

Market Socialism or Capitalism?
Evidence from Chinese Financial Market Development

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I. Introduction

The cornerstone of market socialism, according to Lange, Lerner, and Taylor, is the public ownership of the means of production and the state is regarded as the default representative of the 'public.' Associated with this basic feature, the market socialism literature emphasizes the role of the state to govern markets in resource allocation. The most important coordination mechanisms that a market socialist economy relies on are the administrative mechanism (or "bureaucratic coordination mechanism" (Kornai, 2001)) and the market mechanism. In sharp contrast to the practice of capitalist economies in the world, the market socialism literature does not discuss the functions of financial markets. Market socialist thinkers (e.g. Lange, Lerner, and Taylor) did not mention stock markets although they all discussed product and labor markets in detail. Moreover, the role of law and legal institutions is absent in that literature as well.

A major reason for the sharp contrast in the different roles of financial markets and law in capitalist economies and in the market socialist economy literature is related to the ownership structures in the two models. Individuals in a capitalist economy not only trade products and labor but also trade financial assets of means of production. Consistently private ownership is the dominant ownership structure in a capitalist economy and financial markets are an essential part of a capitalist economy where ownership rights of means of production are traded. Associated with this, legal mechanism is the key to protect private property rights and to govern financial markets for exchanging financial assets. However, in principle, the dominant property right structure is state ownership in a market socialist economy. Consequently, there is no need for financial markets as an institution for exchanges of productive assets. Moreover, as the state has obligation to protect the state properties and employs

administrative power to enforce contracts, legal institutions designed to protect private property rights become redundant, or may be even in conflict with the will of the state bureaucracy.

Finally, the absence of stock markets in market socialism literature is also due to the fact that at the times of the market socialist thinkers (e.g. Lange, Taylor, Lerner) there was no sufficient intellectual understanding of the function of stock markets and law as an essential mechanism for corporate governance. It was not generally recognized that there existed severe incentive problems in state-owned firms, which were caused by the separation of ownership and control similar to that in publicly traded firms in capitalist economies. In fact, even at his late years, Lange still did not realize the importance of incentive problems associated with state-owned firms, although these issues were raised by von Hayek to challenge the market socialist idea. Many of the later leading proponents of market socialism did not realize the central importance of incentive issue either (see a survey by Bergson, 1967). Thus law and finance as mechanisms of solving those problems were unsurprisingly absent in the market socialism literature.

Chinese government has claimed that its goal is to reform the Chinese economy into a market socialist economy. Although the coexistence of a large state sector and the increasingly dominant market forces makes the Chinese economic system apparently look similar to the feature of market socialism in the literature, a basic fact may distinguish China from the literature: China has developed equity markets over the past decade at a large scale. However, in view of the fact that the Chinese stock markets are dominated by state-owned companies and are governed by administrative mechanism, one may argue that these two features seem fit well with the market socialism model.

Though China's equity market under administrative governance bears resemblance to a market socialism model, we argue that the Chinese financial market development is actually inconsistent with a market socialist model. The dominant state ownership of listed companies is only a transitory phenomenon in China's economic transition. Listed state-owned companies are issuing more and more equities to individual investors, introducing into state-controlled companies more private shareholders. More importantly, a general consensus or expectation among scholars and practitioners has been formed that as the Chinese securities markets further develop, the state-owned shares will become ultimately tradable, which allows private investors to acquire state-owned shares. Eventually the state will not hold controlling blocks for many of the listed firms and a substantial proportion of listed firms will not be state owned firms any more. This implies a changing ownership pattern from the dominance of state ownership to that of private ownership. Thus it contradicts with the basic principle of the market socialism.

Then how well does the Chinese financial market development fit with a capitalist model? Extensive evidence has been reported on how markets work in capitalist economies. The literature shows that financial development determines economic development in market economies (Rajan and Zingales, 1998; King and Levin, 1993). From this perspective, it seems that the fast financial development and economic development in China fit with that pattern well. However, on the other hand the literature also shows that the quality of law affects financial market development. In that aspect, it does not seem that China fits with the capitalist model. In the literature the quality of law is measured by formal minority shareholder rights (La Porta et al., 1997; La Porta et al., 1998), by formal mandatory disclosure rules and their enforcement (La Porta, et al. 2002), by the effectiveness of legal institutions

(Pistor et al. 2000), and also by the legacy of legal development in countries being studied (Berkowitz et al. 2003). Deterrence failure and regulatory failure are identified for understanding how law and the related governance operate as important determinants for financial market development in capitalist economies (Pistor and Xu, 2003; Xu and Pistor, 2004). In contrast to the above facts, it has been noticed that China has poor formal legal institutions (Allen et al. 2004; Ohnesorg, 2003; Pistor and Xu, 2005). China had a very weak legal basis when it began to develop financial markets in the early 1990s. Moreover, courts were weak, and have in fact played almost no role in enforcing investor rights to this day. Firm specific information has been highly distorted thereby undermining the effectiveness of newly established regulatory agents. Thus, if to follow the capitalist law and finance model, i.e. to rely on legal governance, the Chinese attempts to jump start securities markets would suffer greatly from the severe deterrence and regulatory failure problems.

