

## Introduction

Over the past four decades, China has made impressive strides to establish a modern legal system. The Chinese Party-state<sup>1</sup> has devoted great attention and resources to the use of law in governing markets. The array and scope of economic law-making and institutions have been particularly astounding.

The conventional premise for embracing law in the context of economic reform calls for a modern legal system as a prerequisite for economic development. The premise suggests that economic exchange between unfamiliar parties requires reliable, uniformly applicable norms and institutions that provide credible commitments for growth. The widely accepted way to define norms in a predictable and uniform manner and to secure the expectations of rights recipients (i.e., market participants) is through a legal system. Without secured property rights, it is argued, market activity will be discouraged.

Yet as many critiques of this conventional “economic-rights-security → leading growth” premise show, China achieved substantial growth and developed markets irrespective of the quality of its legal institutions. Indeed, four decades of economic development in China are surrounded by this great puzzle.<sup>2</sup>

Within its broad growth puzzle, the development of China’s financial markets, particularly its publicly listed firms and their corporate governance system, is especially intriguing.

Capital markets and the firms that populate them are important components in any growth-oriented economy. Firms are the primary vehicle through which large-scale production and commerce take place. Capital markets, in turn, facilitate external

<sup>1</sup> The term “Party-state” refers to a one-party system in which one political party directs both the political process and the administrative governance carried by the state.

<sup>2</sup> The puzzle is of course much broader. Throughout its economic trajectory, China has resisted many policy measures that have long been considered essential for economic growth, including rapid liberalization of monetary policy and trade, privatization, and a Western-style rule of law. China’s distinct economic path spreads along a spectrum of governance dimensions, leaving foreign policymakers, practitioners, and academics across a variety of disciplines puzzled. The role of law in China’s development is but one, prominent, aspect of China’s growth puzzle.

finance beyond relational-based exchange, making capital accessible and less costly for firms. They enable large-scale trade of economic rights between unfamiliar parties while facilitating information flow between firms and investors. This informational function is expected to ensure the allocation of capital to the most deserving firms (commonly referred to as the “efficient allocation of capital”), thereby aiding good firms to grow and expand. Public firms and capital markets are thus considered important steps in financial development and in the overall advancement of the economy – the deeper the capital market, the greater the prospect for further economic growth in a given country.<sup>3</sup>

Here too, and not without controversies, the conventional wisdom has coalesced around certain prescriptions of what may propel capital market development, and by extension growth:

- Dispersed ownership is more conducive to capital market development than concentrated ownership.<sup>4</sup>
- Private ownership is a precondition for prosperous firms and for deep capital markets,<sup>5</sup> while state ownership and heavy statist or political intervention impede market development.<sup>6</sup>
- Law is eminent. Robust legal institutions, particularly those associated with investor protections, are essential.<sup>7</sup>

China, however, misses the mark on these well-established prescriptions.

Take, for example, China’s leading spot in the desired Fortune Global 500 list,<sup>8</sup> to which it had ascended in 2020.<sup>9</sup> Close to 75 percent of the Chinese firms on this list are formally owned by the Chinese government (forty-eight firms are owned by the central government, thirty-two by the local level of SASAC, and twelve firms by state-owned financial institutions).<sup>10</sup> Many ostensibly private firms on the list have some state

<sup>3</sup> Note that this does not mean that capital markets are crucial for economic growth; the evidence for that is far from conclusive. Yet, scholars are largely in agreement that growth can be expanded when capital market activity increases.

<sup>4</sup> R. La Porta et al., “Corporate Ownership around the World,” *Journal of Finance* 54(2) (1999) 471.

<sup>5</sup> M. Boycko et al., *Privatizing Russia* (MIT Press, 1997).

<sup>6</sup> Friedrich Hayek is known for developing a theory according to which legal systems with traditions that constrain government intervention (common law) are more compatible with a market economy than legal systems in which government power was more freely asserted (civil law). See P. Mahoney, “The Common Law and Economic Growth: Hayek Might Be Right,” *Journal of Legal Studies* 30 (2001) 503.

<sup>7</sup> See Chapter 1 discussing the traditional framework, below.

<sup>8</sup> Note, the Fortune Global 500 list includes firms by total revenue size. Many firms in the list are not publicly listed.

