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Institutional Analysis of Legal Change: The Case of Corporate Governance in China

Sonja Opper*
Sylvia Schwaag-Serger**

During the last three decades, China has undergone a period of unprecedented institutional change. The gradual market transition of the economy and China’s integration into the WTO have created a strong demand for new laws and regulations. For institutional economics this period provides a unique opportunity to study the qualities, implications, and driving forces of distinct legal arrangements and their impact on economic development in transition economies. Empirical research not only provides insight into China’s emerging legal system, it also promises important feedback effects for the field of institutional economics. In this paper we argue that meaningful analysis of legal change in transition economies, such as China’s, must look beyond change of law in the books; it requires analysis of institutional frameworks that shape social behavior, which in turn explain the effectiveness of changes in the law. Using the example of corporate governance, we show that changes in the law have not sufficiently been matched by changes in institutional conditions, explaining why, in spite of far-reaching judicial reform, Chinese corporate governance still displays significant weaknesses in practice.

INTRODUCTION

Transition economies are characterized by far-reaching transformations, and often sudden changes, in their given institutional settings, which are not normally observable in advanced market
economies. With rapidly progressing lawmaking processes, transition economies naturally emerge as one of the main field laboratories for studying legal change. Compared to the early twenty-first century, virtually no other period in economic history provides such a high concentration of law-making, such an encompassing breadth of new formal institutions, and such a variety of distinct approaches to implement new formal rules.

This has opened a rare window of opportunity for empirical research. The majority of legal research typically focuses on the quality of new formal norms, but quality assessments are often derived by cross-national and “best practice”-comparisons. For transition economies, however, experience shows that a one-sided focus on legal norms may not be fruitful. Many initially celebrated laws turn out to be ineffective and in need of further revision. An example frequently referred to is the much applauded international harmonization of China’s Intellectual Property Rights Law. Within only 20 years, China went from having no legal protection of intellectual property rights (IPR) to setting up a comprehensive legal framework for IPR protection that is largely in conformity with international standards and practices. Nonetheless, IPR infringements remain serious in China. As an example, according to a recent study by the Business Software Alliance (BSA) assessing software piracy, China’s software piracy rate, measured as the percentage of total software installed that was not legally acquired, was 86% in 2005, generating losses of 3.8 billion U.S. dollars.

We maintain that for transition economies, a one-sided focus on “law in the books” has an inherent tendency to overrate the quality of legality and the degree of international harmonization. Transition economies are typically characterized by weak traditions of private property rights, weak judiciaries, and behavioral patterns shaped by decades of socialist planning. Therefore, transplants of ideal-type laws, which operate successfully in western market economies, will

not exert similar effects in the transition context. Similarly, a one-sided focus on informal constraints would not help to understand economic behavior in transition economies.

Comprehensive institutional analysis that attempts to combine formal and informal norms offers a more reliable approach for capturing the complexities of legal change. Rule enforcement depends not only on the existence and quality of norms and state power; it is the “mixture of informal norms, rules, and enforcement characteristics together [that] defines the choice set and results in outcomes.” The focal interest is thus to understand and explore the institutions that actually shape and influence social behavior. Legal rules which are not enforced and do not influence individual behavior are, in this line of thought, not even regarded as part of an institution.

The case of corporate governance reforms provides a useful illustration of this analytical framework. In essence, the shift to Western-style corporate governance mechanisms implies that centralized and highly politicized command structures based on central planning are replaced by decentralized organizational structures and external market signals, which help to balance inherent agency problems associated with a separation of ownership and control. Legal research on emerging corporate governance systems in transition economies primarily focuses on the quality of new formal norms as specified in Corporate Law and Securities Law. In spite of careful studies of international best-practice in drafting these laws, one of the major lessons was that corporate governance would not automatically develop as a natural response to comprehensive privatization programs and shifts in formal control rights. Instead, privatization and the implementation of national corporate governance systems are actually two separate tasks of institution

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building. Neglect of the specific needs for appropriate internal and external governance mechanisms inevitably undermines the effectiveness of privatization programs. The widespread phenomenon of insider control in Russia, for instance, has been mainly attributed to deficient corporate governance mechanisms.  

This suggests complementing the analysis of new formal norms with a broader framework of corresponding institutional elements. In his *Institutions and the Path to the Modern Economy*, Greif’s definition of an institution as a “system of rules, beliefs, norms, and organizations that together generate a system of (social) behavior” provides a useful starting point. In this sense, legal rules *per se* are only one institutional element, while the quality of corporate governance as an institution is jointly determined by a complex system of complementary and interacting elements. When it comes to the institutional analysis of legal change, this complexity underlines the need to explicitly incorporate the interplay between distinct institutional elements that combine to form the broader system of corporate governance. Incompatibilities between new corporate laws and persisting informal norms may not only undermine the effectiveness of newly instituted formal norms; they can also give rise to informal opposition norms if preferences of stakeholders in an organization are in conflict with newly implemented formal norms. Also, interactions with complementary institutional elements deserve close analysis.

