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Law, finance, and economic growth in China ☆

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Abstract

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, yet it has one of the fastest growing economies. While the law–finance–growth nexus applies to the State Sector and the Listed Sector, with arguably poorer applicable legal and financial mechanisms, the Private Sector grows much faster than the others and provides most of the economy's growth. The imbalance among the three sectors suggests that alternative financing channels and governance mechanisms, such as those based on reputation and relationships, support the growth of the Private Sector.

Introduction

Several related strands of literature on law, institutions, finance, and economic growth have emerged in financial economics in recent years, and their impact on other areas of research has been significant. First, La Porta, Lopez-de-Silanes, Shleifer, Vishny (LLSV hereafter) and others have produced a substantial body of empirical evidence that links the origin of a country's legal system to the country's institutions and financial and economic "outcomes." One of the central results of this literature is that countries with English common-law origin (French civil law origin) provide the strongest (weakest) legal protection to both shareholders and creditors (La Porta et al., 1998, La Porta et al., 2000a). Countries with English origin also seem to have better institutions, including less corrupt governments (LLSV, 1999), more efficient courts (Djankov, La Porta, Lopez-de-Silanes, and Shleifer, DLLS hereafter, 2003), and more informative accounting standards (LLSV, 1998). Better legal protection and better institutions, in turn, lead to better outcomes for the financial system, both at the aggregate and firm levels.[1] Related to the LLSV results, there is a recent body of literature that attempts to understand why and how a country's legal origin affects the country's institutions, and how legal origin and institutions, both jointly and separately, affect economic and financial outcomes.[2]

The second strand of literature champions the view that the development of a financial system that includes a stock market and intermediation contributes to a country's overall economic growth (e.g., McKinnon, 1973). Recently, researchers have strengthened this view by presenting supporting empirical evidence at the country level (e.g., King and Levine, 1993; Levine and Zervos, 1998), as well as at the industry and firm level (e.g., Rajan and Zingales, 1998; Jayaratne and Strahan, 1996). The third strand of literature provides evidence for the link and causality among law, finance, and economic growth at country, industry, and firm level (e.g., Demirgüç-Kunt and Maksimovic, 1998; Levine, 1999; Beck and Levine, 2002).

However, many of the above studies are at the country level, and they treat each country in their sample on an equal-weight basis. For example, among the countries in the LLSV (1998) sample, large diverse countries such as Brazil and India receive the same weight as small homogeneous countries like Jordan and Ecuador. We might expect that small homogeneous countries could have more effective legal systems because they can be closely tailored to these countries' needs. Moreover, most of the studies exclude one of the most important developing countries in the world, China. In this paper, we demonstrate that China is a significant counterexample to the findings of the existing literature on law, institutions, finance, and growth. Despite its poor legal and financial systems, China has one of the fastest growing economies in the world. Using Purchasing Power Parity (PPP hereafter), it presently is the second largest economy, and if current trends continue, will overtake the U.S. and become the largest economy in the world in ten years.

We examine three sectors of the Chinese economy: (1) the *State Sector* includes all companies such that the government has ultimate control (state-owned enterprises, or SOEs); (2) the *Listed Sector* includes all firms that are listed on an exchange and are publicly traded; and, (3) the *Private Sector* includes all the other firms with various types of private and local government ownership.[3] We find that the law-finance-growth nexus established by the existing literature works well for the State and Listed sectors: With poor legal protection of minority and outside investors, (standard) external markets are weak, and the growth of these firms is slow or negative. However, the size, growth, and importance of these two sectors in the economy are dominated by those of the Private Sector. In spite of relatively poorer applicable legal protection and standard financing channels, the Private Sector has been growing much faster than the others and has been contributing to most of the economy's growth. Our conclusion for the imbalance among the three sectors is that there exist effective, alternative financing channels and corporate governance mechanisms, such as those based on reputation and relationships, to support the growth of the Private Sector.

Using measures from the existing literature, we first find that China's law and institutions, including investor protection systems, corporate governance, accounting standards, and quality of government, are significantly less developed than most of the countries in the La Porta et al., 1997a, La Porta et al., 1998 and Levine (2002) samples. We also find China's financial system is dominated by a large but underdeveloped banking system that is mainly controlled by the four largest state-owned banks. Its newly established Shanghai Stock Exchange (SHSE hereafter) and ShenZhen Stock Exchange (SZSE hereafter) have been growing very fast since their inception in 1990, but their scale and importance are still not comparable to other channels of financing, in particular the banking sector, for the entire economy.

We next examine separately financing channels, corporate governance, and the growth of firms in each of the three sectors. The State Sector has been shrinking with the ongoing privatization process, which includes firms going public. Our empirical results on the Listed Sector are based on a sample of more than 1,100 firms listed and traded on SHSE and SZSE. First, we find that the equity ownership is concentrated within the State for firms converted from the State Sector, and founders' families for nonstate firms (e.g., Claessens et al., 2000, Claessens et al., 2002). Second, the standard corporate governance mechanisms are weak and ineffective in the Listed Sector. Finally, when we examine listed firms' dividend policies and valuations and compare them to those in the La Porta et al., 2000b, La Porta et al., 2002 sample firms, we find that both the dividend ratio and firm value of Chinese firms are low compared to similar firms operating in countries with stronger investor protection, consistent with LLSV predictions.

