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**Corporate Governance in China:
Current Practices, Economic Effects,
and Institutional Determinants**

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Corporate Governance in China: Current Practices, Economic Effects, and Institutional Determinants*

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Abstract

In this paper, we provide a preliminary survey of the burgeoning literature on corporate governance in China. We structure the existing research around three themes: (1) What are the current corporate governance practices in China? (2) How do these corporate governance practices affect Chinese firms' valuation and various corporate policies? (3) How does China's unique institutional setting pre-determine the governance model adopted in China? The evidence indicates that the current governance practices adopted in China can be best described as a control-based model, which contrasts strikingly with the market-oriented model commonly used in the US and UK, and championed by most corporate governance advocates. The evidence also shows that Chinese firms, whose corporate governance practices deviate from the control based model, demonstrate stronger performance, and tend to make decisions in line with the shareholders' interest. The evidence from the literature also suggests that the control-based model root in the 'administrative governance' approach adopted by the Chinese regulatory authorities, and is tailed to China's specific institutional setting.

JEL Classification: G3

Keywords: Corporate governance, control-based model, the Chinese economy

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“China’s stock market is worse than a casino. At least in a casino there are rules”

— Wu Jinglian, a famous Chinese economist, 2001

1 Introduction

Corporate governance receives much attention in China in recent years. At the core of such attention is the debate about how China can develop an effective corporate governance system to improve its listed companies’ performance and protect the minority shareholders. The Chinese stock market was officially born in the late 1990. In fewer than fifteen years, it has grown to become the eighth largest in the world. Based on the statistics from the China Securities Regulatory Commission (CSRC), there are already 70 million investor accounts opened across the country. Roughly 200-300 million Chinese people, directly or indirectly, invest in and are also affected by the stock market. How to keep the investors’ overall enthusiasm about the stock market and strengthen their confidence in the market has always remained a heated debate in the public policy arena. It is especially relevant and urgent now, given that a series of recent corporate scandals have terribly undermined the investors’ confidence.¹

Improving the level of the Chinese firms’ corporate governance practices is a long lasting battle that needs the participation of various interest parties, including regulators, market participants, and academics. A still small but burgeoning literature has devoted to studying the corporate governance issues in China. The research so far can be divided into two streams. The first line of research concerns with how to come up with a set of quantified indicators to describe the Chinese firms’ corporate governance practices, and then examine how these quantified variables affect the listed companies’ accounting/market performance and various corporate policies behavior. The second strand focuses on understanding what institutional factors determine the Chinese firms’ corporate governance system and how the system can be improved.

In this paper, we provide a preliminary survey of the literature on corporate governance in China.² We call this survey a preliminary one mainly because the literature on Chinese corporate

¹While this paper was prepared, the Shanghai and Shenzhen benchmark indexes have both dropped to record low in six year.

²See Shleifer and Vishny (1997) for a comprehensive survey on general corporate governance issues. Claessens and Fan (2003) provide an excellent survey of the corporate governance literature on Asia. Although they covered China in their survey, the papers on China were scanted when that survey was prepared.

governance is burgeoning and the papers we survey likely only capture tip points of an iceberg. Also, while great progress has been made to better understand the corporate governance issues in China, many questions remain unanswered and our understanding is still limited. We structure our survey around three key questions: (1) What are the current corporate governance practices in China? (2) How do Chinese firms' corporate governance practices affect their performance, and their corporate policies? (3) What institutional determinants underneath are driving Chinese firms' governance practices? And how could these institutional factors be changed to promote better governance practices.

To understand corporate governance in China, one has to bear in mind that China is going through a transition from a planned economy to a market-oriented economy; and that China started its reforms in an environment, where most elements of institutional infrastructure (e.g., well-defined legal system, rigorous law enforcement, well-functioned financial markets, and so on.) are missing. The two institutional constraints pretty much scope out the various corporate governance practices the Chinese firms follow. They also determine the regulatory framework adopted in China.

The main findings of this paper can be structured around several themes. First of all, we find that the corporate governance model adopted in China can be best described as a control-based model, in which the controlling shareholders (in most cases, the state) employ all kinds of governance mechanism to tightly control the listed firms. It has been found that concentrated ownership structure, management-friendly boards, inadequate financial disclosure, and inactive take-over markets have been the governance norms in China.

Second, the control-based governance model, while promoting the fast-growth of China's stock market, does have many built-in weaknesses, which make it less effective in disciplining management/controlling shareholder, and foster firms' long-term performance. More important, such a model provides the controlling shareholders a large room to expropriate minority shareholders, and eventually undermine the public's confidence in the stock market. We find evidence that firms with their governance practices deviated from the control-based model, but followed the market-oriented governance model, tend to have better performance and make corporate policies that are in the interest of the minority shareholders. The research so far has provided evidence suggesting that the control-based governance model is at most sub-optimal, and

is undermining the healthy development of China's stock market.

The research has also found that these suboptimal governance practices in China root in China's specific institutional setting. Because the initial intention of developing the Chinese stock market is to experiment and find an alternative venue for the state owned enterprises (SOEs) to gain additional capital and improve their efficiency, and the legal environment in China is weak, the stock market regulations in China have been evolved to address the tradeoff between growth and control. The so-called 'administrative governance' approach (see Pistor and Xu, 2004), although fostering fast-growth of the Chinese stock market, also seriously thwarts the emergence of more effective governance models. Under the administrative governance, almost every sector, including the stock market, is heavily regulated. As a consequence, it becomes difficult to separate business and politics. The quality of public governance thus is of the first order importance in shaping corporate governance (Fan and Wong, 2004), because politicians or politician-connected businessmen can easily hijack any governance systems and seek rents for themselves (see Clarke 2003). As a matter of fact, almost every corporate governance practice in China can trace its origin to a certain deficiency in public governance and is more or less related to politician's or politician related businessmen's rent-seeking incentives.