The weak correlation between formal shareholder rights protection and the development of financial markets in transition economies supports the view that law on the books has only limited

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7. Masahiko Aoki, *Controlling Insider Control: Issues of Corporate Governance in Transition Economies*, in CORPORATE GOVERNANCE IN TRANSITIONAL ECONOMIES: INSIDER CONTROL AND THE ROLE OF BANKS 3–30 (Masahiko Aoki & Hyung-Ki Kim eds., The World Bank 1995). Aoki ascribes negative performance effects of insider control in Russian firms to the fact that the Western paradigm of diffuse ownership was applied blindly. While potential principle-agent problems arising from small ownership concentration and widespread shareholdings are mitigated by efficient capital markets, the market for corporate governance, and the market for managers in Western market economies, such corporate governance mechanisms do not yet exist in transition economies. The malfeasance of agents in transitory firms is therefore hidden by an institutional vacuum, which allows the emergence of opportunistic behavior and insider control. *Id.*

8. GREIF, supra note 5.

explanatory power if corresponding institutional elements are missing. Newly emerging corporate governance systems therefore provide interesting cases to explore the operation of newly codified formal rules in a broader institutional framework, incorporating institutions of law enforcement, informal norms, and corresponding institutional elements.

Due to distinct contextual features, legal change in China may provide one of the most informative cases for analysis. Several features stand out. Most importantly, China is one of the few transition economies where market transition is not preceded or accompanied by political democratization, but rather orchestrated by the Chinese Communist Party (CCP). Due to the uncontested monopoly power of the CCP, one therefore would expect distinct trajectories of institutional change, which mainly serve the interests of the old political elite. Closely tied to the one-party rule of the CCP, China lacks an independent judiciary, one of the foremost preconditions for safeguarding property rights, and enabling growth and development.

Second, due to the distinct timing and sequencing of reforms, China’s transition period can serve as a classical example of gradual and evolutionary institutional change. When China’s “open door policy” was initiated in 1978, an overall reform strategy was missing and the eventual reform goal was not clearly defined. Instead it took another fifteen years of ideological debate until the central leadership agreed to institute a socialist market economic system. Furthermore, in contrast with Russia, China’s reforms remained largely independent from international policy advisors. More recently, China’s WTO accession in 2001 has exerted increasing external pressure upon the Chinese leadership to speed up legal harmonization.

of domestic laws in line with international standards and improved law enforcement. Overall, institutional change in China has mainly been determined by the interplay between changing political priorities at the central government level and a shifting power balance between the old political elite and new economic agents.

In the following section, we highlight the complexities of China’s corporate governance reforms in order to support our claim that institutional analysis of legal change needs to go beyond the analysis of legal norms. The remainder of the paper will first focus on the political economy of corporate governance reforms, and then shift to institutional complementarities and enforcement issues. The final section will conclude and call for further research.

I. POLITICAL ECONOMY OF CORPORATE LAW REFORMS

Politics is a major force shaping the structure of national corporate governance systems. In transition economies, the role of political interests is even more pronounced. While the development of joint-stock companies and corresponding corporate governance systems in the Western industrialized nations relied on endogenous evolutionary processes based on free exchange of property rights and profit making objectives, new corporate governance structures in transition economies were created in top-down approaches. This involved the (partial) replacement of established political governance structures reaching into the firm and a fundamental shift of control rights from political actors to private economic actors.

Such reallocation of control rights is likely to meet opposition by stakeholder groups who seek to defend their vested interests. On one hand, state actors defend their direct control rights and rent-seeking opportunities at the firm level as privatization of control rights would deprive them of a convenient instrument to influence local welfare and development (e.g. local employment, health, structural change.


etc. ¹⁷ Also, a redistribution of control rights to private economic actors would limit chances for rent-seeking behavior and other forms of private enrichment.¹⁸ Political opposition against purely market-based corporate governance is therefore likely. On the other hand, managers welcome the continuation of direct state-firm linkages to secure preferential access to resources in a highly insecure and rapidly changing institutional environment. This atmosphere of close and continuing state-firm relations gives rise to a new, hybrid economic order of “politicized capitalism” where state actors tend to remain directly involved in guiding transactions at the firm level.¹⁹ Although the newly instituted formal rules impose certain limits on state interventions in the firm, the system lacks clearly defined state-firm boundaries.²⁰

It fits well into the overall picture of politicized capitalism that the Chinese government rejected a complete privatization of the ailing state-owned sector. Instead, large State Owned Entities (SOEs) were corporatized, and partly privatized while the government maintained controlling shares.²¹ The goal was to raise equity capital without losing state firms as convenient policy tools to influence urban employment levels, and to steer and direct the development and growth of sensitive industries.²² Partial privatization and maintenance of controlling state shares allowed the state to control a growing pool of assets with a fixed pool of equity.


