

Editorial

China's Path to the New Era: The Rise of Regulation

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Abstract

China's financial development and economic growth is achieved under weak legal institutions. The literature attributes this counterexample of law–finance–growth nexus to a) alternative mechanisms in China such as incentives, reputation and relationships and b) a well-functioning xinfang system with common law features. In recent years, China has made increasing efforts to strengthen its rule of law. The Communist Party of China (CPC) has taken the lead by launching a far-reaching campaign against corruption, establishing a system of inspection tours, and promulgating a large number of regulations. We argue that using regulations to complement laws is effective: CPC has enough bureaucratic prowess to crack down on corruption whereas the courts are subject to subversion by powerful interests. We also discuss the drawbacks of this approach: regulations aiming at ex ante control of corruption substantially increase procedural formalism and limit the discretion of local governments and state-owned enterprises.

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1. Introduction

2018 marks 40th anniversary of China's reform and opening-up. In 1978, China was largely an agricultural country. Around 81% of its population lived in countryside and 82% were in absolute poverty. In the following four decades, the Chinese economy exhibited exceptional performance. The average GDP growth rate reached 9.6%, making China 2nd largest economy in the world and lifting 700 million people out of poverty. China's stock exchanges were not opened until 1990, but its stock market has become the world's second-biggest since 2014. Having said these achievements, legal institutions in China remain weak. The Corruption Perceptions Index by Transparency International and Rule of Law Index by World Justice Project place China the 87th and 75th in the world in 2018 respectively.

Given the importance of legal institutions to promote financial development (e.g. La Porta et al., 1997; 1998) and in turn economic growth (e.g., Coase, 1960; North and Thomas, 1973; King and Levine, 1993), China provides a counterexample to the conventional wisdom. Allen et al. (2005; 2013) argue that using law in finance and commerce is a Western idea and can be optimal in static environments; in the dynamic environment like China, however, it may be better to use other mechanisms such as reputation, financial incentive and connections which can reduce inefficiencies of laws associated with political economy factors. An et al. (2016) refer to an alternative formal institution in China, namely xinfang system, that plays key roles in addressing a wide array of commercial, contractual, property, and financial disputes. Xinfang system handles more cases than the judicial system and has advantages in its efficiency, independence and adaptability.

Nonetheless, Xi Jinping has pledged to promote rule of law and to enforce law-based governance in all areas, believing they are critical to achieve the "Two Centenary Goals" i.e. to build a moderately prosperous society by the time the CPC celebrates its centenary in 2021 and to turn China into a modern socialist country by the time the People's Republic of China celebrates its centenary in 2049. CPC, and its Central Commission for Discipline Inspection in particular,

have played a leading role to implement this initiative to build the rule of law in China. To do so, CPC has issued a large number of regulations to discipline the daily activities of cadres including public servants, managers in state-owned enterprises and academics in universities among others, making the Chinese society vastly more regulated. Today, public expenses, event planning, business trips and reimbursement follow heavily regulated procedures. Is regulation a good idea? Should judges or regulators enforce law and order? This paper discusses the benefits and unintended consequence of China's regulation approach to improve institutions in achieving its further development.

The reminder of the paper proceeds as follows. Section 2 introduces the articles in this special issue; Section 3 discusses the rationale of China to institute more regulations; Section 4 discuss the problems to be addressed and Section 5 concludes.

2. Introduction of the Special Issue

China continues to carry forward reforms, as the 19th Communist Party of China (CPC) National Congress in 2017 set a timetable for China's ultimate economic goal. China aims to basically realize socialist modernization by 2035 and to become a leading global power by 2050. To study the challenges in China's development, Chinese Economic Association (CEA, UK/Europe) jointly with *Journal of Chinese Economic and Business Studies* (JCEBS), the official journal of CEA, organised two conferences at the University of Edinburgh (22-23 June) and Tsinghua University (9-10 Sep) in 2018 respectively. 2018 also marks the 30th anniversary of CEA and the 15 anniversary of JCEBS. CEA was founded in 1988 in London by overseas Chinese economists, many of whom served as the advisors of the China's economic reforms in 1980s.