As the research on the Chinese corporate governance is just emerging, many issues remain unanswered. For example, we still do not know how the control-based governance will evolve under the current institutional environment. The causality and dynamics between the current governance practices and the various institutional constraints are yet to map out. We need to better understand what combinations of governed mechanisms can better fit into China's institutional setting, and generate the largest benign impact. We also need to understand how China's governance practices can grow out of the existing institutional constraints. Although the market-orient governance model has emerged as the consensus (see e.g., Bai, Liu, Lu, Song, and Zhang, 2004), we do not fully understand how Chinese firms can migrate to that model. Specifically, we do not have implementable execution strategies that can help the Chinese firms to overcome various institutional obstacles, and pursue a higher level of governance practices. Lastly, it is still not clear how the historical legacy could be resolved before China can move towards a market-oriented model. All of the remaining issues pose great challenges to policy makers and academic researchers, and call for

future research.

The rest of paper is organized as follows. Section 2 reviews the current corporate governance practices in China. We offer a set of quantified indicators to describe these practices. We also discuss China’s corporate governance performance in the context of cross-country comparison. Section 3 details the economic effects of the control-based model. We discuss its valuation implications and how it affects firms’ corporate policies. Section 4 is devoted to understanding how various institutional factors amalgamate to determine the control-based model in China. We also discuss the dynamics between public governance and corporate governance. Section 5 concludes the paper by listing the pending challenges.

2 Corporate Governance Practices In China

“ If I were the only one who lost money, I would blame my poor IQ or wrong decisions; But now everyone has lost money, so it’s a problem with the market.”

— a Chinese investor

2.1 A Dismal Picture

In 1990 and 1991, China’s two stock exchanges — the Shanghai and Shenzhen Stock Exchanges were opened with great fanfare. In slightly over fourteen years, China’s stock market has grown to become one of the largest in Asia (second only to the Japanese market) with market capitalization of close to US\$500 billion. About 1,400 firms have gone IPO and raised close to 800 billion RMB (around US\$100 billion) (see Table 1 for annual issuance data and an overview of China’s stock market). Corporate China, especially the state owned enterprises (SOEs) has benefited greatly from rapid equity issuance growth and public enthusiasm for the equity market due to a lack of other attractive investment vehicles. China now boasts 1,400 listed companies, more than 130 securities firms, over 100,000 practitioners, and over 70 million investor accounts.³

While the growth of China’s stock market has been impressive by any standard, its further development has been bottle-necked — Chinese investors are quickly losing confidence in the stock market, partly due to their concerns with the listed firms’ poor corporate governance practices, and partly due to their concerns with many uncertain policy initiatives intended to solve the problem but

³Data source: the CSRC website.

complicate the matter instead. During 2000-2004, as China's GDP grew by 53%, the Shanghai and Shenzhen benchmark indexes fell by more than one third each. A recent on-line survey on 25,675 Chinese investors conducted by the internet portal *sina.com* showed that 94.28% of investors lost money in their stock investment, 67.34% of whom claimed to have lost more than half of their investment (source: *www.sina.com*, March 30, 2005). Even more strikingly, after four years' bear market, the market capitalization of tradable shares in China has dropped from close to 1.7 trillion yuan to 0.7 trillion yuan (up to early May of 2005).⁴ One trillion yuan worth of wealth disappeared in just 4 years and the trend is still continuing. If we only consider the value of tradeable shares, China's two stock markets are currently valued even lower than Denmark's stock market.

What had happened? Clearly, the deviation of the stock market performance from the strong performance in the real sectors says something. Not surprisingly, poor corporate governance has been singled out as the primary usual suspect. In this section, we discuss in detail the current corporate governance practices commonly adopted by the Chinese firms, and try to describe them in a quantitative manner.

2.2 Firm-Level Corporate Governance Practices in China

The seminal work by Berle and Means (1932) argues that, in practice, managers of a firm pursue their own interests rather than the interests of shareholders. In recent years, another set of conflicts of interests arises as controlling shareholders take actions to benefit themselves at the expense of minority shareholders. La Porta, Lopez de Silanes, Shleifer, and Vishny (1998) assert that the central agency problem in large corporations is to restrict expropriation of minority shareholders by controlling shareholders.⁵

In this context, our profession's understanding about corporate governance has also broadened. Taking different sets of conflicts of interest due to the separation of ownership and management into consideration, Denis and McConnell (2003) define corporate governance as a set of *mechanisms*,

⁴Due to special institutional arrangements imposed by the Chinese government, which we will detail later, only about one-third of shares are tradable in China.

⁵This expropriation takes a variety of forms, e.g., excessive executive compensation, loan guarantees for, and transfer pricing between, related companies, and dilution by new share issues. Johnson, La Porta, Lopez de Silanes, and Shleifer (2000) use the term tunneling to describe the transfer of resources out of firms for the benefits of controlling shareholders. Evidence from the Asian financial crisis indicates that tunneling is a serious agency problem in emerging markets.

both institutional and market based, that induce the self-interested controllers of a company (including both managers and controlling shareholders) to make decisions that maximize the value of the company to its owners. Similarly, TIAA-CREF defines corporate governance as the set of mechanisms that maintains an appropriate balance between the rights of shareholders and the needs of the board and management to direct and manage the corporation's affairs.

2.2.1 Corporate Governance Mechanisms Employed in China

In essence, good corporate governance comprises a set of mechanisms to ensure that suppliers of finance get an adequate return on their investment. China is no exception. To better describe the current corporate governance practices in China, we focus on a particular set of corporate governance mechanisms, and try to quantify each of them in the context of China's listed firms.⁶

Broadly speaking, there are two types of mechanisms that resolve the conflicts between owners and managers and between controlling shareholders and minority shareholders. The first type consists of internal mechanisms, e.g., the ownership structure, executive compensation, the board of directors, and financial disclosure. The second are external mechanisms, e.g., the effective takeover market, legal infrastructure, and product market competition.