More interesting results are found for the Private Sector. Our evidence is mainly based on a survey of 17 entrepreneurs and executives in Zhejiang and Jiangsu provinces, two of the most developed regions in China. First, the two most important financing channels for these firms during their start-up and subsequent periods are financial intermediaries, including state-owned banks and private credit agencies, and founders' friends and families. Firms have outstanding loans from multiple financial intermediaries, with most of the loans secured by fixed assets or third party guarantees. During a firm's growth period, funds from “ethnic Chinese” investors (from Hong Kong, Taiwan, and other countries) and trade credits from business partners are also important sources. When asked about the prospect of going public, founders and executives list “access to large scale of funding” and “reputation increase” as the most important benefits, and “disclosure of valuable information to competitors and outsiders” and “large amount of fees paid” as the most critical disadvantages of going public.

Secondly, despite the almost nonexistence of formal governance mechanisms, alternative mechanisms have been remarkably effective in the Private Sector. Perhaps the most important of these is the role of reputation and relationships (Greif, 1989, Greif, 1993). Without a dominant religion, the most important force shaping China's social values and institutions is the widely held set of beliefs related to Confucius; these beliefs define family and social orders and trust, and are different from western beliefs on the rule of law. Another important mechanism that drives good management and corporate governance is competition. Given the environment of low survivorship during early stages of a firm's development, firms have a strong incentive to gain a comparative advantage. The third important mechanism is the role of local governments. Within the regions that witnessed the most successful economic growth and improvement in living standards, properly motivated government officials support and participate in the growth of Private Sector firms.

Our results on the differences among the three sectors in China challenge the law-and-finance view that it is the legal origin that causes the difference in financial systems, the finance-and-growth view that it is the development of stock markets and a banking system that causes the difference in growth of firms and economies, and the view supporting the law–finance–growth nexus. Moreover, the success of the Private Sector in China also challenges the view that property rights and the lack of government corruption are crucial in determining financial and economic outcomes. Although our results are based on China, similar “substitutes” based on reputation and relationships may be behind the success of other economies as well, including developed economies. Thus, a thorough examination of these substitutes has more general implications and can provide valuable guidance for many other countries.

Some of our results are consistent with existing research on economies in transition (from Socialist, central planning systems to market-based economies), including Eastern European countries, Russia, Vietnam, and China (e.g., McMillan, 1997; McMillan and Woodruff, 2002). Unlike existing research, our paper provides both aggregate and firm-level evidence on the finance aspects of the Chinese economy, and examines why China differs from other countries studied in the strands of literature on law, institutions, finance, and economic growth.

The rest of the paper is organized as follows. Section 2 compares China's legal and financial systems to those of other countries, and discusses its growth in the State, Listed, and Private Sectors. Section 3 presents evidence on financing channels available to firms in China and other countries. Section 4 examines the Listed Sector. In Section 5, we first provide anecdotal and survey evidence on Private Sector firms, and then discuss alternative financing channels and governance mechanisms. Finally, we conclude in Section 6. Appendix A contains explanations of all the variables that we use in the paper, and Appendix B provides details of our empirical tests on the Listed Sector.

Section snippets

Evidence on China's legal and financial systems, and growth in the three sectors

In this section we first provide an assessment of China's entire economy, and then of the status of its legal and financial systems. We next compare China to the countries studied in the existing literature, namely, the LLSV sample and the Levine sample. Finally, we compare the growth in the State, Listed, and Private sectors of China.…

Firms' financing sources: Aggregate evidence and cross-country comparisons

In this section we compare, at the aggregate level, how firms raise funds in China and in LLSV-sample countries with the emphasis on emerging economies. It is then worthwhile to study what other channels of financing are playing the role of substituting for external capital markets and standard, textbook financing channels.…

Evidence on the Listed Sector

In this section, we focus on publicly traded companies and examine their financing and investment decisions. As stated in the Introduction, we want to draw general conclusions on whether there are fundamental differences between the Chinese firms and firms studied in previous papers (LLS, 1999; La Porta et al., 1997a, La Porta et al., 2000b, La Porta et al., 2002). Before doing so, we first look at the unique ownership structure and corporate governance mechanisms in Chinese firms.…

Evidence on the Private Sector

In this section we study how firms in the Private Sector raise funds, their various growth paths, and the alternative mechanisms employed by owners that can substitute for formal corporate governance mechanisms. Due to data limitations, much of this evidence is by necessity anecdotal or by survey.[11]…

Concluding remarks

In this paper we examine and compare China's formal systems of law and finance and the alternative institutional arrangements and governing mechanisms, and the relation between the development of these systems and China's economic growth. With one of the largest and fastest growing economies in the world, China differs from most of the countries studied in the law, institutions, finance, and growth literature, and is an important counterexample to the existing findings: Its legal and financial…

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