

ECONOMIC INSTITUTIONS IN CHINA: REFORMS AND TRANSITION

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ABSTRACT

The functioning of economic institutions is vital in all economies. This paper examines the current structure of economic institutions in China. The objective is to evaluate the viability of economic institutions in providing the necessary framework for the country's rapid economic growth. The paper discusses the nature and effect of the existing administrative structure and the functioning of economic institutions. Topics discussed include property rights, contractual rights, foreign direct investment policies, privatization, capitalization, banking, financial reforms, intellectual property rights, economic and political risk, corruption, and the need for reforms to establish key supporting institutions to assist economic growth and development in the region.

INTRODUCTION

There has been a plethora of literature on the sudden growth of China as an international economic power but the reasons behind such growth have rarely been analyzed. The growth has mostly been attributed to increased Foreign Direct Investment. For example, in 2006, \$7.5 billion FDI was invested in China in every six weeks (World Bank, 2008). Multinational companies and Chinese citizens have benefited greatly from the country's rapid economic growth. Investors realized huge savings mostly from cheap labor and location-specific advantages, amounting to \$70 billion in 2005 (Morgan Stanley, 2007). At the same time, the nation has become richer, enabling Chinese citizens to buy more industrial and foreign import products. The average per capita income in China increased five times since the country's economic boom started.

However, despite this rapid growth, China continues to be a difficult and controversial market with many opportunities and threats. In *The Elephant and the Dragon*, Meredith (2007) reports that more than \$60 billion has been invested in China since 1978, surpassing what the U.S. spent on the Marshall Plan. China's cheap labor has been a big incentive to investors to move their production and manufacturing there. At the same time, the size and location of the country offer the advantage of easy access to a huge market (1.3 billion consumers in China) and easy proximity to the region, a rapidly growing Asian market. According to Morgan Stanley (2007) labor costs savings in China amounted to \$70 billion in 2006 for U.S. companies, increasing their profits and passing on \$100 billion in savings to American consumers.

China's economy seems to have taken off like a rocket, but the rise has not always been smooth. During the early 1990s, foreign companies encountered many difficulties operating in China partly because of the Chinese government's strict policy on foreign investment and partly because of the huge bureaucracy, corruption, and differences in the cultural, political, economic, and business environment. Many foreign companies found that they were wrong about their profit predictions in China, even though Chinese incomes have more than doubled in a decade. China reached an average GDP per capita of \$2,000 only in 2007 and there has been a

continuous wide gap between regions and incomes across the country. Although one hundred million Chinese were able to afford nonessential goods in 2006, a great majority of Chinese still cannot afford basic products such as toothbrush, cars, or computers (Meredith, 2007). However, the increase of middle-income consumers is expected to rise to 200 million by 2010 which will create a market nearly as big as the US or the EU.

Despite the increasing opportunities, a recent survey conducted by the World Bank shows that only about 38% of all foreign invested manufacturers were covering their operating costs in China (World Bank Report, 2008). The costs of doing business in China include dealing with inefficiencies due to lack of training and technology, difficulties in government bureaucracy, delays caused by slow financial transactions, and differences in legal, political, cultural and economic environment. China's business climate, despite its opportunities, continues to be slowly evolving to include market forces and integrate competitive factors of a global economy.

LITERATURE REVIEW

Economic institutions are formal organizations created by members of society to undertake a particular type of activity. North (1990) defines institutions as: "the rules of the game in a society, or more formally, the humanly devised constraints that shape human interaction" (p. 3). Economic institutions provide a framework and structure for all economic activity of a country. The system may encourage or discourage economic activities of entrepreneurship, innovation, trade, foreign investment, industrial growth and economic development. Economic institutions also provide the framework for consumers and industry for savings, investment, spending, monetary/financial rules, foreign exchange operations, profit, and economic growth orientation.

The main role of economic institutions is to provide a mechanism for decision-making about what, how, and for whom will society perform the economic activities that are considered a priority in that nation. Economic institutions are the fundamental determinants of economic development. Developing countries that adopted protection of property rights, free trade, and an open-door policy for foreign investment were able to achieve a rapid economic progress in the last decade (Bosworth & Ofer, 1995, Shanker, 2003, Winters & Yusuf, 2007).