Among the four internal governance mechanisms, ownership structure is crucial to the firm's value maximization. Concentrated equity ownership gives the largest shareholders substantial discretionary power to use the firm's resources for personal gain at the expense of other shareholders.⁷ To capture the ownership aspect of corporate governance, we compute the stake of the largest shareholder, and use it to measure both the largest shareholder's interest in a company and also the largest shareholder's power on the board.

The board of directors is a second mechanism through which shareholders can exert influence on the behavior of managers to ensure that the company is run in their interests (see Hermalin and Weisbach, 2003; and Bhagat, Carey, and Elson, 1999). With respect to the board of directors, we

⁶Our description of the corporate governance mechanisms employed in China is based on the framework proposed in Bai, Liu, Lu, Song, and Zhang (2004).

⁷Claessens, Djankov and Lang (2000) find that cross-holding and pyramidal ownership are common in Asian economies. This ownership arrangement allows the controlling shareholders to obtain even more control for minimal capital expense, so that tunneling becomes easier. Although in general cross-holding, pyramidal schemes, and deviations from one-share-one-vote are not common in China, Fang, Wong, and Zhang (2005) find that Chinese listed companies' ownership is getting more and more complicated. Multi-layer corporate structure is emerging in the Chinese stock market.

create a dummy variable that equals 1 if the CEO is the chairman of the board of directors and 0 otherwise. The monitoring role of board of directors is compromised when a CEO controls fully or partially the board. Therefore, we expect this variable to have negative impact on a firm's overall corporate governance level. To measure the degree of outside control of the board, we take the ratio of outside directors, who are not members of the management team, to inside directors. If the board is dominated by members of the management team, we do not expect it to play an effective monitoring role.

Providing the executives with incentive-related pay is another powerful mechanism to govern their behavior (Jensen and Murphy, 1990; Murphy 1999). The interest of the top managers are better aligned with that of shareholders if they have a larger stake in the firm. Regarding executive compensation, we note that stock options are rare in China. Furthermore, the information on executive pay is not complete and often inaccessible. Hence, we choose the following alternative variable to capture the alignment of interests between the managers and the shareholders. We first define the top executives of the firm to be its CEO, the executive vice presidents, the chairperson and the vice chairpersons of the board of directors. We take the percentage of shares held by these top executives as a measure of their economic interests in a company.

Finally, financial transparency and adequate information disclosure are crucial in developing countries. Sufficient, accurate and timely information regarding the firm's operations, its financial status, and the external environment is important for shareholders to be able to monitor the firm, to make investment decision affecting the firm, and to exercise control over the firm through other means.⁸ Regarding financial transparency, most listed companies in China are audited by local accounting firms but no reliable information exists to determining which accounting firms are more reputable. However, companies that issue H shares, which are traded on the Hong Kong Stock Exchange or B shares, which are open mainly to foreign investors in domestic stock exchanges, must adopt international accounting standards. We take a dummy variable that equals 1 if a company has H shares traded in the Hong Kong Stock Exchange or B shares traded in Shanghai or Shenzhen stock exchange and 0 otherwise.

Now we turn to the external mechanisms. An active market for corporate control is considered

⁸Bushman and Smith (2001) survey the relationship between financial accounting information and corporate governance.

to be essential for the efficient allocation of resources. This market allows able managers to gain control of sufficient shares in a short period of time to remove inefficient managers. Proxy fights are not usually successful in deposing the existing management or board directors because share holdings are often dispersed among small shareholders. Friendly mergers and takeovers occur in all countries and account for most of the transactions in the market for corporate control. In developed countries, the percentage of these activities ranges from 60% to 90%. Hostile takeovers occur fairly frequently in the U.S. and the U.K., but much less so in Germany, France and Japan. Empirical studies suggest that takeovers increase significantly the market value of target firms, although the gain for bidding firms is zero and possibly even negative. Studies using accounting data find that changes and improvements in operations can explain partially takeover premiums (Shleifer and Vishny, 1997).

However, an active corporate control market does not exist in China. We thus measure the market for corporate control by the concentration of shares in the hands of the second to the tenth largest shareholders. We take the natural logarithm of the sum of squares of the percentage points of shareholding by the 2nd to the 10th largest shareholders. This variable should have a positive impact on a firm's overall corporate governance level for three reasons. First, large shareholders other than the largest one are obstacles to tunneling activities by the largest shareholder because these shareholders have incentives to monitor and restrain the largest shareholder. Second, the efficiency of the market for corporate control is enhanced because these large shareholders can either initiate a fight for corporate control or assist an outsider's fight for control when the existing management underperforms. Third, these large shareholders have an incentive to monitor the management directly.

Regarding overall legal environment, another important external mechanism, companies that have issued H shares or B shares are subject to stricter legal rules. Hence, the dummy variable we define early can be viewed as a proxy for a better legal environment.

Lastly, we consider one final variable to indicate whether or not the controlling shareholder is the government. We define a dummy variable that equals 1 if the government is the controlling shareholder and 0 otherwise. The government is likely to have goals other than profit maximization, such as maintaining employment and social stability. A controlling government stakeholder can use

the listed company as a vehicle to achieve these other policy goals even though they may conflict with shareholders' interests (Bai, Li, Tao, and Wang, 2000).

2.2.2 Are Chinese Firms Performing Well?

We argue that the eight corporate governance variables discussed in Section 2.2.1, defined solely based on publicly available information, are able to capture different aspects of Chinese listed firms' corporate governance practices. We now examine how Chinese firms perform on each of those variables. We focus on the period 1999-2001 and report the results in Table 2.

As shown in Table 2, the largest shareholder in China on average holds 44.8% of shares, indicating a very *concentrated* ownership structure.

A large majority (78.9%) of the publicly listed firms, in China have a parent company. A listed firm being situated within a group company complicates the listed company's operation and also reduces its transparency.

More than one third of the CEOs are also the chairman of the board of directors, which hinders board from playing an effective monitoring role. The proportion of outsider directors on the board is surprisingly high, with a mean of 70.6% and a standard deviation of 18.3%. The evidence suggests that the Chinese listed firms score quite high on the 'board of directors' front.