Based on these two events, JCEBS publishes this special issue with five articles, covering the topical issues of income disparity, infrastructure, globalisation and legal institutions. Zhang and Zhao (2019) argue that China's falling Gini coefficients since 2009 may have resulted from the omission of unreported income of wealthy families. Chen et al. (2019) argue that find that

urbanization in China has contributed to the reduction in income disparity which is largely driven by the income gap between rural and urban residents. Zhang et al. (2019) studies China's rapid development of infrastructure and find that the high-speed rail has stimulated China's fixed assets investment and foreign direct investment. Wang (2019) discussed China's active role in achieving shared growth, engaging in global governance and participating in rule-setting in the era of globalization 4.0, which is shaped by the fusion of advanced technologies and the shift to a multipolar world. Zhang (2019) tests the two opposite interpretations of China's economic success of past four decades: China model view Vs the universal model view. He finds that China's success is attributed to the marketization and development of non-state sectors rather than the strong power of government and the state sector.

3. The Rise of Regulation

The Central Commission for Discipline Inspection of CPC[†], the highest internal control institution of the Party, has been substantially empowered in Xi Administration to lead the signature anti-corruption campaign aiming to crack down both corrupt high-level and local cadres. It also co-ordinates with the Organization Department of CPC to implement on-site inspection tours on governments, state-owned enterprises (SOEs) and universities to inspect the enforcement of internal regulations of the Party. Due to the underdevelopment of legislation, CCP and Chinese governments mainly rely on the issuance and enforcement of a large number of internal regulations at various levels and ad hoc notifications to strengthen institutions. This is against Coase's "free market" idea of establishing law and order: private property right protection should rely on litigation rather than regulations.

We argue that there are at least three good reasons for the Party to institute more regulations. First, litigation is less vulnerable to subversion than litigation. The career concerns of

[†] It was merged with the National Supervisory Commission of China, the highest anti-corruption agency in 2018.

the officials at the Central Commission for Discipline Inspection protect them from succumbing to outside influence; Second, regulations focus on precautions i.e. ex ante control of corruption; Third, public regulators have better expertise and motivation to pursue social objectives than judges (Shleifer, 2005). During the Progressive Era from 1890s to the 1920s, the United States also increasingly used regulations to control market behaviour. Landis (1938) sees regulations during New Deal in the United States (US) between 1933 and 1936 as a political response to the failure of litigation. Glaeser et al. (2001) attribute the rapid development of securities markets of Poland to its highly motivated regulator and stringent regulations.

Glaeser and Shleifer (2003) consider choice of private litigation and government regulations as alternative mechanisms of controlling market behaviours and develop a theory of law enforcement. Their finding is as follows: a) Developed countries that have achieved highest levels of law and order should rely on private litigation rather than the less efficient regulations; b) In countries with weak law and order where judges and regulators are vulnerable to political pressure and bribes, the optimal government policy is to institute fewer regulations because justice will be subverted; c) in an environment with intermediate law and order, regulation is desirable. We argue that since China has intermediate enforcement capacity, regulations combined with litigation could be a good solution of improving institutions. The Commission for Discipline Inspection of CPC is less likely to be subverted than courts; and the regulations that restrict corrupt conduct reduces cost of identifying violations can enhance enforcement and overall efficiency (Glaeser and Shleifer, 2001).

The benefits of the regulation approach are empirically supported by some early evidence based on the short-run market reaction and firms' response. The anti-corruption campaign triggers positive market reactions on SOEs (Lin et al., 2016), reduces corporate fraud (Zhang, 2018), increases R&D investment and patents (Xu and Yano, 2017), optimizes credit reallocation between SOEs and non-SOEs (Li et al., 2018), and reduces discount when local government sell land to

Princelings (Chen and Kung, 2018). However, none of the studies in the literature quantitatively studies regulations issued around the campaign and we encourage future research on this topic.