²¹ Id.

²² Donald C. Clarke, Corporate Governance in China: An Overview, 14 CHINA ECON. REV. 494 (2003).
A key element to secure persisting and unchallenged state-control was the establishment of a segmented stock market operating with different share-types and distinct trading rules. While shares held by the state (state-shares) and “legal person” shares are only transferable upon state approval, the domestic market of freely traded shares is limited to so-called A-shares and B-shares, which on average cover one-third of the total company stocks. Share trading across different share types is prohibited; a stable ownership distribution between the state, legal persons, and individual shareholders is thereby guaranteed. These features reveal that the government was not ready to lose direct ownership control over the public production sector but still sought to embed stock listings within the framework of socialist ownership. Stock market listings were, primarily, convenient tools to raise fresh capital.

This general motivation has strongly influenced China’s newly instituted corporate governance system. Particularly, China’s first Company Law (effective in 1994) reflects the government’s intent to provide a legal framework to modernize the state-owned sector without giving up the socialist principle of public ownership and state control. The provision of incentives for business development and private firm growth was not prioritized. In this sense, the Company Law in its original form displays a restrictive and suppressive character, signaling a historically deep-rooted skepticism toward any form of privately generated wealth not controlled by the state bureaucracy.

Formally, the Company Law specifies a hybrid corporate governance system, mainly modeled on the Anglo-U.S. system and complemented with elements borrowed from the German two-tiered
board system and components of the Japanese main-bank system.\textsuperscript{29} The eclectic mix of institutional elements, all successful in their respective institutional environments of origin, led to the creation of an organizational hybrid, which turns out to be particularly weak in exerting effective corporate controls, either market based or stakeholder-based. To further illustrate how general policy priorities shaped the Company Law and laid the foundations of a distinct, essentially patrimonial corporate governance system, the following section highlights two key areas of organizational reforms: the newly established vertical command structures within the firm and the extent of private shareholder protection.

\textit{A. Vertical Command Structures}

While China’s Company Law seeks to institute vertical command structures (including CEOs, boards of directors, and supervisory committees) resembling Western-style systems of organizational control, political control structures reaching into the firm have not been fully dissolved. The official policy-line was a separation of government and business,\textsuperscript{30} but formal rules reveal a certain degree of ambivalence and inconsistency. According to the official policy line, the state’s role was supposed to be constrained to that of a normal shareholder without any priority rights.\textsuperscript{31} In spite of these statements, the Company Law revealed a more ambivalent position toward firm

\begin{itemize}
\item \textsuperscript{29} O N KIT TAM, \textsc{The Development of Corporate Governance in China} (1999); Transparency International, Corruptions Perceptions Index 2007 (Sept. 26, 2007), http://www.transparency.org/news_room/in_focus/2007/cpi2007 [hereinafter CPI 2007].
\item \textsuperscript{30} This concept, referred to as “zhengqi fenkai,” was mentioned in \textit{Gufenzhi qiye shidian banfa}, in ZHONGGUO RENMIN ch. 1, ln. 1, (Daxue Jinrong yu Zhengquan Yanjuqu ed., 2000).
\item \textsuperscript{31} In this sense, it has been postulated that:
  
  The government performs the functions of shareholder in the state-financed enterprise or state shareholding companies via its designated representatives, enjoys rights to share profits from assets, make major decisions and select managers in accordance with the scale of investment, bears limited responsibilities for enterprise debts, and will not interfere in the daily operations of enterprises. . . . In terms of personal and financial management, party and government departments at different levels should fully separate themselves from the economic entities they run or enterprises they directly administer.
\end{itemize}
depoliticization. Article 14 codifies a continuing supervision of enterprises by the government and social masses. Inevitably, this claim is in conflict with the intended enterprise independence. More serious deficits of the official depoliticization strategy result from the continuing influence of the “three old political committees”—party committee, labor committee, and trade union—placed within the firm. Although these “old committees” lose a large amount of their inherited coordination and control rights to the newly established positions—CEO, shareholder, board of directors, and supervisory committee—their survival invites a continuation of political involvement within firm decisions. Particularly, their long tradition as central political bodies within the firm provides fertile grounds for continuing informal involvement.