Explaining the Chinese financial governance approach, Pistor and Xu (2005) argue that China has deployed an administrative governance structure in their financial markets, which has mitigated deterrence and regulatory failure. Comparing this Chinese practice to the capitalist model, we argue that the Chinese financial market governance does not fit with a 'typical' capitalist model. The anchor of the Chinese financial market governance institutions was the so-called quota system. This system effectively enlisted pre-existing institutions of state and party governance in the selection of companies for listing on a stock exchange. It was based on the existing regional competition, and it created further competition among regions for access to centrally controlled equity market entry. It tapped into the insider knowledge about firms by state bureaucrats at companies and/or local governments, which was not accessible by other means. Our evidence suggests that the quota

system creates incentives for regional governments to select better firms. Specifically, the allocation of quotas to each region was determined by the earlier aggregate performance of the listed firms from the region. This implies that regional governments selecting better performing firms at IPOs in previous periods had been rewarded by gaining more quotas later; and vice versa. Moreover, our evidence from the cross-region financial development shows that the regional financial development (in equity markets) in China is positively correlated with levels of regional economic development and internationalization. That is, although different from the capitalist model of financial market governance, the cross-region financial development under this Chinese structure is consistent with the trend of capitalist economies discovered in the cross-country studies (e.g. Claessens, et al. 2002).

Finally, we conclude the paper by arguing that although the initial stage of jumping start stock markets in China is a success, this administrative governance may not be a long run solution for China's financial development. Thus even purely from governance structure point of view this cannot be regarded as a workable model of market socialism. Our evidence shows that the Chinese governance structure is failing to monitor companies once they are listed on the market. This indicates that this Chinese administrative governance is not a stable system. Moreover, this administrative governance structure does not work effectively for non-state owned firms, which is a necessary condition in a capitalist model of financial market. Therefore, it is neither a stable market socialist model nor a stable capitalist system.

The rest of the paper is organized as follows. Section II explains briefly the Chinese non-capitalistic financial market governance institution. Section III provides evidence how this institution works. Section IV demonstrates that the Chinese regional financial development seems consistent with the pattern discovered from

capitalist economies. Finally, Section V concludes that although initially successful the Chinese financial market governance structure is losing its effectiveness. Thus, it is only a transitional phenomenon.

II. Non-capitalistic Governance of Financial Markets

Compared with a capitalistic financial market governance model, China is very weak in public law enforcement record and has no record on private law enforcement. However, almost all standard measures for stock market performance suggest that China is performing better than most other transition economies, which are all adopting a capitalist model. Particularly, China has outperformed all other transition economies on what might be the most important aspect – the ability of listed firms to raise funds. China has the most liquid of all stock markets, with only Hungary coming close. Companies in Central and Eastern Europe have only rarely used IPOs to raise capital except Poland with 47 IPOs between 1994 and 2001. By contrast, in the same period of time, there were 873 IPOs in China. Between 1998 and 2001 alone China witnessed 414 IPOs with firms raising a total of 508.6 billion RMB (or 61.6 billion US\$). No other transition economy is even close (Pistor and Xu, 2005).

Non-capitalistic governance or a weak legal institution on the one hand and a strong performance on jumping start stock market on the other hand make China a puzzling case. We argue that China's financial market development was based on an administrative governance regime, which partially substituted formal legal institutions and prevented the worst enforcement failures. The core of it was the so-called quota system. The quota system was officially in place from 1993 and 2000. De facto it governed financial markets up to the end of 2002 or further.

The quota system functioned to promote decentralized information collection in an environment that was plagued with information problems far exceeding those commonly known in developed financial markets. Investors as well as regulators face substantial obstacles to obtaining access to corporate information, particularly for companies that launch their initial public share offering (IPO), as little information about them is known to the market. In Western markets, mandatory disclosure rules seek to reduce information problems. Conditions for the efficacy of mandatory disclosure rules, however, were not present in China. Under centrally planned system state owned companies operated according to accounting standards that contained little information relevant for evaluating their market values. Even when books were converted by applying international accounting standards, the conversion process was subject to a substantial margin of error (Fang, 1995). Professional market watchdogs capable of and willing to verify accounts were only beginning to emerge and the creation of an effective governance structure for these intermediaries lagged even further behind. Absent effective governance, accountants, auditors, and securities analysts often participated in fraud (Green, 2003). Against this background, disclosure rules could not be credibly enforced and therefore were ineffective in resolving the severe information problem investors and regulators faced. Instead, mechanisms were needed to induce insiders to reveal critical information that could be used for a meaningful selection of companies for public offerings.