4. The Problem of Procedural Formalism

Following the anti-corruption campaign, the Chinese society has become vastly more regulated. New regulations are issued at various levels on weekly basis; and some outdated regulations are enforced again without being revised timely. For example, Shanghai is the 6th most expensive city in the world by annual cost of living by Mercer, but a regulation from the Ministry of Finance only permits accommodation that costs no more than 500 Yuan/night for cadres, managers of SOEs and academics on business trips to Shanghai. Reimbursement also requires more approvals and evidence. Cadres now spend significant time to fill out forms and write report because regulations have substantially increased procedural formalism. The effects of the procedural formalism are controversial (Djankov et al, 2003). On the one hand, it advances benign political goal and deter subversion by powerful interests; one the other hand, it brings about unnecessary burdens such as extreme costs and delays. The net effects of procedural formalism represent a timely and important research question.

To measure procedural formalism, Djankov et al. (2003) construct an index on the operation of litigation and find that it determines the performance of courts. The major motives for the government to regulate civil procedures are to control the outcome and to avoid subversion by the powerful. The important finding is that the procedural formalism, which is systematically greater in civil law countries, brings about the cost of longer proceedings but not better justice: In fact, higher formalism is associated with lower quality of the legal system. Likewise, Djankov et al. (2002) show that heavier regulation of entry is associated with higher corruption but not better quality of public or private goods. Botero et al. (2004) find that heavier regulation of labor is associated with lower labor force participation and higher unemployment.

While the regulation approach in China reduces the room of corruption and other misconducts, it at least brings about two problems. First, it substantially increases the bureaucracy and paperwork of cadre, holding back their efficiency and motivation. Second, some regulations are too specific, eliminating the discretion of cadres to make decisions in accordance with local conditions. We encourage future research to construct indices to measure the trend of procedural formalism and to conduct fieldwork to reveal the insights of the unnecessary burdens associated with the anti-corruption campaign. The results will be very helpful for the Party and governments to optimize regulations.

The discretion of local cadres was found to be very important for China's development. The Chinese political system combines decentralized economic governance and centralized political governance to foster economic growth (Xu, 2011). With respect to decentralized economic governance, local governments influence the allocation and use of resources, the provision of public goods, infrastructure, and law enforcement, and the initiation and implementation of local regulations and reforms (Chen and Kung, 2018). As discussed in Qian and Xu (1993) and Maskin et al. (2000), decentralized economic governance systems tend to be more effective at generating economic growth than centralized systems. Extensive regulations and the system of inspection tours make China's political structure more centralized and may harm the economic growth over the long run.

The problems of regulation approach in China are not trivial because they could offset the benefits. To what extent the Party and governments can be addressed them determines the success of China's efforts to uphold rule of law. Although some short-run benefits of China's anti-corruption campaign was documented, Griffin et al. (2018) point out that there have been little overall decreases in measures of potential corporate corruption apart from reported entertainment expenditures. China's ranking in the control of corruption index by Transparency International in fact dropped from 80th to 87th from 2012 to 2018, indicating the little improvement or deterioration in corruption perceptions.

5. Conclusion

While China has achieved its growth miracle in the absence of strong legal institutions, Xi administration has increasingly emphasized the importance of rule of law. The revised constitution of the CPC in 2017 specifies CPC's pronged comprehensive strategies including to fully advance the law-based governance of China and to strengthen Party self-governance in every respect. The Party aims to strengthen the implementation of law and to bring all the work of the state under the rule of law.

This paper introduces the special issue based on two conferences to celebrate CEA's 30th anniversary and JCEBS' 15th anniversary, and discuss the rational and problems of China's regulation approach to strengthen its institutions. While some short-run evidence suggest that the Party's efforts have been effective to some extent, the regulation approach also brings about non-trivial problems of formalism which could at least partially offset the benefits over the long run. We encourage future studies to measure the formalism associated with regulations during the anti-corruption campaign in China and evaluate its long-term economic impact. The findings will make important policy implications for the Party and governments to optimize the regulation approach in achieving further development and growth in the new era.

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