Vague legal specifications facilitate political interference. Local party committees are supposed to exert their activities in accordance with the constitution of the CCP. Article 31 of the CCP Constitution, in turn, broadly delegates the implementation of Party decisions to the local Party committees. Further specifications of tasks and duties are not made. The lack of precise legal specifications seems to reflect the central government’s reluctance to respond to the economic necessity of building a new system of modern corporate governance, for fear of losing support from the political committees at the grassroots level. Former General Secretary Jiang Zemin even suggested broad responsibilities for the Party, saying it should (1) remain in charge of the overall implementation of the Party line at the firm level, (2) fulfill tasks related to production and management, (3) take part in important business decisions, and (4) assist and support the board of directors, the supervisory committee and management.

35. CCP CONSTITUTION, art. 31 (P.R.C.).
36. In accordance with this line of thought, Wu Bangguo (1997), member of the CPC Central Committee and a member of the Politburo of the CPC Central Committee since 1992, warned that the “Party must absolutely not lose its political leadership powers with regard to the enterprises,” and claimed that the “Party should take part in the decision-making in the enterprise with regard to major issues.”
Close overlap among these recommendations and specifications on the Party’s role in traditional SOEs, as codified in Article 32 of China’s Constitution, reinforces the state’s interest to maintain its control and right to participate even under the new corporate organization.

**B. Shareholder Protection**

While the specific legal rights of the party committees may not yet seem threatening, party control is reinforced through strong state ownership within the firms. With more than 80% of China’s listed firms being state-controlled, the Chinese market displays one of the highest levels of state ownership globally.\(^{38}\) In the Global Fortune 500 ranking from 2007, a list published annually by *Fortune* Magazine that ranks companies according to size, all 22 companies from mainland China that made it onto the list are state-owned.\(^{39}\)

Within such a state-controlled ownership structure, private shareholders have virtually no “voice” when it comes to crucial company decisions such as the selection of CEOs, and nomination of members for the supervisory board. In essence, the state is the largest shareholder and its administrative representatives can make recruitment decisions independent of all other shareholders. The resulting dependence typically guarantees close cooperation and communication ties between management, supervisors, and state representatives.\(^{40}\)

Limitations on individual shareholder rights further weaken shareholder protection, and increase the relative power of state-dominated insider networks. The Anti-Director Index covering a set of seven predefined dimensions of shareholder rights provides a convenient tool to proxy the extent of formal shareholder protection.\(^{41}\) While the underlying assumption that “good” legal provisions do not depend on contextual local features is surely

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contestable, the Index provides an informative measure on the
direction of legal change and on the extent of intended shareholder
rights protection according to the law.\textsuperscript{42} China’s Company Law
grants only three out of seven shareholder rights covered by the
Index. First, the law guarantees one vote for each share. Second, the
law provides legal mechanisms against perceived oppression by
directors. Finally, the percentage of share capital needed to call an
extraordinary shareholders meeting, is only 10%; quite low in
international comparison.\textsuperscript{43} However, it is notable that the 10%
benchmark is easily reached by a single “legal person” or state
shareholder, while the highly dispersed ownership shares of private
shareholders make non-state initiatives to call shareholder meetings
highly unlikely. The remaining shareholder rights covered by the
index are not granted.\textsuperscript{44}

A 2001 Supreme Court decision emphasized the oppression of
minority shareholder rights vis-à-vis the state-dominated firms listed
on China’s stock markets.\textsuperscript{45} First, the decision restricted lawsuits
against a listed company to those cases where companies lied in their
information disclosure. Market rigging and insider trading were
excluded as causes of action.\textsuperscript{46} Second, courts could only take up
civil cases if the Chinese Securities Regulatory Commission (CSRC)
already confirmed incidents of financial fraud.\textsuperscript{47} Though the CSRC is
formally legally independent, it is not sufficiently shielded from
political pressure exerted by party and government, who possess not
only regulatory, but also ownership interests of firms. In this sense,
the government has a vital interest to control the total amount of
pending lawsuits, as these feed back on the resulting investment
climate at the stock exchanges. The power of market supervision is
thus concentrated in the hands of the government and its regulatory

\textsuperscript{42} Pistor et al., \textit{supra} note 3.
\textsuperscript{43} Company Law (1994), art. 104(3) (P.R.C.).
\textsuperscript{44} These are the availability of proxy by mail, cumulative voting and the rule to not
block shares from trading before shareholding meetings.
\textsuperscript{45} See \textit{www.p5w.net}: CSRC Unhappy with Court Rulings on Losses, Nov. 2, 2001, \textit{and}
“Cases Against Stock Fraud Suspended”, \textit{CHINA DAILY} (Internet Edition), Sept. 27, 2001.
\textsuperscript{47} Id.
bodies, while individual shareholders enjoy only limited independent means to control and sanction financial malfeasance. Sluggish market development eventually led to three further amendments of the Company Law, which gradually increased shareholder rights. The last amendment, which became effective in 2006, now provides a legal basis for minority actions against controlling shareholders and fraudulent managers. If, for example, directors and senior management personnel breach their duties or the company’s articles of association, and thereby harm the interests of shareholders, a shareholder now has the formal right to sue them directly in court.