The manner in which economic institutions operate depends on the type of economic system that the country adopted. China has a command economy with a communist government that has allowed for gradual introduction of market forces in the economy. According to the Pew Research Center (2009), China's GDP in 2008 had an increase of 10.4% compared to that of last year. The country also had a trade surplus of \$86B, up 83% from last year. FDI investment has increased manifold but the majority of business is still conducted in state-owned-enterprises (SOE) that are often inefficient and highly bureaucratic, lacking innovation and profit motives.

China's central planning system has a high degree of control by the central government and the concentration of authority leaves little space for decisions outside of the plans which further straightjackets the ability for economic agents' decision making. Local governments are granted little discretion over resources and decision making and are allowed only to act on behalf of the central government to carry out rules as instructed. The two main fatal effects of this system are: (1) lack of information for effective decision-making and (2) lack of economic incentive for

achieving (a) productive efficiency: ensure maximum production possible with limited resources at the lowest minimum price possible and (b) allocative efficiency: ensure production of the right goods with maximum utility to customers.

MARKET TRANSITION

Economic Reforms

China's economic reforms started with first breaking-up the rural cooperatives that hindered the agricultural growth. Privatization policies included the 1999 Constitutional Amendment that allows the formal recognition of the private sector in China but only leading to the formation of a socialist economy. Privatization proceeded in three phases: first, private firms only supplementing the state sector, next, allowing for small business formation, and recently, larger scale privatization permitted in 15 targeted industries (Diamond, 2005 and Greif, 2006).

These reforms encouraged entrepreneurial start-ups and small business ventures on a small scale. The idea of profit-making, which was strictly prohibited under communism, became acceptable and spurred a new type of behavior among entrepreneurs and small business owners. The next phase of reforms consisted of privatization of state-owned enterprises by encouraging foreign investment and joint venture formation to increase economic and industrial development. The infusion of foreign capital, technology, and management knowledge created incentives for achieving market efficiencies and economic growth (Winters & Yusuf, 2007).

To further encourage foreign investment, the government introduced several Foreign Economic Trade Zones (FETZs) that offer tax incentives, tax preferences, and free tariff area for company operations and merchandise storage/distribution. These policies further accelerated economic growth as FDI contributed to much needed capital infusion, infrastructure development, labor and management training, and technology adoption. Furthermore, FDI provided jobs for Chinese labor and contributed to the increase of incomes of millions of Chinese people (Bosworth & Ofer, 1995).

Banking and Financial Reforms

In the command economy, the banking system is a conduit of capital flows from government to state-owned enterprises. In the socialist system, prices were set without regard to cost. Therefore, state-owned companies were generally unprofitable and had to be supported by government loans. As a result, banks were burdened with a huge portfolio of non-performing loans.

In addition, most command economies, the service sector is hugely inefficient. China's banking industry had serious problems. Customer service was pitiful, back-office operations were outdated, many of the advanced financial products were unavailable to customers, and technology upgrades were in dire need. Chinese banks have been an obstacle to the country's transition to a market economy (Prime, 2002). Bank liberalization was needed to assure further economic growth.

When China joined the World Trade Organization (WTO) in 2001, one of the stipulations was to adopt the market mechanism for allocating economic resources. Price controls had to be

abolished and the government had to relinquish direct involvement in the management of SOEs (Toshiya, 2002). Banking, insurance, information technology, and telecommunications had to become accessible for foreign companies over a period of several years. Financial services and banking was limited to 49% foreign ownership (Clifford & Roberts, 2001). Privatized SOEs, FDI, JVs, and new private companies became the main vehicles for economic activity.

Under the WTO arrangement, China agreed to 100% foreign ownership in banking after 2005 and the phase-out of geographic restrictions. The agreement states that two years after accession, foreign banks would be allowed to conduct local currency transactions with Chinese enterprises. Transactions with Chinese individuals would start five years after the initial membership. After a period of five years, there would be a complete lifting of geographic and customer restrictions for foreign banks. According to this, foreign banks would be able to operate anywhere in the country, take deposits and make loans in local currency, having full privileges in every aspects of banking and financial services (Geib & Pfaff, 2005).