Under the particular Chinese conditions, the quota system created an incentive structure that helped solve informational problems at the IPO stage. Regional competition has been essential in various reforms in China. That competition among regions has developed vested interests for regional government officials in their regions' economic performance, which became a critical factor for their own career

advancement (Qian and Xu, 1993; Maskin, Qian and Xu, 2000). By rewarding better regional corporate performance with more quotas in share issuance for that region in subsequent periods, the quota system encouraged the local governments to bring the better performing firms in their regions to be listed on the stock market. Moreover, the quota system is believed to be efficiency-enhancing because allowing regions with better corporate performance to issue more shares is largely equivalent to allowing regions with better economic performance to raise more equity finance. From the restoration of stock markets in the early 1990s until now, the performance of regional companies on the two major stock exchanges has been directly linked to the region's economic performance. Two factors contribute to this link. First, the political-consideration-motivated sources of funding for corporations have diminished. The central credit allocations were curtailed and firms are less dependent on regional budgets. The allocation of funds has been more and more driven by efficiency considerations. Second, more sources of non-state-administered corporate finance came into being. Listed companies gained access to equity finance where private investors play an important role; firms also obtain bank financing from other regions.

III. Quota as an Incentive System to Regional Governments: Evidence

Quotas have been a basic feature of state and regional economic management in China prior to and during the transition period, in particular for allocating critical resources among regions¹. The annual quota for each region was established in an intense bargaining between regional governments and relevant central agencies (i.e. the ministry for energy, or the central bank). The primary purpose for extending the quota system to China's fledging stock markets was to maintain control over its size

¹ For the purpose of this paper, we use the term "region" to refer to administrative sub-division at the provincial level.

and stability (Fang, 1995). In its practical application, however, it is related to the existing regional competition; and it created further regional competition for the allocation of quotas, which in turn fostered a selection and information collection process that facilitated market development during the crucial start-up period.

Each year the PBoC established the amount of shares firms were allowed to issue to the public. In 1993, the first year when the quota system was in full operation, 5 billion shares were made available at the national level. Individual regions received quotas in the amount of 50 million to 500 million shares (Fang, 1995). Governments at the provincial level negotiated the size of the quota for that region with the respective provincial branch of the CSRC. When they had reached an agreement, the request together with information about the companies the province wanted to bring to the market was submitted to the center. The CSRC decided over the allocation of quotas to different provinces and ministries on the basis of the information it had received and within the quantity constraint established by the PBoC. As we will further argue below, this promoted competition among the regions and induced them to collect and reveal critical information about the relative quality of companies operating in each region.

After the regional quota had been allocated, the selected companies had to go through an individual approval process. At this stage the applicants were vetted for compliance with the formal merit and disclosure requirements set forth in relevant statutes and regulations (Fang, 1995).

The quota system de facto served as an important administrative governance device, which consisted of incentives for decentralized information collection. That limited serious fraud at the stage of IPO. Specifically, the quota system imposed a 'quantity constraint' to provinces. With competition among provinces, this created

incentives for local governments to select companies that would enhance the province's future access to quotas. By involving regional governments as the owners of regional state-owned firms the quota system also tapped into insiders' knowledge and thereby reduced the information problem.

If the operation of the quota system provides incentives, we should observe that future allocations of quotas to a region are related to past performance of companies from that region. That is, quota allocations to regions should be positively correlated with past performances of listed companies from corresponding regions.

Quota allocated to each region is the total number of shares allowed to be issued from the region. However, time series information about the size of the quota allocated to different regions is not publicly available. The proxy for the size of a region's quota we use is the number of shares issued by firms from different provinces.² We use the rate of increase in the number of shares issued to control for the variation in the size of regions. To account for the time lag between the allocation of shares to a province and the actual public offering, we use changes over a three year period. Specifically, the rate of increase in quota for region i at period t is measured as $[y(i, t) - y(i, t-3)]/y(i, t)$, where $y(i, t)$ is Total Shares of Region i in Year t where t ranges from 1995 to 2003 and i covers 31 Chinese provinces and provincial level municipalities³. To link quota to regional performance of listed companies, we employ several measures for the performance of listed companies as independent variables, which encompass indicators such as total and tradable market capitalization, price/book-value ratio, turnover ratio, and net profits, respectively. We

² In reality there is usually a time lag between quota allocation and the listing of a firm.

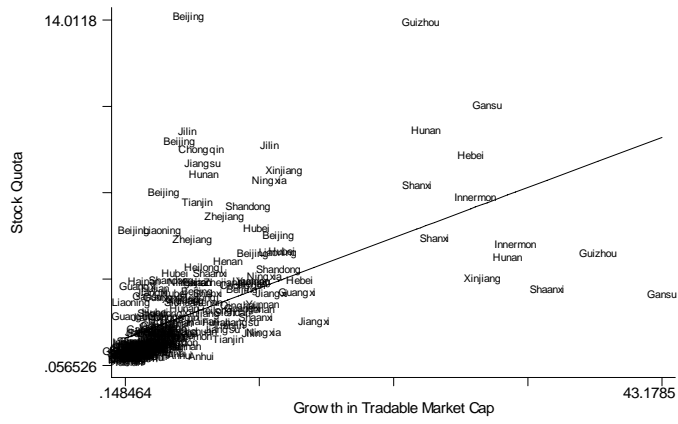
³ If we stretch the beginning year of the sample to 1994 or 1993, the calculation of quota requires data on shares issued in year 1991 or 1990. However, very few provinces were allowed to put firms onto stock exchanges at that time so that we cannot conduct meaningful statistical analysis.

also use the rate of increase in these variables over a three-year period in our regression analysis.