To sum up, the internal organizational structure and the extent and specification of shareholder rights originally formulated in China’s first Company Law—while modeled closely on Western models—reflects, in crucial areas, the government’s intent to establish a corporate governance system which combines state control and leeway for direct state intervention with limited protection of private shareholder rights.

II. LEGAL ENFORCEMENT

In addition to the politicized vertical command structure and weak shareholders protection, ineffective law enforcement further undermines the position of minority shareholders in China. To begin with, China’s legal history differs markedly from the civil and common law traditions, as civil order was mainly based on family and local community arbitration. Chinese law was essentially limited to criminal law. The concept of subjective rights, in contrast, has only a short history. It was imported from the Western imperial powers no sooner than the nineteenth century, and treated with great reluctance by the Communists until the beginning of economic reforms in 1978. Since then, China has forcefully sped up its legal reforms, but with two clear limitations.

To start, China shares problems typical of other developing and transition economies, such as insufficient financial resources and a

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scarcity of well-trained human capital. Most pronounced is a severe shortage of legal professionals. In China’s pre-reform period, there was nearly no legal recourse, or legal system in place, for private citizens seeking to address injustices or grievances. It is estimated that only one-fifth of all lawyers have formally studied law at an institution of higher education; the fraction of university trained judges is assumed to be even lower. Thus, the problem is more pronounced among judges than lawyers. Judges enjoy low social status and are poorly paid, which makes them particularly vulnerable to corruption. In spite of widely publicized efforts to clamp down on bribery, nepotism, and other abuses of power, corruption remains widespread and even seems to be rising again. According to the World Bank Governance Indicators, control of corruption has actually decreased continuously since 1996.

More importantly, the legal system did not change in one crucial aspect: it is still anything but independent from the Party. Local courts are restricted to a subordinate position in relation to the local party committees with court officers being “hired, paid and promoted” and budgets provided by local government officials. This invites political guidance and frequently skews court judgments against outsiders. Foreign shareholders, for instance, are typically in a weak position to sue their local partners. Local shareholders can exploit personal connections, which frequently leads to the judge’s

decision to dismiss the case or to delay a lawsuit. Similar problems apply to other individuals from outside a local context, as well as local people who do not belong to, or question, the network of political and local government interests. Lawsuits involving state interests are usually handled in line with political priorities such as local employment levels and welfare conditions. The threat of social instability, for instance, can have a decisive impact on court rulings. Conflicts between individual and public interests are particularly common when it comes to the protection of minority shareholder rights. The government defends its interests as a holder of state shares in distinct companies, but also has a general interest to secure an overall positive atmosphere towards security investments. State officials therefore seek to limit any tendencies that could trigger a general loss of trust in security investments. Clarke notes that the Supreme People’s Court has actually set certain limits on the number of cases local courts are allowed to hear on securities-related claims. Legal justice and unbiased law enforcement is therefore not to be expected, as long as the state remains involved as a regulatory authority while maintaining political monopoly power and asserting strong economic interests as the dominant holder of industrial assets. But even if lawsuits are accepted, failure to enforce legal judgments is a common feature of China’s judicial system. According to recent estimations, only 60% of court rulings are actually enforced, with much lower averages in the less developed hinterland.

This, however, is not to say that overall legality is receding. Instead, legality varies depending on whose interests are affected and particularly on whether disputes are between private parties or whether they involve a clash between private and state interests. Written contracts, for instance, are the basis of most business operations. The World Bank’s Investment Climate Survey conducted in the years 2000 and 2002 confirms that, overall, 89% of firms enter into written contracts with their clients. The use of written contracts,
however, varies across different legal company forms. Contracts are less pronounced among the traditional public firms—state-owned firms (86%) and collectively owned firms (84%)—but they are more common among incorporated state-holding firms (97%) and listed companies (92%).