<sup>9</sup> In 2020, China topped the list with the largest number of firms (124 including mainland China and Hong Kong, excluding Taiwan), exceeding Western leadership of the list for the first time in history. A. Murray & D. Meyer, “The Fortune Global 500 Is Now More Chinese than American,” *Fortune* (Aug. 10, 2020), <https://perma.cc/HA66-KSVN>. Note, however, Chinese firms still lag behind US firms in terms of total revenue. See “Visualize the Global 500,” *Fortune*, <https://perma.cc/UC3E-zTBZ>.

<sup>10</sup> 独家解读2020年(财富)世界五百强上榜国企名单 [Interpretation of the 2020 Fortune Global 500 List of State-Owned Enterprises, Report by the State-Owned Assets Supervision and Administration Commission of the State Council], Aug. 11, 2020, <https://perma.cc/T2EW-EUFP>.



FIGURE 0.1 Total market capitalization, compared

investments as well or are subject to the political clout of the Chinese Communist Party (CCP) even without any state ownership. Haier Group, Huawei, and even Alibaba and Tencent are among the Fortune Global 500 private firms that arguably have ties to the Party-state.<sup>11</sup> Clearly, concentrated state ownership and political influence did not stand in the way of these firms' expansion and their global prominence. Quite the contrary.

China's capital market has similarly avoided the conventional receipt for growth while sustaining one of the fastest capital market growth rates in economic history (Figure 0.1).

China's capital market has seen largely constant and significant growth, as measured by total market capitalization and by the number of firms listed. At the end of 2005, mainland China stock exchanges – the Shanghai Stock Exchange (SSE) and the Shenzhen Stock Exchange (SZSE) – had 1,377 public companies with a market capitalization of 401.8 billion USD. In 2010, the number of listed firms reached 2,063 with a total market capitalization of 4.028 trillion USD. By the end of 2019, China's capital market reached a striking 3,777 firms listed, with a total market capitalization of 8.5 trillion USD (Figure 0.2).<sup>12</sup>

As seen in Figures 0.1 and 0.2, the growth of China's capital market is telling in relative terms as well. In less than three decades, the market grew to be the second largest in the world, outgrowing veteran competing markets. It now represents 10.1 percent of global stock market capitalization.<sup>13</sup>

<sup>11</sup> C. Milhaupt & W. Zheng, "Beyond Ownership: State Capitalism and the Chinese firm," *The Georgetown Law Journal* 103(3) (2014) 665.

<sup>12</sup> Data drawn from the World Bank. World Bank capital market data on the United Kingdom extends only through 2014.

<sup>13</sup> China's total market capitalization is second only to the United States', whose market capitalization represents thirty-six percent of the global market capitalization.

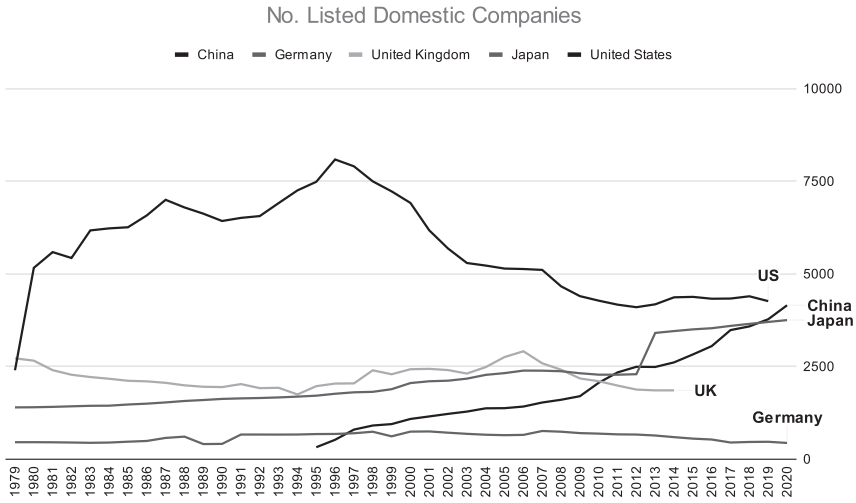


FIGURE 0.2 Number of listed companies, compared

Interestingly, notwithstanding the preference by some Chinese firms to list offshore (mainly high-growth tech companies), the number of IPOs (initial public offering) in China continues to rise, reaching 429 IPOs in 2017, 36 percent of global IPOs that year.<sup>14</sup> This occurred while the OECD reports that capital markets in other countries have been shrinking,<sup>15</sup> and despite China's known stringent IPO approval system (recently being gradually replaced), and the relatively high cost of capital for Chinese issuers.<sup>16</sup> Extreme levels of oversubscription to Chinese domestic IPOs suggests high demand on part of public investors.<sup>17</sup> The demand by foreign investors is perhaps even more striking.<sup>18</sup>