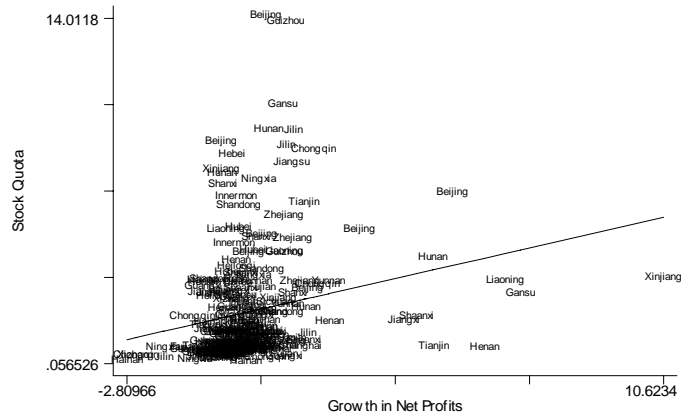
Specifically, Performance Indicators for Listed Companies from Region i in period t includes the three-year growth rates of market capitalization of total tradable shares of listed companies, of the market capitalization of tradable shares, of the P/E ratio, of the P/B ratio, of the turnover ratio, of the net profits and of the earnings per share. In regressions, the performance indices are lagged by one year, that is, $[y(i, t-1) - y(i, t-4)]/y(i, t-4)$, where $y(i, t-1)$ and $y(i, t-4)$ are Region i 's Performance in Year $t-1$ and $t-4$ respectively. To save space, we report only two scattered plots to illustrate our regression results whereas the details of regression models and tables are omitted.

Figure 1 presents the scatterplot of the relationship between the earlier performance indicators and the subsequent quota allocation on the basis of the panel data of the two variables over the period 1995-2003. We can see that the earlier performance indicators such as the growth in market capitalization of tradable shares and that in net profits show strong positive correlations with the later quota allocation. Similar positive correlations can also be observed between later quota allocation and earlier performance measured by other aspects of market or accounting performance.

Figure 1



Stock Quota vs. Growth in Tradable Market Capitalization

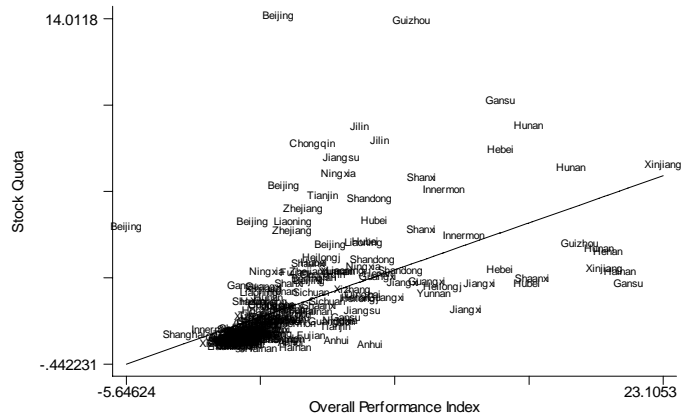


Stock Quota vs. Growth in Net Profits

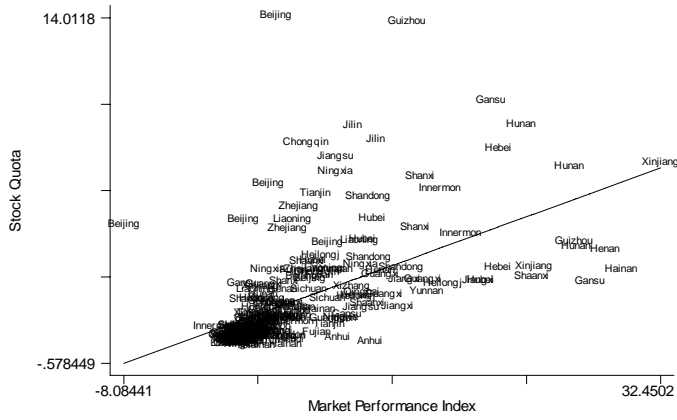
Next, we construct performance indices of listed companies from region i at period t . We group individual performance indicators into two broad categories. One group is based on stock market performance, while the other group is built upon the accounting data. We thus construct three categories of indices in our two regression models: Overall Performance Index, Market Performance Index and Accounting Performance Index. Market Performance Index is calculated as the simple average of the three-year growth rates in regional aggregate levels of market capitalization of total shares of listed companies, the market capitalization of tradable shares, the P/E ratio, the P/B ratio, and the turnover for each region. Accounting Performance Index is the simple average of the three-year growth rates in regional average levels of net profits and earnings per share. Overall Performance Index is constructed as the simple average of the three-year growth rates in market capitalization of listed companies, the market capitalization of tradable shares, the P/E ratio, the P/B ratio, the turnover, the net profits and the earnings per share for each region. In regressions, the performance indices are lagged by one year, that is, $(\text{Regional Performance in Year } t-1 - \text{Regional Performance in Year } t-4) / \text{Regional Performance in Year } t-4$.