In spite of strong reliance on contractual agreements in private business relations, the individual perception of legal protection remains rather unsteady, and is most insecure when private interest collides with state interests. The overall predictability of the judicial system remains low. Respondents of the same survey indicate that the predictability of the judicial system reaches on average only 17% (with values ranging from zero for no predictability to 100, in cases of absolute predictability). Unsurprisingly, when polled, state holdings, firms generally perceived to be at the center of the state’s interest and which are deeply embedded in high-level political networks, perceive judicial predictability to be much higher, averaging 36%. A cross-industry comparison of judicial predictability reveals an even wider spread. Highest scores are observed in key industrial sectors with strong government involvement, such as biotechnology (33%), chemical products (34%), and transportation equipment (26%); while the mainly privately organized sector for consumer products shows a low of only 4%. A firm’s perception of the predictability, reliability, and fairness of legal protection in China, thus, seems closely related to its relative proximity to or distance from political and governmental networks.

III. THE ROLE OF INFORMAL NORMS

One of the general lessons from this is that institutional reforms require a “goodness of fit” between the specific innovation and the country’s broader institutional environment, including its norms and beliefs. Many of the different attempts to institute capitalism by

61. Id.
62. Id.
63. Id.
64. Brian Levy & Pablo T. Spiller, The Institutional Foundations of Regulatory
design ignored “the persistence of routines and practices, organizational forms and social ties that can become assets, resources, and the basis for credible commitments and coordinated actions in the post-socialist period.” 65 This applies profoundly to the case of corporate governance, where mixed and often conflicting stakeholder interests contribute to structural and organizational inertia. Persisting behavioral patterns slow down the implementation of new organizational structures and the reorganization of internal command structures. The effect of two social norms will help illustrate the case.

A. The Norm of Political Control

While formal rules specified in the Company Law have transferred control rights from the old socialist committees to the new company representatives of CEO and board of directors, members of the old elite benefited from the established power structure that allowed them to occupy key positions in the firm. Actual party and government representation within the firm, therefore, is far more pronounced than could be inferred from the formal specifications regarding party activities within the firm.

The preservation of the party’s monopoly supports the strong role of the party within the firm. Uncontested power at the macro-level easily triggers a “voluntary” acceptance or even the request for political involvement at the firm level, as long as the enterprise decision-making elite believes that cooperation will yield positive economic returns either for the insiders or for the firm. Survey data confirms a high representation of party members and officeholders in leading firm positions. 66

According to the World Bank Investment Climate Survey in 2003, 67% of CEOs in 2351 surveyed firms were party members. 67 Forty-two percent of the interviewed CEOs even played an active political


66. See WORLD BANK, supra note 60, all raw data.
67. Id.
role as party secretaries, deputy party secretaries, or party committee members. The respective distribution in China’s large-scale stock listed firms is even higher. Eighty-four percent of the interviewed CEOs were party members, and 55% held a party position. Close party-firm relations are reinforced by the government’s involvement in recruitment decisions. Seventeen percent of firms report that the CEO was not—as legally required—appointed by the Board of Directors, but directly recruited by the responsible government authorities. Evidently, the new governance structure of China’s large-scale business sector is still heavily controlled by party and government elites, which almost necessarily implies a neglect of non-state owner interests.

B. The Norm of Authoritarian Leadership

The implementation of new organizational structures and hierarchies is clearly at variance with the established power structure and authoritarian leadership style factory directors are accustomed to. This has triggered a de-coupling of the formal and factual authority division within the firm, which weakened the effectiveness of formal board representation by independent directors. Though both Company Law and regulatory stipulations call for the inclusion of independent actors on the board of directors and the supervisory board to fight insider control and management malfeasance, the general social norm is that independent directors are not expected to “actively” perform their formal duties. Good independent directors are actually those who do not interfere and contest insider decisions. Most importantly, there is a common practice that independent directors are recommended by the CEOs and appointed by the state, which weakens their ability to monitor management decisions independently. Instead, they provide assistance to the manager rather than any form of independent supervision. Board decisions thus

68. Id.
69. Id.
70. Id.
The norm of authoritarian leadership also has led to a concentration of several functions in one person, causing so-called CEO-duality. The most common example is for one person to be chairman or vice-chairman of the board, CEO, and CCP representative at the same time. By combining the strategic and operative powers in one person, the board of directors no longer serves as an independent internal control mechanism. Operational and strategic decisions are merged, and there is neither effective monitoring of the management decisions, nor supervision of the implementation of these decisions. Equally important, party interests are naturally reflected in management and board decisions due to the strong representation of political interests among the firm’s decision makers. As a result, shareholders’ interests are not safeguarded, and the absence of control and corrective mechanisms increases the probability of power abuse and opportunism. The problem is aggravated by the fact that very few company boards have established steering groups for different operational divisions which serve the important function of increasing executive and managerial efficiency.