However, the research by Chen, Fan and Wong (2004) argues that although the proportion of outsider directors on the board is high, the level of board independence and professionalism is not necessarily good. For example, they find that in China, politicians and state controlling owners occupy most board seats. They report that almost 50% of the directors are appointed by state controlling owners, and another 30% are affiliated with various layers of governmental agencies. There are few professionals (lawyers, accountants, finance experts) on Chinese boards and almost no representative of minority shareholders. Based on their findings, the evidence in Table 2 likely overestimates Chinese firms' performance on the board of directors category.

Top managers typically own very little of their companies' shares, on average only 0.1%. Incentive pay is unlikely to be a primary corporate governance mechanism. However, the managers may be able to grab rents from the firms through other channels, e.g., excessive perks not reflected in salary and bonus, gains from insider trading, etc. Thus, the above variable does not reflect the

Chinese managers' true incentives, unless we can identify some reliable proxies to capture those 'gray' incomes.

The mean and the standard deviation for the concentration of the second to the tenth largest shareholders are -5.98 and 2.72, respectively. These numbers do not mean much by themselves. However, the sum of the percentage of shareholding held by the second to the tenth largest shareholders has an average of 16.93% and a maximum of 61.97%. These results, on the one hand, suggest that the ownership structure is highly concentrated among the Chinese listed firms; on the other hand, suggest that if other large shareholders can act jointly, they can still accumulate a large amount of votes to challenge the largest shareholders. But these numbers do not tell us much with regard to how active the takeover market is in China.

Neither dual listing nor multiple listing is common for Chinese firms as the average proportion of companies issuing H or B shares is about 10%. Finally, over 50% of companies are controlled by the government.

Clearly, the corporate governance practices adopted by the Chinese listed firms can be best described as a control-based model, in which the controlling shareholders (in most cases, the state) tightly control the listed firms through concentrated ownership, management friend boards, and low transparency in operations. Table 3 shows that the ultimate controlling shareholders for more than 80% of Chinese firms are central government or local government. The state has incentive to keep enough equity interest so it can achieve other policy goals easily through the listed firm vehicle.⁹

What is worth noting is that the effectiveness of varied corporate governance mechanisms crucially hinges on the level of overall institutional environment. When the legal system is incomplete and law enforcement is weak, and when business is tightly connected to politics, the effectiveness of the conventional governance mechanisms could be greatly compromised. We will discuss how effective the above-mentioned mechanisms is in Section 3.

⁹We will discuss how the control-based model emerged in China in Section 4.

2.3 Where is China? Cross-Country Evidence

The firm level evidence does not tell how good the Chinese firms' corporate governance practices are, compared to other countries/economies. Thus, we need to consider China's corporate governance level in a cross-country setting. The Asian financial crisis and the recent corporate scandals in the US (i.e., Worldcom, Enron, etc.) has greatly intensified the worldwide interest in the corporate governance issues. Numerous initiatives have been proposed by international organizations, academics, and private sector to better understand and frame the corporate governance practices in the world, which provide an opportunity for us to understand China's corporate governance practice in an international context.

For example, the IMD in Switzerland surveyed sixty economies in the world in 2004, and provided an economy-level corporate governance ranking. When examining an economy's performance on corporate governance, IMD emphasizes its performance on the following four categories: corporate board, shareholder value, insider trading, and shareholder right. (see Panel A of Table 4). Among sixty economies surveyed, China ranks the 25th on the corporate board category, 40th on shareholder value, 57th on insider trading, and 44th on shareholder right. Its overall ranking, not surprisingly, appears on the low-end of the sixty economies surveyed.

Panel B of Table 4 provides another economy-level corporate governance ranking provided by the World Economic Forum in 2003, when 49 economies are surveyed. The results in Panel provides a message very similar to that in Panel A. That is, China underperforms in corporate governance category — among the forty-nine economies surveyed, China's overall ranking is only the 44th, slightly better than Indonesia, but worse than other Asian economies such as Taiwan, Malaysia, Thailand, and India.

We now revisit the four categories listed in Panel A of Table 4. China ranks the 25th on corporate board, which is higher than Japan (50th) and Korea (53th), and surprisingly, the US (35th) and Germany (44th). Obviously, a series policy initiatives introduced by the CSRC, aiming at improving the independence of corporate boards, have been acknowledged by the ranking agencies. However, apart from those low-hanging fruits, China scores very low on other governance aspects.¹⁰ The protection of shareholder rights is poor, insider trading is rampant, and the listed companies

¹⁰Arguably, it is easier to improve firms' performance on corporate board.

do not take shareholder value maximization as their primary goal, in practice.¹¹

3 Economic Effects of Corporate Governance In China

How do the current corporate governance practices, which are best described as a control-based model, affect corporate policies and the firms' performance? A growing literature is examining the economic effects of various governance mechanisms in China. In this section, we focus on reporting their effects on the Chinese firms' valuation, profit reporting behavior, tunneling activities, and other behaviors. We also discuss how different governance mechanisms interact and impact on the corporate sectors.

3.1 Corporate Governance and Firm Valuation

A firm's various corporate governance practices shape its behavior and eventually affect its stock market performance and accounting performance. Earlier research on this front focuses on examining the relation between *state ownership* and firm performance. For example, Xu and Wang (1999) report that Chinese firms' accounting performance is negatively related to the level of state ownership. Sun and Tong (2003) also find that share issue privatization is associated with improved corporate performance.

Tian (2001) is one of the first that study the ownership structure and the Chinese listed firms' stock market valuation. He finds that government ownership's impact of stock market valuation is non-linear — it worsens a firm's performance when government ownership is small, but improves a firm's performance when government ownership gets significantly larger. Tian (2001) attributes the non-linearity of government ownership to stock market valuation to the state's varying interest alignment with other shareholders when state ownership increases.

