms toward transparency and accountability, combined with tougher regulatory enforcement against insider trading, chronic loss-

making and other forms of malpractice, have helped Chinese investors regain their long-lost confidence in the securities markets.

The reforms of securities regulation preceded restructuring of the State Food and Drug Administration, which, at the time of writing, is undergoing painful cleansing. It will likely emerge a more professional regulatory body. Although less dramatic, the reforms in other regulatory areas, such as environmental enforcement and supervision of land management, are equally fascinating.

### **Conclusion**

Most developing countries would look enviously at China's trillion-dollar foreign exchange reserves, double-digit growth rates, and rapid increases in central government revenue. If these constitute 'the pathologies of a trapped transition', many countries would like to catch the same disease that causes such symptoms. Witness the efforts by various Asian countries, including India and Japan, to learn from China's special economic zones.

Institutionally, it is necessary to get the omnipresent state to retreat in some areas of the economy; to change its behavior in others; and yet, to build and rebuild the institutions and capacity to govern markets and provide various forms of public goods. This was not easily achieved by the early industrializers, and it is not easy for China today. But there is much evidence that significant institutional reforms are under way in China.

So is China 'doomed to stagnation'? At some point, China's growth will slow down from double-digit levels. But it will likely be at a much higher level of development, and at a level of which many Chinese will be proud. After all, the countries that experienced the terrible side-effects of the industrial revolution had to live through the London fog, the Cleveland river on fire, or Tokyo Bay in distress, yet they have all become leading world economies. And why should not China? I for one would not want to underestimate the desire and ability of the Chinese to live, learn, and improve.



### ***The Foundation***

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### ***Rule of Law in China: Chinese Law and Business***

The main objective of the programme is to study the ways in which Chinese law and legal institutions encounter and interact with the social environment, including economic and political factors, at local, regional, national, and international levels.

The Foundation's perspective in pursuing this objective is that of entrepreneurs considering investment in China, the lawyers advising them, executives of an international institution or non-governmental authority, or senior public officials of another country. The combination of this objective and our particular perspective constitutes a unique approach to the study of the role of law and its relationship to other aspects of society in China.

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Among his books are *Remaking the Chinese Leviathan: Market Transition and the Politics of Governance in China* (Stanford University Press, 2004); *Calamity and Reform in China: State, Rural Society and Institutional Change Since the Great Leap Famine* (Stanford University Press, 1996); and *Beyond Beijing: Liberalization and the Regions in China* (Routledge, 1997).

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