From Figure 2, we can see that earlier Overall Performance and Market Performance indices exhibit fairly strong positive correlation with the later quota allocations based on the panel data over the period 1995-2003. The earlier Accounting Performance Index also moves positively with the later quota allocations, though the correlation is weaker.

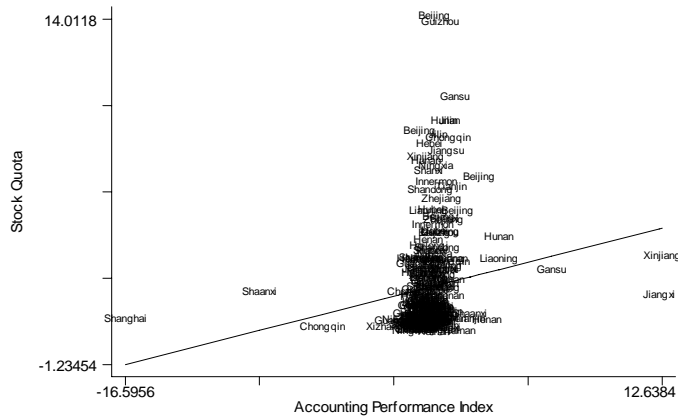
Figure 2



Stock Quota vs. Overall Performance Index



Stock Quota vs. Market Performance Index



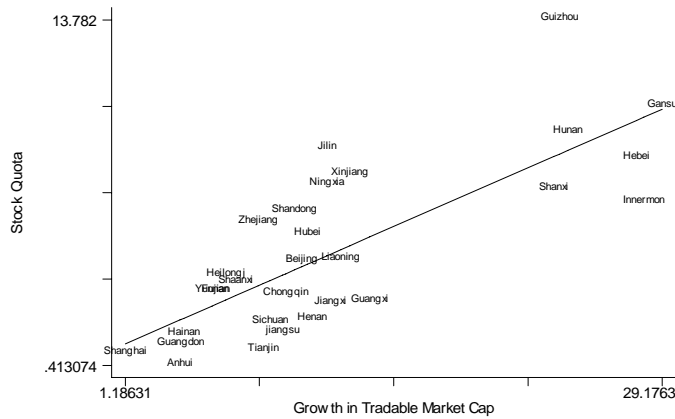
Stock Quota vs. Accounting Performance Index

Although strong correlations between previous performance and later quota allocations suggest that performances determine quota allocation, statistically it does not completely rule out a reverse causality. To address this issue, we conduct some cross-section regressions based on the early stage of the stock market development and quota allocation. The idea of this exercise is that when the stock market was initially established, it is much harder to imagine that initial quota allocation had major impacts on corporate performance.

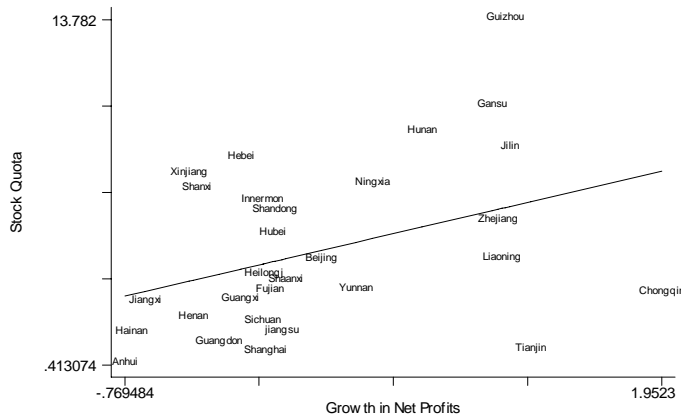
The quota system was initiated in 1993, and only in 1994 and 1995 most of the Chinese provinces (29 provinces) began to have corporations listed in Shanghai or Shenzhen stock exchanges. The number of shares issued in these initial years reflects the initial allocation of quota for almost all provinces. It provides a starting point for us to analyse how the allocation of quotas in subsequent periods responds to regional variation in corporate performance. In other words, only until 1994 and 1995, most provinces successfully put their firms onto the stock market. Then they ran a horse race to compete for quota allocation by presenting their better performing firms.