<sup>14</sup> There was a sharp decline in 2018 and a rise thereafter with 197 IPOs in 2019. See "Global IPO Trends: Q4 2017," *EY Report*, at 15–18, <https://perma.cc/4RMQ-2Q4M>; Cf. "Global IPO Trends: Q4 2019," *EY Report*, at 16–19, <https://perma.cc/4RNS-Y9UR>. Note, these numbers represent mainland China only, excluding IPOs of "Chinese firms" in Hong Kong. The IPOs of Chinese firms comprise a substantial number of the Hong Kong IPO market. See *infra* note 33. After including IPO numbers in Hong Kong, greater China markets had 394 IPOs in 2020 (up until and including Q3), forty-five percent of global IPOs. See E. Cheng, "Chinese Companies Are Leading the IPO Rush Amid a 'Flight from Uncertainty'," *CNBC* (Oct. 27, 2020), <https://perma.cc/WBZ3-MK2K>.

<sup>15</sup> "OECD Corporate Governance Factbook 2019," OECD 18–21 (2019), [www.oecd.org/corporate/Corporate-Governance-Factbook.pdf](http://www.oecd.org/corporate/Corporate-Governance-Factbook.pdf).

<sup>16</sup> Y. Qian et al., "Initial Public Offerings Chinese Style" (Jan. 13, 2021) (working paper), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3682089](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3682089).

<sup>17</sup> Of course, price restrictions may artificially boost demand.

<sup>18</sup> T. Groswald Ozery, "Illiberal Governance and the Rise of China's Public Firms: An Oxymoron or China's Greatest Triumph?," *University of Pennsylvania Journal of International Law* 42(4) (2021) 921 (an effort to explain the puzzle of foreign investments in the Chinese capital market).

If a reliable, effective, and efficiency-oriented legal system was in place, the picture above would not have been so puzzling. Such a legal system would have presumably supported private ownership and other investors' rights, overcome a multitude of structural predicaments that characterize public share ownership in China, reduced the cost of doing business and raising capital, and thereby would have supported and explained growth. Having such a system in operation would have conformed to many prevailing views in both law and development and comparative corporate governance analyses.

The rise of firms in China and the growth of its capital market, however, had little to do with such a legal framework. Indeed, as this book and others have shown, the impressive development above has happened even while the Chinese Party-state maintains market control, state ownership, and weak legal institutions. State ownership and political governance mechanisms are deployed in many Chinese firms, and their presence is growing. Not only have these mechanisms not receded as the market grew strong, in fact they have only amplified, while many corporate laws and traditional governance institutions remain weak by design.

Many prior studies have explicated this puzzle, pointing to the ways in which China's growth diverges from the "economic-rights-security → leading growth" premise.<sup>19</sup> The problem lies in that most critiques of the premise rely on the same analytical framework that highlights the economic functions of law. Consequently, the studies inevitably undervalue the role of law in China's development process. Put differently, focusing on the economic functions of law, legal scholarship naturally pivots around the quality of rights-securing legal institutions, particularly private enforcement through the court system. As a result, many scholars across disciplines and popular thinking outside China assess the role of law in China as a mere political instrument, a marginal governing tool secondary to political edicts, or simply view it as window dressing with little contribution to the country's economic rise.<sup>20</sup> When one looks only to the economic-rights-securing promises of law, a disregard for the role of law in supporting China's growth becomes almost inevitable.

<sup>19</sup> Clarke has labeled this premise "The Rights Hypothesis." D. C. Clarke, "Economic Development and the Rights Hypothesis: The China Problem," *The American Journal of Comparative Law* 51(1) (2003) 89; see also X. C. Long, "Does the Rights Hypothesis Apply to China?," *The Journal of Law and Economics*, 53(4) (2010) 629; F. Upham, "From Demsetz to Deng: Speculations on the Implications of Chinese Growth for the Law and Development Theory," *New York University Journal of International Law & Politics*, 41(3) (2009) 551; J. K. M. Ohnesorge, "Developing Development Theory: Law and Developmental Orthodoxies and the Northeast Asian Experience," *University of Pennsylvania Journal of International Economic Law* 28(2) (2007) 219.