However, so far the restrictions on foreign ownership in Chinese banks have been limited to 20% per individual foreign shareholder and 25% total foreign ownership which indicates that control has been in Chinese hands mostly (The Economist, January 7, 2006). The new regulations following WTO membership have increased foreign bank activities in China. According to Clifford & Balfour (2002), several US banks were negotiating deals with Chinese banks. Citibank started negotiations with Pudong Development Bank in Shanghai. HSBC, the private equity arm of J.P. Morgan, invested into the Bank of Shanghai. However, overall there was a slow progress and red tape kept foreign banks from opening more than one or two branches per year (Clifford & Balfour, 2002).

By the end of 2003, the need for reforms in the banking system became even more important due to the undervalued Yuan. To address the currency issues, the banking system had to be reorganized. The State Council, called for broad changes in 2004, such as trading of state-held shares and liberating investment rules for pension funds. Hong Kong banks were allowed to accept Yuan deposits and the Bank of China and China Construction Bank (CCB) were prepared for global listings (Balfour, 2004).

However, in spite of China's outstanding growth, most of the money from exports and savings by citizens was poorly allocated by China's big banks and local lenders. According to Ernst & Young's 2006 report, China's non-performing loans had nearly doubled since 2002 (Mandel, 2006). To resolve this financial distress, the plan was to link the Big Four banks in China, which together made 57% of all corporate loans, with one or more foreign banks before the end of 2006. This would allow the banking industry to be fully open to foreign investors. The hope was that foreign stakeholders with their expertise would reform operations and straighten out the big banks' loan portfolios. However, according to analysts, government overseers would not allow foreign partners too much real control over management (Bremner, 2005).

By October 2005, 22 foreign banks had spent \$1.65 billion on stakes in 17 mainland lenders but had gained little real influence in the China's banking system (The Economist, January 7, 2006). Bank of America paid \$2.5 billion for a minority stake in CCB. CCB was the first to go public and sell shares overseas. Several other major US banks and investment banks such as Citigroup,

Goldman Sachs, HSBC Securities and American Express paid up to \$20 billion to buy into China's financial institutions (Bremner, 2005).

Today, China's banking system is less dominated by political lending and has some nominally stronger banking institutions than before reforms started. However, the financial system is still at an introductory stage in China. The use of the banking system and payment system in China is still limited. For example, debit cards were only introduced in 1993 and the use of credit cards has still not become universal according to Euro Monitor (2006). The four largest state-owned banks, The Bank of China, Industrial and Commercial Bank of China, CCB, and Agricultural Bank of China, have all started to offer their own personal investment services. However, this market lacks relevant legislation (Euro Monitor, 2006).

Progress has been made by the Chinese government recapitalizing the largest state-owned banks. The know-how and technology supplied by minority partners (foreign banks and investors) has started some modest modernization and improvement of Chinese financial institutions. However, the Chinese government agencies use red tape, long time tables, and capitalization requirements that are restrictive and keep foreign banks from expanding fast in China. Furthermore, oversight, transparency, and relevant legislation are still lacking. Therefore, government red tape and local bureaucracies hinder banking reforms that can provide a well-functioning financial system.

Laws and Legal Protection

According to North (1997):

In the Western world the evolution of courts, legal system and a relatively impartial body of judicial enforcement has played a major role in permitting the development of a complex system of contracting that can extend over the time and space, an essential requirement for a world of specialization" (p. 2).

Qian (1999) notes that one of the most important aspects of the economic role of the "rule of law" is the law applied to the government to provide a foundation for secured property rights. Under communism, laws regulating individual and property rights are practically non-existent or grossly limited. However, to ensure efficient market behavior, it is necessary to have a system of laws that ensure property rights and regulate individual and business behavior with clear guidelines on individual rights, liabilities, and obligations. The government should protect private property rights to enforce contract and to create a level field for market competition.