Focusing on the early stage of stock market launch, we examine how the quota allocation in the period 1995-98 responds to the changes in the provincial corporate performance indicators. Figure 3 demonstrates cross section regressions, where the dependent variable is the three-year growth rate in the total number of shares from 1995 to 1998. The independent variables are growth rates in the performance indicators, such as growth rates of tradable market capitalization or of net profits over the period 1994-1997. We see that all the individual performance indicators show a clear positive correlation with the subsequent growth in quota allocation.

Figure 3



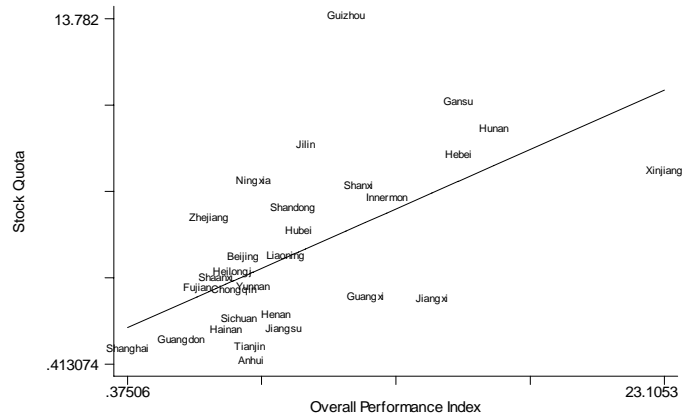
Stock Quota vs. Growth in Tradable Market Capitalization



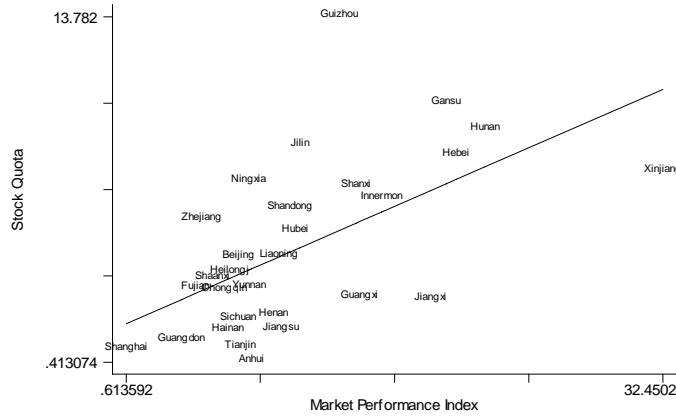
Stock Quota vs. Growth in Net Profits

In Figure 4, we present the relationship between the three aggregate performance indices and the later quota allocation based on the period 1995-98. Clearly, there is strong positive correlation between the two variables based on the cross-section regression.

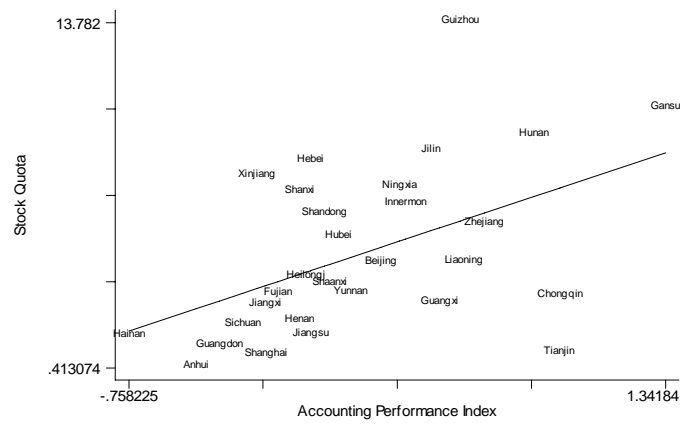
Figure 4



Stock Quota vs. Overall Performance Index



Stock Quota vs. Market Performance Index

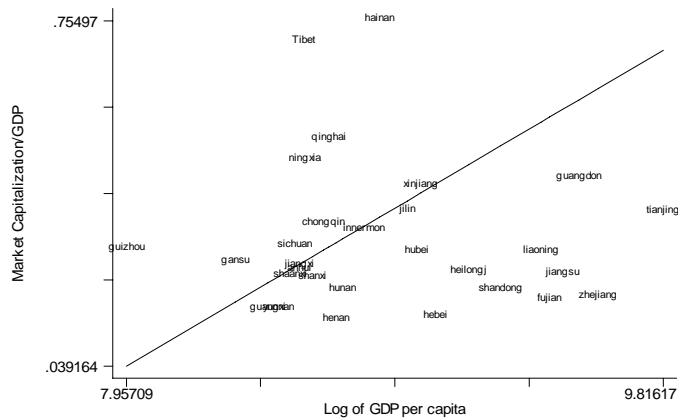


Stock Quota vs. Accounting Performance Index

V. Regional Financial Development: Evidence

Evidence from the preceding section suggests that a non-capitalist governance approach seems working in Chinese financial market development, i.e. the quota system was a de facto incentive scheme to motivate regional governments to select better firms at IPO stages. That is because regions with better-performed firms in stock markets are more likely to acquire more quota allocation in the future. The cross-country study from capitalist economies shows that there is a strong positive correlation between financial development and economic development. It is interesting to compare the Chinese cross-region financial/economic development with the pattern discovered from the capitalist world. Figure 5 plots regional (provincial) per capita GDP against regional market capitalization over GDP ratio in 2002. It suggests that similar to cross country results for capitalist economies, the Chinese regional distributions of the two indicators also show a strong positive correlation.