<sup>20</sup> Several studies share the position taken in this book and do not find a simplistic instrumentalist view about law in China satisfactory. Recent studies that offer a more intricate analysis of Chinese law instrumentalism include T. Zhang & T. Ginsburg, "China's Turn toward Law," *Virginia Journal of International Law* 59(2) (2019) 306; S. Liu, "Cage for the Birds: On the Social Transformation of Chinese Law, 1999–2019," *China Law and Society Review* 5(2) (2021) 66; S. Wang, *Law as an Instrument: Sources of Chinese Law for Authoritarian Legality* (Cambridge University Press, 2022), pp. 162–177.

In this book, I call to reevaluate that approach.<sup>21</sup> The framework that was used thus far, although valuable in questioning the “economic-rights-security → leading growth” premise itself, does not explain China’s growth puzzle and creates a dissonance with the extent to which the Party-state has been advancing the use of law to govern markets over the reform eras.

We have been too quick to dismiss the role of law in China’s economic development as we have neglected to fully evaluate and understand its political functions. The book offers an alternative framework through which to observe China’s growth puzzle and to assess the role of law within it. The alternative framework studies the relationship between formal law and market development in China from the vantage point of political power dynamics. Analyzing the role of law through this framework allows us to appreciate the full functions of law in the development process. It suggests that the law supports China’s market development in a multitude of ways, notwithstanding its slow-to-evolve, and at times limited, economic functions.

The book employs two layers of analysis: the market development macro layer and the corporate governance and capital market micro layer.

Part I delineates the conceptual and analytical frameworks underpinning the book. Chapter 1 explains the traditional framework that commonly guides thinking about the role of law in development and in financial markets specifically. Chapter 2 presents the difficulties with the traditional approach and offers law and political economy as an alternative analytical framework.

Part II establishes the new framework by tracking the evolving role of law in China’s market reforms and identifying how the two functions of law – economic and political – have developed side by side, each supporting the other. I examine the legal configurations of political-power dynamics through a systematic investigation of the vast body of market-related primary and secondary sources of law and CCP documents that have been promulgated in China since early reforms until the present day. This part of the book offers a macro layer of analysis which outlines a three-stage shift in the allocation of market governance authorities within the Party-state system through legal evidence:

Chapter 3 looks at the role of law during the Early Reform Era (Dec. 1978–1991), when the Party-state vested economic decision-making authorities with its local governments, giving them a relatively free rein to experiment with and administer economic activity by limiting central government law-making. Chapter 4 moves on to examine the subsequent Legal Modernization Era (ca. 1992–2009) – a golden age for legal reformers in China. During this era, market governance authorities were reconfigured and recentralized with the central state through a massive project of national-level institutional and legal reforms. This reconfiguration of powers

<sup>21</sup> Yu Guanghua took a similar perspective combining law with politics to understand economic development in his book: G. Yu, *The Roles of Law and Politics in China’s Development* (Springer, 2014).

via the legal system also set the foundation for what is known today as China's state capitalism. Chapter 5 examines the current era, which I label the Legalized Politicization Era (2010–present). During this era, the consequences of state capitalism brought a new reconfiguration through law in two directions, intensifying the presence of the regulatory state in the market on the one hand while shifting substantial market governance powers directly to the CCP itself on the other.

Relying on these findings, Part III then applies the suggested analytical framework of law & political economy at the micro level by delving deep into China's corporate and capital market development puzzle. Here, the book merges questions about the role of law in development with inquiries on the evolution of financial markets and corporate governance specifically. This Part uses the alternative analytical framework developed in Parts I and II to better understand the evolution of the public firm and the role of law in China's capital market growth. It demonstrates how the explanatory power of law and political economy can bring more clarity to China's evolving approach to corporate governance. Here, I analyze the evolution of the public firm in China and pay particular attention to the creation and efficacy of corporate governance institutions, both traditional and idiosyncratic, that operate in the market:

Chapter 6 focuses on the emergence of the public firm in China and looks at how the legal framework that governed firms in the early stages of market development was shaped by, and helped secure, the political-economy dynamics of that time. Chapter 7 moves on to examine the corporate governance institutions that developed during the legal modernization era. The chapter provides a thorough analysis of traditional corporate governance mechanisms, both internal and external to the firm, showing how China's facially convergent, investor-oriented corporate governance framework diverges in practice. It illuminates the political functions of law in this era, showing how the corporate governance framework supported the reconsolidation of powers and the shift toward state capitalism. The chapter also offers comparative insights drawn from additional systems of corporate governance and analyzes the implications of China's corporate governance framework for investors. Chapter 8 looks at the recent politicization of corporate governance in the current era. It explicates how the CCP has advanced its corporate governance capacities and its roles in governing markets more broadly, through the use of law. Chapter 9 considers the potential benefits and costs of using a politicized corporate governance system as a functional alternative in the Chinese market.

The analysis illuminates how political-power shifts at each era of development resulted in the reconfiguration of the legal framework that governs the market, and how such reconfiguration, in turn, helped secure a new political-economic equilibrium. These iterative dynamics also mobilized market participants (both economic and political) to develop and deploy various growth-promoting

mechanisms within firms and in the market at large. Such mechanisms at times supported, at times impeded, and at times substituted for conventional corporate governance institutions.

When applied to China's capital market development puzzle, the law and political economy framework not only helps us to better understand the existing infirmities in the Chinese market but also may hold the key to understanding its unprecedented success. The framework, furthermore, provides new insights on the different functions that the law may hold in the development process.



## PART I

## Economic Development and the Role of Law

Scholars have long regarded certain attributes of corporate governance (i.e., a term that can be broadly defined as the legal and market mechanisms that govern the relationships between different constituents of a firm), particularly legal institutions that protect investors, as engines for financial development, capital market expansion, and growth. Yet, the development of China's market challenges many of the underlying assumptions in such theories and leaves its observers puzzled. Consequently, many have dismissed the role of law in China's economic rise. But they have neglected to consider the political functions of law and how these functions have bolstered the development of the Chinese market. Chapter 1 unpacks the traditional framework that shapes how scholars and policymakers think of corporate governance and its role in financial development and market growth. Chapter 2 offers law and political economy as an alternative analytical framework through which to address the puzzle and the role of law within it.

## 1

## The Traditional Framework

The linkages between corporate governance, financial development, and economic growth more broadly have a long intellectual pedigree. Legal scholarship in the field, specifically, has drawn upon two main strands of literature, law and development studies and the new institutional economics (NIE) tradition. These strands of thought, both developed in the Western parts of the world, in many ways laid the foundation of the main building blocks of corporate governance scholarship – the theory of the firm, agency costs analysis, and eventually the law and finance approach.

Law and development took root as a distinct field of legal studies following World War II, when efforts to reform legal systems around the world became systematic.<sup>22</sup> Growing out of the “modernization movement” of broader social sciences,<sup>23</sup> law and development theorists supported the notion that the adoption of certain principles, said to characterize the “advanced” societies of the time, can accelerate stages of development in others. Particularly, it was argued, underdeveloped societies can march toward modernity and prosperity by the “diffusion of capital, institutions and values from the First World ... involv[ing] the emergence of a free market system, rule of law, multi-party politics, ... and protection [of] human rights and basic freedoms.”<sup>24</sup> Having modern laws was thus perceived to be a prerequisite to development.

With the rise of neoclassical economics, however, the development discourse turned away from thinking about law to ideas of limited government as the basis

<sup>22</sup> The observation that law and economic development are related is of course much older, dating back at least to the nineteenth-century sociologists and political economy thinkers Max Weber and Karl Marx and their views on the rise of capitalism in Western Europe. For an intricate examination of Weber’s thesis about the connection between capitalism and the existence of a “logically formal and rational legal system,” see, A. H. Y. Chen, “Rational Law, Economic Development and the Case of China,” *Social & Legal Studies* 8(1) (1999) 97.

<sup>23</sup> D. Trubek & A. Santos, “Introduction: The Third Moment in Law and Development Theory and the Emergence of a New Critical Practice.” In D. Trubek & A. Santos (eds.), *The New Law and Economic Development: A Critical Appraisal* (Cambridge University Press, 2006).

<sup>24</sup> K. Davis & M. J. Trebilcock, “The Relationship between Law and Development: Optimists versus Sceptics,” *The American Journal of Comparative Law* 56 (2008) 895, at 900.