Several other studies examine the impact of other governance mechanisms on Chinese listed firms' performance. Ning and Zhou (2005) find that employee stock ownership does not work in improving firm performance in China, suggesting that negligible fractional ownership does not

¹¹Besides the two rankings we discuss in this paper, other organizations such as S&P, CLSA, Asian Development Bank, have also provided corporate governance ranking at country/economy level, positioning China in the low end of those lists.

provide meaningful employee incentives. Kato and Long (2005) find evidence that CEO turnover-firm performance sensitivities are larger for privately controlled listed firms than for state controlled firms, indicating the inefficiency of state ownership from the CEO turnover perspective.

Bai, Liu, Lu, Song, and Zhang (2004) offers a comprehensive analysis on how various governance mechanisms impact on firm market valuation. They examine how eight different corporate governance variables, which are designed to capture the control-based governance model adopted among the Chinese listed firms, affect the Chinese listed firms' market valuation. Using the data over 1999-2001, they find that the effect of the shareholding of the largest share holder is non-linear. There is a U-shaped relationship between a firm's market valuation and the proportion of shares held by the largest shareholder, which confirms the finding in Tian (2001). Interestingly, they find evidence that the degree of concentration of shares held by other large shareholders, excluding the largest one, positively affects firms' market valuation. It is argued that when shares are concentrated in the hands of other largest shareholders, they are more likely to monitor the largest shareholder and prevent him from tunnelling a firm's resources. In a related paper, Bai, Liu and Song (2004) provide evidence that the concentration degree of shares by other largest shareholders is a good proxy for the likelihood of emerging an corporate control market. As such, it captures the effects on firm performance of an active takeover market, which has been widely touted as an effective external governance mechanism.

Bai, liu, lu, song and Zhang (2004) also find that issuing shares to foreign investors helps to improve firms' valuation, partly due to the monitoring effect of the relatively more sophisticated foreign investors, and partly due to more transparent financial disclosure required for cross-border listings. Among other governance mechanisms, they find that CEOs being the chairmen of boards negatively affects firm valuation, indicating that increasing the independence of boards of directors helps to enhance firm performance. They also find that when the largest shareholders are the state, the firms tend to have lower market valuation.

Based on a firm's performance on various governance mechanism, Bai, Liu, Lu, Song, and Zhang (2003) propose a composite index — the CG index — to capture a firm's overall corporate governance performance. They find that firms scoring higher in their CG indexes tend to have higher market values. More important, they find that as firms improve their corporate governance

practices and migrate from lower CG ranking to higher CG ranking, their market values will go up. Figure 1 plots the relation between firms' market valuation measure and their CG index scores.

The control-based corporate governance model, resulting from China's partial share issue privatization, creates rent-seeking incentives for politicians, which may hurt the performance and corporate governance of newly listed state enterprises. Fan and Wong (2004) report that almost 28% of the CEOs in their sample are ex- or current government bureaucrats. They also find that the three-year post-IPO average stock returns of these *politically-connected* firms underperform the market by almost 30%. They conclude that the appointment of politically-connected CEOs does not enhance shareholder value but rather fulfill political goals of politicians.

3.2 Corporate governance and Stock Returns

Corporate governance practices shape a firm's behavior. It is therefore natural to expect that they also affect a firm's stock returns. Although intuitive, there is a paucity of evidence on this line of reasoning. Wang and Xu (2004) is one of few that actually examine the relation between corporate governance and stock returns in a cross-section. Studying the data from 1996 to 2002, Wang and Xu find that size, not book-to-market, helps to explain cross-sectional stock returns in China. They argue that due to the speculative nature of the Chinese capital markets and low quality in the accounting information, book-to-market does not reflect fundamentals in China's stock market. Instead, Wang and Xu suggest that firm-specific floating ratio is a good proxy for expected corporate governance in China, which helps to predict a firm's future cash flow. They find evidence that adding floating ratio increase the asset pricing model's fitness level from 81% to 90%.

It is not clear whether floating ratio is a sufficient statistics of firm-specific corporate governance practices. But low floating ratios in the Chinese listed firms is one of the consequences of China's partial share issue privatization. Such a practice leads to the co-existence of several types of shares in the listed firms — state shares, legal person shares, and public shares. Only the shares held by the public are tradeable. The transfer of state shares and legal person shares are strictly controlled by the government. The so called '*gu quan fen zhi*' (the same company's shares having heterogeneous venues of trading, some are tradable and some are nearly non-tradable) has caused much trouble in the Chinese stock market. Floating the state shares and legal person shares may cause a gush

of tradable shares in the marketplace, which may further depress the stock prices.

3.3 Corporate Governance and Firm Profit Reporting

Corporate governance has direct impact on firms' profit reporting incentives. If the managers or the largest shareholders want to expropriate the minority shareholders and tunnel firms' resources, they have incentives to camouflage the true performance of the firms they are running.

Not surprisingly, the low level of corporate governance practiced by the Chinese listed companies has made earnings management or even falsifying financial reports easily accessible. Such incentives are further strengthened, since the CSRC relies on accounting numbers to regulate the listed companies (i.e., decide whether to grant them the rights to issue new shares, or de-list them due to poor performance) — the Chinese listed firms demonstrate greater incentives to manage their earnings above certain accounting indicators, especially the return on equity (ROE), thresholds. Figure 2 presents a histogram of ROE for China's listed companies from 1999 to 2001. It is apparent that a disproportionately high number of companies reported ROEs just slightly over 0, 6%, and 10% — the three spikes demonstrating two most important incentive to manage earnings: avoiding losses; and making ROEs above 10% or at least 6%.¹²

Liu and Lu (2004) study the relationship between governance mechanisms and earnings management. Using data covering the Chinese listed firms over 1999-2001, they find the severity of earnings management is *positively* related to the proportion of shares held by the largest shareholder, the shares held by the top management, and the dummy variable indicating CEO as the chairman of the board, but *negatively* correlated the dummy variable indicating whether a firm issues stocks to foreign investors. These results suggest that higher level of corporate governance practices is associated with smaller degree of earnings management.