Figure 5



GDP per capita vs. Market Capitalization/GDP in 2002

To gain a further insight into the relationship between geographical distribution of quota and economic development, we group all provinces and province-level municipalities into three broad regions --- the east coast region, the central region, and the western region. The general consensus is that the socio-economic development level is the highest in the east coast region and declines gradually in going to the central and western regions respectively. In Table 1, we present some summary statistics for the financial market development in the three broad regions in two years --- 1994 and 2002. The indicators of financial development that we look at comprise market capitalization/GDP, tradable A-share market value/GDP, and aggregate market turnover ratio. Consistent with our expectation, the east coast region clearly enjoys a substantially higher level of financial development, registering a larger value of these three indicators than the central and western regions in the year 1994. Though the gap shrinks in 2002, the east coast region still claims the highest value of these three indicators of financial market development. However, there is no clear difference in the level of financial development between the central and the western regions. This is probably because the east coast region leads the nation in stock market development and corporatization, while both the central and western regions are lagging behind and lying at similar levels.

Table 1

This table shows the summary statistics of the ratio of market capitalization over GDP, the ratio of tradable A-share market value over GDP, and Aggregate market turnover ratio at two points in time (year 1994 and year 2002). The series are averages across provinces that are grouped into three regions --- the east coast region, the central region, and the western region. East coast region includes Beijing, Fujian, Guangdong, Hainan, Hebei, Jiangsu, Liaoning, Shandong, Shanghai, Tianjin, and Zhejiang. Provinces such as Anhui, Heilongjiang, Henan, Hubei, Hunan, Jiangxi, Jilin, and Shanxi are classified into the central region. The western region encompasses Chongqing, Gansu, Guangxi, Guizhou, Inner Mongolia, Ningxia, Qinghai, Shaanxi, Sichuan, Xizang (Tibet), Xinjiang, and Yunnan. (Guangxi and Inner Mongolia are centrally located, but they participate in western development scheme.)

	No. Obs.	1994					2002					
		Market Mean	Cap / Median	GDP Max	Min	Std.Dev.	No.Obs	Market Mean	Cap / Median	GDP Max	Min	Std. Dev.
East Coast Region	11	0.16	0.021	1.14	0.0098	0.33	11	0.54	0.27	1.82	0.14	0.57
Middle Region	8	0.029	0.021	0.098	0.0059	0.029	8	0.23	0.23	0.36	0.13	0.065
Western Region	9	0.021	0.016	0.043	0.0070	0.013	12	0.34	0.30	0.71	0.16	0.16
	No. Obs.	Tradable Mean	A-Share Median	Market Max	Value/ Min	GDP Std.Dev.	No.Obs	Tradable Mean	A-Share Median	Market Max	Value/ Min	GDP Std. Dev.
East Coast Region	11	0.031	0.0080	0.15	0.0017	0.047	11	0.14	0.091	0.34	0.044	0.024
Middle Region	8	0.0066	0.0063	0.012	0.0023	0.0042	8	0.082	0.082	0.13	0.043	0.064
Western Region	9	0.0067	0.0044	0.015	0.0021	0.0052	12	0.13	0.11	0.27	0.053	0.064
	No. Obs.	Aggregate Mean	Market Median	Turnover Max	Ratio Min	(%) Std.Dev.	No.Obs	Aggregate Mean	Market Median	Turnover Max	Ratio Min	(%) Std. Dev.
East Coast Region	11	20156.45	8263.84	115231.80	2651.04	33116.25	11	13627.51	11928.5	35178.16	3769.87	10294.74
Middle Region	8	3414.79	2350.12	8034.55	618.03	2677.17	8	6804.95	6799.63	11333.79	2866.84	2355.79
Western Region	10	3604.70	1657.50	14839.64	848.64	4361.98	12	4466.93	3336.35	13177.62	1930.96	3059.26

V Conclusion

Our analysis of the quota system as an alternative governance device to allow ex ante screening in an environment that is hampered by lack of information and effective ex post law enforcement does not account for how markets were governed in the post-listing stage. It is becoming increasingly clear that the quota system is ill-suited for dealing with problems of continuous disclosure or market manipulation. Moreover, the CSRC is not well placed to use law enforcement mechanisms against companies that have the entire backing from the regional authorities, because even though it is a central government agency, it is not formally superior to provincial governments. In the public offering stage, this was less of a problem, because the CSRC could play regions off against each other and thus leverage on the fact that regions were competing with each other. However, these governance devices are significantly weaker in the post-listing world.