One explanation for concentration of power is the failure to clearly appoint tasks and responsibilities to individuals, which itself stems from a desire to avoid conflicts. The striving to establish formal control structures within a company has thus led to a fusion of western-style organizational structures with authoritarian-style concentration of power.

73. Nee, supra note 20.
74. Shutang Gu et al., Zhongguo shang shi gongsi neibu zhili de shizheng fenxi [A Practical Analysis of Insider Control in Chinese Listed Firm], 6 GUANLI SHIJIE 144 (1999).
IV. COMPLEMENTARY INSTITUTIONS

Institutional change of corporate governance is not limited to internal organizational governance as specified by the Company Law. Equally important are complementary institutions of external governance which shape incentives and constraints at the firm level. If such external mechanisms are missing, deficits of internal governance are reinforced, and the effectiveness of distinct tools is undermined. The efficiency-increasing effects of performance-related management compensation, such as executive stock options, rest on the efficiency of stock markets. In the presence of illiquid and easy to manipulate markets, stock options do not necessarily lead to improved firm performance, but may simply invite price-manipulation and management self-dealings.

The Chinese discourse on corporate governance has long neglected the systemic character of Western corporate governance and focused one-sidedly on internal organizational issues, agency problems and the state’s position vis-à-vis the reformed state-owned sector. The underlying notion has been that the modernization of internal control structures and the inclusion of private shareholders would create sufficient incentives to promote enterprise growth and profitability. External incentives shaping and guiding firm behavior have hardly been covered in the corporate governance debate. The narrow definition of corporate governance may reflect the government’s longstanding position that weak performance of firms is mainly caused by weak management and organizational deficiencies. In contrast, the incentive role of markets has been widely neglected. While China’s leadership promoted product market competition already at an early stage of reforms, a skeptical view of the free working of the market mechanism persisted in areas such as financial markets, markets for land-use rights and various monopoly sectors. As a result, external governance of China’s listed firms remains limited.

Because of distinct ownership distribution and the existence of segmented markets, China effectively has no active take-over market. Furthermore, external financial controls of the state-dominated banking system remain ineffective. Thus, while the Commercial Bank Law, effective in 1995, guaranteed the formal-legal independence of commercial banks, it nonetheless stated that loan decisions should be taken under the “guidance of state economic policies.” Empirical evidence indicates that local governments can easily intervene in loan decisions. Even the stock listing of China’s state commercial banks in 2007 is unlikely to bring about the urgently needed depoliticization of the credit market since the government remains the controlling shareholder in all corporatized state banks. Continued politicized lending, frequent debt rescheduling, and high default rates of borrowers confirm that the capital market cannot yet provide effective external controls.

In addition, protection of creditor rights remains weak. Insolvency and bankruptcy procedures offer wide leeway for government intervention, which limits the credibility of firm liquidation as the ultimate sanctioning mechanism. The Supreme Court further complicated bankruptcy procedures when it advised the People’s Courts to apply mixed standards that include not only consideration of creditor rights, but also general economic goals such as the modernization of the local industrial structure and maintenance of social security. Even if the court agrees to liquidate a firm, creditors enjoy only weak protection, as liquidation teams are typically made

76. Commercial Bank Law (1995), art. 34.
78. Zhu, supra note 53, at 538.
79.
up of shareholders, government agencies and professionals.\textsuperscript{80} Creditors themselves are not represented,\textsuperscript{81} which naturally reduces their chance to secure at least part of the granted loan.

The market for managers, another external mechanism for sanctioning management malfeasance, does not exert effective corrective pressure. Although management turnover in China’s corporations has been increasing continuously, and most recent studies confirm that chairman turnover is related to a firm’s profitability, the material consequences for managers are quite limited.\textsuperscript{82} Thanks to China’s dire market for qualified managerial personnel, reemployment, often accompanied by substantial salary increases, is almost guaranteed. This is in line with evidence suggesting that companies rarely improve their performance after a management turnover.\textsuperscript{83} Hence, the market does not yet provide the pool of managers which would allow a better “fit” with company profile and required experience and skills. This is also partly the result of the politicized recruitment process that still favors politically well connected candidates.