Liu and Lu (2004) also provide evidence that the purpose of earnings management in China is to tunnel, that is, to facilitate the largest shareholder's expropriation of the small shareholders. Jian and Wong (2003) provide more direct evidence. They find that group-controlled firms in China are more likely to use related transactions to manipulate earnings and tunnel firm value. Aharony

¹²The CSRC regulates that a firm has to maintain a minimum of 6% of reported ROEs and a three-year average of 10% of ROEs in order to get the rights to offer new shares. Thus both 6% and 10% of ROE are quite critical for the Chinese listed firms.

et al. (2000) examine earnings management in the IPOs of China's B- and H-share companies. They provide evidence that these Chinese firms demonstrate strong incentives to "package" their earnings before IPOs.

In another related research, Liu and Xiao (2004) study the profit reporting incentives across six different ownership types in China — private firms, collective firms, SOEs, foreign invested firms, Hong Kong/Taiwan invested firms, and lastly joint stock companies. They identify a profit-hiding order across ownership in China. The incentive, ranked from the weakest to the strongest, is: foreign firms, HK/TW firms, SOEs, joint stock firms, collectives, and private firms. The evidence clearly shows that ownership matters a lot in explaining Chinese firms' profit reporting incentives.

Chen, Lee, and Li (2003) examine local government's roles in listed firms' earnings management. They find evidence that local government has actively participated in earnings management of the listed firms located in her jurisdictions by providing them with fiscal transfers. The primary purpose of this government-assisted earnings management is to assist the firms to manage accounting earnings so as to meet the regulations stipulated by the central government.

3.4 Ferreting out Tunneling

La Porta et al. (1999) conclude, "... the central agency problem in large corporations around the world is that of restricting expropriation of minority shareholders by controlling shareholders..." China, where both legal enforcement and corporate governance are weak, is no exception. Since more than 78% of listed companies belong to certain groups and have parent firms as the controlling shareholders, parent firms, if necessary, can easily tunnel the firm resources out of the listed entities. Numerous anecdotes illustrate how listed firms' controlling shareholders expropriate the minority shareholders and tunnel firm resources. For example, in 2001, the largest shareholder of Meierya — a then profitable company — colluded with other insiders to embezzle US\$44.6 million, 41% of the company's total equity. In the same year, the largest shareholder of Sanjiu Pharma, a one-time blue chip in China, extracted US\$309.1 million, 96% of the listed company's total equity. A study conducted by the Shanghai-based Shenyin and Wangguo Securities Co., Ltd, surveyed 130 listed firms and found that those firms' controlling shareholders on average own the listed companies US\$40 million in the form of accounts receivables or outright parent borrowing (Source: Caijing

Magazine, June 5, 1992).

Given its very nature (subtle and hard to detect), large-sample evidence of tunneling is hard to come by. Jian and Wong (2003) study a sample of 131 Chinese listed firms in the basic materials industries such as mining, lumber, chemicals and building materials, they find that firms that are controlled by groups engage in more related party transactions than firms that are not. They also find that once group-controlled listed firms have generated more free cash flows, they divert resources back to the group through providing other member firms generous *trade credits*.

Lee and Xiao (2004) examine the Chinese listed firms' dividend payout policy. They provide evidence that state dominant firms have high propensity to pay cash dividend but low propensity to subscribe rights offering. Furthermore, state dominant firms often increase cash dividend soon after rights offerings. Since state-held shares in China are non-tradable, giving up subscription rights and using receipts from rights offering to pay cash dividend are equivalent to selling a portion of the non-tradable shares by the majority shareholders to the minority shareholders, especially the computed prices are on average three times higher than that of officially approved private placement. They interpret such a dividend paying practice as the evidence of tunneling.

Bai, Liu and Song (2004) suggest an innovative way to gauge the extent of tunneling in the Chinese listed companies. They study the Chinese ST firms' post-ST stock market performance.¹³ They argue that in China, when a listed firm has normal financial performance, its controlling shareholder—a state-owned enterprise (SOE) in more than 80% of cases—enjoys the support of the local government, the regulatory authorities, and other large shareholders. Its control over the listed firm is secure. However, when a listed firm is designated an ST firm and its incumbent controlling shareholder cannot immediately drag it out of financial trouble, it may lose all support. The local government, out of concerns that it may lose face and, more importantly, the valuable listing quota,¹⁴ will either force the incumbent to present a credible restructuring plan, often requiring

¹³In order to enhance the Chinese listed firms' governance practice and protect minority investors' interest, the CSRC introduced a special delisting mechanism in 1998. Under the guidelines set forth by the CSRC, China's two stock exchanges started to classify some firms as special treatment firms (ST firms) if their performance triggers certain threshold levels. ST firms are facing the possibility of being delisted if they failed to improve performance within certain time frame. See Bai, Liu, and Song (2004) for detail.

¹⁴Until recently, access to listing in China's stock markets was strictly administered by the central government. The China Securities Regulatory Commission (CSRC) assigned a quota to the planning commissions of the various provincial governments. These, in turn, allocated the quota to IPO candidates in their own provinces, mostly to state-owned enterprises. There was fierce competition among the local IPO candidates for the listing quota. In

substantial resource commitment, or give up its control to another party whose restructuring plan is more convincing. Meanwhile, firms interested in the ST firm, especially those in the same region, will be encouraged to bid for the listed company.