Only in 1999, the principle of governing the country according to law was incorporated in the Chinese constitution (Li, 1999). Although foreign investment penetrated every major manufacturing sector through joint ventures, technology transfer, export manufacturing, public securities, construction, real estate, and heavy industry, according to Corne (1997), the legal system in China is still uncertain. The law appears to be vaguely drafted, misapplied and arbitrarily enforced.

The Western style laws were introduced to attract foreign investment but the extent to which these have been established in the socialist legal system is open to question. Corne (1997)

characterizes this as a “normative dislocation” because the normative cultural values influenced how the Western laws have been practiced often leading to nepotism, corruption and guanxi to run the system.

The Company Law of 1994 regulates the rights of Private Chinese citizens to ownership of a company and limited liability enterprise. The Company Law of 2000 stipulates three types of companies: state-owned company, limited liability company, and joint stock company. The Foreign Invested Enterprise (FIE) law covers three types of enterprises: equity joint venture, contractual joint venture and wholly foreign-owned enterprise. Unlike in Western countries, the incorporation of a company is created not by right but through approval by the Ministry of Foreign Trade and Economic Cooperation (MOFTEC) and the Office of State Administrative of Industry and Commerce (SAIC).

Interestingly, Chinese written law does not reflect Chinese law in practice. Yuan (2000) notes that “part of the explanation of this problem is the de facto supreme position of the Communist Party in China... The policies of the Communist Party of China are superior to the constitution and to governmental legislation... Therefore, some provisions of the Company Law and the FIE laws are not strictly enforced and are sometimes even totally disregarded by government agencies and that some government agencies, without any statutory authority, may impose additional requirements to the written laws and regulations (p. 483).

Administrative law comprises organic law, civil servants law, administrative acts, and sectorial law. Sectorial laws include administration of foreign investment, industry, public security, customs, finance, city ordinances, advertising, prices, transport, health, safety, insurance, environment, patents, labor, quality, product standards, and natural resources. Unlike Western democracies, administrative organizations in China exercise overwhelming power in the Chinese legal system, acting as legislative, interpretive, and enforcing institutions.

To introduce market socialism and also maintain central state control, China adopted a rationale that lends itself to the creation of laws that are “inherently flexible so that they may be adjusted according to the vagaries of human behavior” (Corne, 1997, Shanker, 2003). For example, the new Company Law of 2000 is vague about private property when it talks of special rights over assets belonging to privatized companies.

Several individual laws govern governing economic contracts, technology contracts, contracts between Chinese and foreign partners, labor rights, and labor contracts (Shanker, 2003). Recent reforms were aimed to assure a more systematic assurance of protection of value, business ownership, and individual property rights. However, more improvement is needed to provide legal protection for individuals and business interests in China.

Intellectual Property Rights

China’s intellectual property rights (IPRs) are highly debated. In spite of the Sino-US agreements, the US lost over \$2 billion due to intellectual property piracy in China (Seth, 1998). The 1979 Agreement between China and the US required that “each party shall seek under its laws with due regard to international practice, to ensure to legal or natural persons of the other

party protection of patents and trademarks and shall take appropriate measures of copyright protection correspondingly.” Following this, China introduced a new trademark law in 1982 and patent statute in 1984, and joined the Paris Convention for the Protection of Industrial Property in 1982 and 1984 respectively.

Following China being placed on a priority watch list, China passed a new copyright law in 1990 and a separate set of computer software regulations in 1991. After threatening each other with trade sanctions, China and the US signed a Memorandum of Understanding on the Protection of Intellectual Property, also called the 1992 MOU. However, according to the National Trade Estimate Report of 1995, US industries lost more than \$850 million due to copyright theft alone which was further accentuated by the export of counterfeit products to other countries (Hu, 1996). According to Feder (1996), “intellectual property laws in China are sporadic at best and virtually non-existent for copyrighted works.”

On February 16, 1995, Chinese Minister Wu Yi confirmed a series of actions taken and also enclosed an action plan to deal with the infringement of intellectual property rights. Among this was the closure of 26 compact disc factories including The Shefei factory in Shenzhen (Shanker, 2003). The new Accord stipulated that China would close down its piracy factories but it forbade American officials from monitoring and conducting on-site verification.