Finally, the weak status of the financial information industry is worth mentioning. The government maintains state control and censorship over information.\textsuperscript{84} Even foreign press agencies have been placed under the supervision of the Chinese news agency, Xinhua. Among the more recent attempts to control information has been China’s ban on newspapers to reprint stories from online sources without censorship.\textsuperscript{85} Though there are examples of newspapers uncovering and publishing irregularities, newspapers still depend on political goodwill for their survival and thus have to accept close supervision.\textsuperscript{86} Detection of financial scandals, such as accounting

\begin{footnotesize}
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80. See Zhu, supra note 53, at 538.
81. Id.
82. Id.
84. According to Freedom House, China ranks 181 of 195 countries ranked, with comparable levels of unfree press with countries such as Syria, Iran, and Rwanda. See www.freedomhouse.org.
86. One example was when financial newspapers such as Caijing contributed to the revelation of insider trading and accounting fraud of listed companies.
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fraud, violation of shareholder rights, and insider trading, are only publicized as long as the “healthy” development of the securities market and overall stability are not affected. The guiding principle is therefore, that reports should not exceed a critical level. The role of the emerging financial press is therefore limited to the detection of isolated cases of management malfeasance; revelation of systematic problems that permeate the whole financial system and could seriously weaken investor confidence is less likely.

In summary, China’s strategy of corporate governance reforms is best described as a selective approach, which focuses on the import and adaptation of isolated institutional elements without introducing the necessary complementary institutions. Particularly, market-based external governance mechanisms remain weak. However, the separation of ownership and control,87 with its inherent information asymmetries and monitoring problems, builds on the existence and effective operation of external market mechanisms.

CONCLUSION

Since its economic opening, China has impressed with its rapid pace of legal reforms in fields such as Company and Securities Law. As one observer remarked, “no nation has ever produced legislation—substantive, organizational, procedural—as the People’s Republic has in the last quarter of a century.”88 However, while many laws are in place, their effectiveness in ensuring good corporate governance is low. This ineffectiveness, we argue, is best understood with an encompassing institutional approach, which goes beyond distinct “norms” to understand laws as but one element of relevant institutional complexes. While normative, often comparative, perspectives may provide useful tools for legal analysis across countries with comparable standards of legal independence and similar social belief systems, an isolated focus on legal regulations is of little value for most transition and developing economies. Some of the initially celebrated laws and regulations have turned out to be

88. Cohen, supra note 51.
ineffective, while laws described as ill-defined from a Western perspective seem to lower transaction costs by a significant margin.

Our cursory analysis demonstrates that a focus on formal norms would inadequately capture the directions and qualities of legal change. The case of China’s emerging corporate governance system illustrates the complexities of legal change, which call for an institutional approach covering the distinct elements that jointly shape and constrain human behavior. The political economy of law reforms has illustrated that China’s Company Law and Security Law reflect the prevailing power balance and persistence of socialist and anti-market sentiments. Complementary institutions and persisting informal norms weaken the limited power of independent shareholders and stakeholders. The de facto system of corporate governance is thereby further removed from the Anglo-American model of corporate governance than a narrow legal comparison would suggest. Low profitability, insider control, and low dividend payments, among other things, support our analysis that there are not yet reliable control mechanisms in place to sanction management malfeasance and thus address weak performance.89

On the theoretical side, institutional analysis, which places changes of legal norms in the broader institutional context and explicitly incorporates the interplay between formal and informal norms, provides an untapped opportunity to test standard institutional knowledge in different institutional environments. While it is widely accepted that formal and informal norms jointly shape social behavior, there is still very little analysis that aids in understanding how formal and informal norms “combine to shape the performance of organizations and economies.”90 Without further research on the interaction and combined effects of distinct institutional elements, analysis of legal change will continue to suffer from indeterminacy. It is the transfer of distinct formal norms into different institutional settings that helps tease out the interplay and relevance of contextual

90. Nee, supra note 9.
factors. While institutional theory typically assumes the existence of mature markets and independent and impartial judicial systems guaranteeing the implementation of *de jure* rights, none of these preconditions are fulfilled in transition economies. Research on institutional change in transition economies provides a new and still underutilized opportunity to gain deeper insights into determinants and directions of institutional change. Transition economies contain strong institutional variations offering valuable data sets to investigate the way institutions develop, the existence of institutional complements and substitutes, and the interplay between formal and informal institutions, such as social norms and private ordering. Cross-country comparisons, and also observations over time, may give important insights on how institutional elements combine to constrain and motivate human behavior. For instance, under which conditions are new formal norms implemented? When do informal norms have a lasting and modifying impact on newly instituted norms? Institutional analysis of legal change not only provides a more accurate tool to grasp the quality and direction of legal change, it also promises new theoretical insights, which may advance current research programs seeking to better understand the combined effect of formal and informal norms.  


92. “The promise of an autocrat is not enforceable by an independent judiciary or any other independent source of power, because autocratic power by definition implies that there cannot be any judges or other sources of power in the society that the autocrat cannot overrule.” Mancur Olson, *Dictatorship, Democracy, and Development*, 87 AM. POL. SCI. REV. 567, 571 (1993).