Therefore, the ST designation system triggers the opening of a market for corporate control which otherwise does not exist. In fact, during the period from 1998 to 2000, fewer than 10% of non-ST firms changed their largest shareholder. In contrast, more than 50% of ST firms changed their largest shareholders. In their contest for the control over the ST firm, the contestants compete by offering to prop up the ST firms either through injecting quality assets or through relieving those firms' overriding debt burdens, which eventually benefits minority shareholders. Therefore, propping — entrepreneurs use their private funds to prop up their firms (see Friedman, Johnson, and Mitton 2003) — is common among these ST firms and likely driven by a stiff contest over corporate control. They estimate that that the 31.8% of abnormal stock market value two years after the firm were designated ST reflects the price a controlling shareholder—incumbent or entrant—is willing to pay in order to maintain or obtain the control rights, or equivalently the magnitude of the propping. Obviously, the price the controlling shareholder is willing to pay depends on the degree of competition in the corporate control markets and the size of private benefits he can enjoy after he secures the control over the firm. Thus, *how much to prop up depends on how much the controlling shareholders can tunnel in the future*. They estimate that on average a Chinese listed firm are able to tunnel a wealth equivalent to 31.8% of the firm value.

3.5 How Do Other Mechanisms Work in China

Other governance mechanisms may also help to discipline the listed firms and protect the minority shareholders. However, their effectiveness hinges on the overall legal and regulatory environment. For example, DeFond, Wong, and Li (1999) find that when China adopted rigorous new auditing standards to increase auditor independence, the listed firms take a flight from high quality auditors to low quality auditors in order to avoid modified opinions issued by high quality auditors.

early 2001, the listing quota was abolished in favor of an expert-review system. All IPO candidates now have to go through a one-year preparatory phase before an application can be submitted. Investment banks must submit these applications on behalf of the candidates, and selected members from an 80-member expert committee review the qualifications of the candidates. However, the CSRC still tightly controls the number of IPO applications and the pace of IPOs. Even under the new system, going public is still very time-consuming and costly.

Liu and Zhou (2005) examine whether engaging the big-five audit firms improves auditing quality. They study the Chinese listed firms' financial reports over 1999-2001. They find no correlation between the hiring of the big-five audit firms and the quality of reports issued by them. They attribute the evidence to these audit firms' market share concern. More important, since the big-five audit firms are not running any legal risks operating in China (class action lawsuits are not allowed in China; also the public enforcement of laws and regulations have been weak), the incentives to please existing clients and attract more new clients may dominate the incentives to release honest opinions. Obviously, employing quality auditors as a corporate governance mechanism does not work effectively in China.

An active take-over market can also discipline firm behavior and protect shareholder rights. Liu and Xu (2005) find that the majority of mergers and acquisitions (M&As) transactions in China are actually driven by sound economic rationales. For example, they find that more competitive industries, or industries that are going through regulatory shocks, are more likely to consolidate themselves and eye-witness many M&As. They also find that firms in regions, where capital markets are well developed, are more likely to engage in M&A deals. Since the M&As in China are driven by economic considerations, we expect them to be an effective external governance mechanism. However, the takeover market in China is still in its infant stage and the total M&A transaction value is only several percent of GDP. It will take time for M&A to become more effective in governing China's listed firms.

Arguably, product market competition can also play as an external governance mechanism since competitive pressure may discipline the management. However, Cai, Liu, and Xiao (2005) find that when firms use unethical behavior as instrument to gain competitive advantages, competition may encourage unethical behaviors. Empirically, using a large sample of Chinese industrial firms, they find that competition surprisingly fosters firms' incentives to misreport profits. They also find that firms at disadvantageous positions demonstrate stronger propensities to hide profits, all else equal.

Another study, Niu and Li (2005), examines the relations between product market competition and various governance mechanism in the Chinese stock market. They provide evidence that when ownership structure are highly dispersed or higher concentrated, product market competition is complementary to governance mechanisms. They also show that for firms with modestly

concentrated ownership, product market competition substitute for governance mechanisms. Lastly, they find that product market competition complements board efficiency and the effectiveness of executive compensations.

Lastly, government regulations could also serve as an effective governance mechanism, especially when the law and law enforcement are weak (Johnson, Glaeser, and Shleifer, 2001). In China, since the legal infrastructure is particularly weak, Pistor and Xu (2004) argue that the so-called ‘administrative governance’ has played an active and positive role in the development of the Chinese stock market, at least in its earlier stage. However, more recent evidence shows that government regulations are also sources of many problems in the Chinese stock market. Public governance more likely is a complement of corporate governance, but not its substitute. Therefore, the effectiveness of government regulations has been seriously questioned (see Section 4.2 for details).

4 How Do We get Here? The Institutional Determinants

“ The concept of corporate governance has not been well developed or understood in our country. This may be partly due to our transitional stage from a planned economy to a market economy, and partly due to the entanglement of ownership rights with management responsibilities.” — Laura Cha, former Vice Chairman of the CRSC

How do we get here? Why do the various corporate governance practices, even after their negative impact on the corporate sector has been fully exposed, still stick in the Chinese economy as business norms? To answer these questions, we need to first of all understand how the control-based governance model emerged in China, and what institutional determinants underneath are driving its evolution across time?

Several unique features specific to the Chinese economy have shaped the emergence and development of China’s stock market. First of all, China is a transition economy, where most components of the institutional infrastructure are lacking or inefficiently enforced. Second, in order to improve the SOEs’ efficiency, the Chinese government has adopted the corporatization policy for the past two decades. The main purpose of ‘corporatization’ is to reform the business processes of SOEs by subjecting them to the rules of the “modern enterprise system”. Developing a stock market

and allowing the SOEs to raise capital through equity issuance is one part of the consideration (See for example, Clarke, 2003). Third, financial markets are still poorly developed in China (see Allen, Qian, and Qian 2004). Attractive investment vehicles are lacking in China. The stock market, soon after it was established, becomes an attractive investment alternative for the general public. The general public have shown tremendous enthusiasm for China's infant stock market.¹⁵ Because of the heavy involvement of the general public, the securities regulators are constrained in their policy spectrum. Any turmoils in the stock market may potentially spread out and endanger the social stability.

4.1 Reforming the SOEs

The Chinese stock market was organized by the government as a vehicle for its state-owned enterprises (SOEs) to raise capital and improve operating performance (Green, 2003). Since the birth of the Chinese stock market, the regulations have been evolving to address problems typically found in emerging markets. In particular, the China Securities Regulatory Commission (CSRC) has been managing the tradeoff between growth and control. Since the primary objective of developing equity markets in China is to help SOEs relax external financing constraints, regulations introduced have been asymmetrically in favor of SOEs or the companies with close ties to the government.