Despite the new agreements, Chuang (2000) found that counterfeiting of trademarks, brands and other forms of intellectual property appears to be still on the rise in China. US Customs seized counterfeiting and infringing goods worth \$29 million from China making China the leading country of origin of counterfeit goods accounting for 28% of the total seizure in the US (Chuang, 2000).

Wang (2000) and Hu (2001) note that the problem of intellectual property rights in China relates to the “infant legal system” which has just started to come to terms with the enactment and enforcement of the Intellectual Property Law. The authors note that China has not been a pluralistic society and did not need laws regulating business transactions because it was a small scale farming society. The rule of law was approved only in principle until 1996. China’s legal system is still in the developmental stage.

The legal profession has been established only in the 1980s and Chinese law firms are not state funded. Judges are not qualified at all and the majority of the judges have political background and no legal background, many of them coming from the army. Legal training is not necessary to become a judge. The law of judge was enacted only in 1995. There are only a very few contract theories and rules in old traditional China and practically none in socialist China.

Recent piracy and copyright violations include Kiwi shoe polish, Dupont chemicals, Chrysler Jeeps, Kellogg’s cereals, Eli Lilly products including several pharmaceuticals and Prozac, fungicide Limisil and the immunosuppressive agent Neoral both patented by Novartis AG. The lack of IPR protection in China creates high risk for foreign investors and undermines trade relations between the US and China. Therefore, it must be drastically addressed.

IMPLICATIONS

The above analysis suggests that China must introduce an institutional system that provides the framework and rules of a market oriented economic, financial, and legal system that allows for economic growth, protection of individual rights, contractual rights, foreign investors' assets, and assurance of intellectual property rights and their enforcement.

China is fast emerging as an economic super power. However, its institutional system must be modernized to assure further economic progress and transparency in business transactions. China is in an early stage of the development of a commercial banking system, rule of law including company law, institution of private property, intellectual property laws, and privatization.

However, ethnic Chinese networks along with discriminatory preferential treatment of Chinese products compared to products from other developing countries by Western countries helped China gain a significant share of foreign investment. The lack of democratic labor rights has also made China an attractive investment and production center for a large number of multinationals.

Difficulties in conducting business in China relate to high bureaucracy, government corruption, slow payment, questionable labor practices, human rights violation, safety and quality issues, intellectual property rights infringement, and environmental safety issues. These constitute high risk in the economic, political, and economic environment of the country. Despite the many opportunities in China, these issues must be addressed both at the macro and micro-level.

RECOMMENDATIONS

Economic challenges in China include increasing disparity between regions that are industrialized and those that are not, such as mainland China. With an increasing middle-class, China needs to institute a system of sound income distribution that balances income disparity while it allows for incentive of productivity and efficiency.

China has an ageing population that requires support and economic safety net. However, there is no formal social security system and no formal organizations that can address this in China.

China must reform its tax laws as these are vague and not enforced efficiently. IPRs, property rights, and contract rights must be strengthened to ensure individual and business interests and provide a mechanism for enforcement and incentives for innovation and entrepreneurship.

Reforms of the financial and banking sector must assure efficiency and capital formation incentives, as well as transparency in financial reporting, accountability, sound financial backing of loans, modernized banking services, improved management, infusion of foreign bank ownership, and the protection of foreign investment stakeholders' interests.

China's rapid industrialization and lack of environmental laws must be addressed to assure strict environmental regulations that protect the country's natural resources and assure a safe and healthy environment for individuals and business using sustainable and socially responsible business practices.

CONCLUSION

China is a growing market that has a huge potential for economic development. However, the economic institutions are not providing for economic efficiency even though economic reforms have allowed for transformation of SOEs and gradual market reforms with an infusion of FDI and private enterprise development.

For China to become an economic power in the 21st century and to participate in global business, the institutional systems must be reformed to assure economic freedom, financial stability, legal protection of property, contractual rights, intellectual property rights, and laws and mechanisms that protect individuals, businesses, and foreign enterprises.

Furthermore, economic, administrative, and legal frameworks must curtail the wide-spread corruption to assure transparency, reduce bureaucracy and government red tape, and institute policies that encourage innovation, capital formation, economic growth, and entrepreneurship.

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