Violations by firms that have been already listed have become rampant in recent years. Summarizing data collected by the CSRC, Table 2 indicates that more than 90% of all violations by firms listed in Shanghai and Shenzhen Stock Exchanges were related to violation of continuous, that is post-listing, disclosure, of which 64% concerned violations of ad hoc disclosure requirements.

Table 2 Violations on Shanghai and Shenzhen Stock Exchanges (1993-2001)

	Type of Information	Type of Disclosure Violation	# of violations	Share as % of Total	Share as % of Total
Violation of disclosure requirements at public offering	IPO	False Information Disclosure re listing	9	3.6	4
	Stocks distributed to employees	False Information Disclosure re employee held shares	1	0.4	
Violation of continuous	Periodic Disclosure	Non-disclosure in Annual Report	34	13.6	

disclosure requirements	(Annual Report)	False Disclosure in Annual Report	14	5.6	28.80
		Other Annual Report Disclosure Violations	24	9.6	
	Periodic Disclosure (Midyear Report)	Non-disclosure in Midyear Report	3	1.2	4
		False Disclosure in Midyear Report	7	2.8	
	Interim Information Disclosure	M&A Information Disclosure	2	0.8	58.8
		Non-disclosure of Major Investments	3	1.2	
		Non-disclosure of Guarantees	12	4.8	
		Non-disclosure of Major Transactions	13	5.2	
		Non-Disclosure of Major Litigations	15	6	
		Non-Disclosure of Connected (Related) Transactions	18	7.2	
		Non-disclosure of Predicted Losses	31	12.4	
		Unapproved Interim Disclosures	3	1.2	
		False Interim Information Disclosure	1	0.4	
		Failure to Make Interim Disclosure	49	19.6	
Others	Other Reasons	Other Reasons	11	4.4	4.40
	Total		250	100	100

Source: HE Jia et al., *Chinese and Foreign Disclosure Systems Comparison and Their*

Effectiveness [Zhong-wai Xinxi Pilu Zhidu jiqi Shiji Xiaoguo Bijiao Yanjou], Table 3-5, Shenzhen Stock Exchange Research Institute, 2002.

The ineffectiveness of the governance mechanisms based on ex ante screening for stemming violations that occur in the post listing stage is corroborated by data on the regional distribution of violations (Table 3). Interestingly, the best performing regions, Northern China, Eastern China, and Southern China, are on opposite ends of the spectrum, suggesting that the post – listing violations are independent of economic performance. The number of listed firms from Northern and Eastern China accounted for more than 56% of all listed firms in the two stock exchanges, whereas their violations amounted to less than 31% of all violations. This seems to suggest that better performance is associated with greater compliance, or less cheating. By contrast, the data on Southern China suggest the opposite. Only 15% of listed firms

are located in the Southern region of China, but they accounted for 28% of all violations – the worst region in the nation.⁴

Table 3. Regional Distribution of Listed Companies Penalized For Disclosure Violations

Regions and provinces within them	# Of Firms Fined	% Of All Firms Being Fined	Number of Firms Listed as % of National Total	Violation Indicator
Northeast Heilongjiang, Jilin, Liaoning	31	14.22	10.51	+35.30
Northern China Beijing, Tianjin, Inner Mongolia, Hebei, Shanxi, Shandong	22	10.09	17.98	-43.87
Eastern China Shanghai, Anhui, Zhejiang, Fujian, Jiangsu, Jianxi	47	21.56	28.58	-24.56
Southern China Guangdong, Guangxi, Hainan	62	28.44	15.38	+84.92
Central China Henan, Hunan, Hubei	25	11.47	9.99	+14.79
Northwest Shaanxi, Gansu, Ningxia, Qinghai, Xingjiang	6	2.75	6.69	-58.86
Southwest Changqing, Yunnan, Guizhou, Sichuan, Tibet	25	11.47	10.86	+5.86
TOTAL	218	100	100	0

Source: HE Jia et al., *Chinese and Foreign Disclosure Systems Comparison and Their Effectiveness* [Zhong-wai Xinxi Pilu Zhidu jiqi Shiji Xiaoguo Bijiao Yanjou], Table 3-11, Shenzhen Stock Exchange Research Institute, 2002

Our paper demonstrates that although the initial stage of jumping start stock markets in China can be seen as a success, this administrative governance may not be a long run solution for China's financial development. Thus even purely from governance structure point of view this cannot be regarded as a workable model of market socialism. Our evidence shows that the Chinese governance structure is failing to monitor companies once they are listed on the market. Therefore the Chinese administrative governance will not be a stable system. Moreover, this admin

⁴ The fact that the Northern, Eastern, and Southern China are the best economic performing regions is supported by other sources of data, such as Chinese Statistic Yearbook (all the years since the mid 1990s). The fact that the Northern and Eastern China are among regions that followed law best (or least corrupted), and Southern China is among regions that followed law worst (or most corrupted) is also supported by other sources of data, such as Xie and Lu (2003).

governance structure does not work effectively for non-state owned firms. Therefore, it is neither a stable market socialist model nor a stable capitalist system.

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