As pointed out in Clarke (2003), a fundamental dilemma of the above approach stems from the state policy of maintaining a full or controlling ownership interest in enterprises. The state wants the enterprises it owns to be run efficiently, but not solely for the purpose of wealth maximization. Other more immediate purposes include maintenance of urban employment, direct control of sensitive industries, and politically motivated job placement. The state therefore wants to continue to involve in the build up of the Chinese stock market. However, such state involvement creates a conflict of interest between the state as controlling shareholders and other other shareholders. Even worse, the state is playing two roles at the same time — controlling shareholders and regulators.

This dilemma generates many implications on the Chinese firms' corporate governance practices. First of all, the ownership of Chinese listed companies is heavily concentrated on the hands of the state, simply because the state wants to keep enough equity interest to control the listed firms.

¹⁵The average subscription ratio for new shares have been over 200 times throughout the first 10 years since the Chinese stock market opened, while retail investors dominates domestic issuance.

As shown in Table 2, on average, state-owned shares and legal-person shares (indirectly owned by government) account for over 70% of the total shares in China's listed companies. Furthermore, the largest shareholder (in 80% of cases, the government) controls 48% of listed companies' shares, while the second largest shareholder typically owns less than 10% of shares. Second, since the state or state-alike legal persons are normally the largest shareholders of the listed companies, the state representative generally dominate the boards of directors. The independence of boards is thus greatly compromised. Third, developing stock market in China serves several purposes (i.e., allowing SOEs to leverage the market to get more capital, improve SOEs' efficiency, setting up a new organization form to promote the development of non-state sectors, maintaining employment, etc.). Shareholder value maximization, or put it another way, protection of minority shareholders, is not the only, not even the primary objective of firm operations. Providing investors with timely and accurate information is not the priority. Corporate transparency in China is low despite that new laws and regulations require more disclosure.

4.2 Weak Legal Environment and Administrative Governance

The growing law and finance literature has established the importance of legal environment, and more specifically the extent of investor protection, in fostering good corporate governance practice (see La Porta, Lopez-De-Silanes, Shleifer, and Vishny, 1997, 1998, 2000, 2002). China, however, under performs in terms of the legal infrastructure and actual law enforcement. As detailed in Pistor and Xu (2004), both private enforcement of investor rights and public enforcement of contractual disputes have been extremely weak in China. Weak legal system, on the one hand, limits the scope of corporate governance practices a firm can follow; on the other hand, predetermines the set of regulatory frameworks that China can choose from.

Pistor and Xu (2004) argue that as effective law enforcement is lacking in China, China has to rely primarily on an administrative governance structure built around the quota system to regulate the stock market. Under the quota system, the CSRC assigns the listing quota to the planning commissions of various provinces, then to IPO candidates.¹⁶ Pistor and Xu (2004) argue that the quota system served two important functions with respect to development of stock market. It helps

¹⁶In most cases, the corporatization (or corporate restructuring) is organized based on the actual quota an IPO obtains. The local government, in order to boost the post-IPO performance of the listed firms, has incentive to inject quality assets into the listed companies, and divest low quality assets or debt.

to mitigate the asymmetric information problems investors and regulators face. It also provides the local bureaucrats an incentive to choose viable companies to go IPO. Partly due to quota system, China has achieved partial success in its stock market development.

The quota system however has inherent weakness. Like any other quota systems employed in the transition economies, the adoption of quota provides the local bureaucrats with “rent seeking” opportunities.¹⁷ The local bureaucrats thus have incentives to select the firms (IPO candidates), through whom they can grab the largest rents. Similarly, they also choose the ownership structure by which their benefits can be maximized. The utility function of the local bureaucrats is definitely different from that of the minority shareholders.

Because of the implementation of the quota system, the corporatization of SOEs in China is not complete. A firm obtains a certain amount of quota and will corporatize itself according to the amount of shares it can issue. Suboptimal ownerships are thus selected to maximize the state’s control and the local bureaucrats’ utilities. This can explain why ownership has been so concentrated in the hands of the state in China through direct control or the control of legal persons. It also explain why the floating ratios in China are in general quite low (e.g., less than 40% based on the information on the CSRC website.)

4.3 The Emergence of Corporate Pyramids in China — A Case Example

Fan, Wong, and Zhang (2005) examine the formation of corporate pyramids in China, and present a relevant case example to understand how institutional settings in China help to form firms’ ownership structures — arguably the most important aspect of all governance mechanisms.

Pyramidal ownership structure, a common structure used in Korea, Singapore, Hong Kong, and other Asian economies,¹⁸ was not commonly observed in the earlier stage of China’s stock market. However, in recent years, the ownership structure of the Chinese listed firms is moving towards a multi-layer mode. Based on Fan, Wong and Zhang (2005), more than 70% of government-controlled listed firms have two or more than two pyramidal layers, and almost all entrepreneur-controlled firms have more than two pyramidal layers. Although the number of pyramidal layers in Chinese

¹⁷E.g., see Shleifer and Vishny, 1998.

¹⁸See, for example, La Porta, Lopez-de-Silanes, and Shleifer, 1999; Claessens, Djankov, Lang, 2000; Claessens, Djankov, Fan, Lang, 2002.

firms does not look as impressive as those in Korean, Hong Kong, and Japan, where pyramidal and cross-holding ownership structures have been in practice for more than four decades, its ever-increasing complexity concerns academic researchers and policy makers.

Fan et al. (2005), while explaining the determinants of pyramiding behavior of government-controlled listed firms, emphasize the local government's incentives to credibly decentralize their firms decision rights to firm management without selling off their ownership. Here, local governments' choice set is limited by various institutional constraints — local government cannot use outright sales as a means to transfer its decision rights in the firm to a third party (decentralize), but it has incentives to boost the firms' long term performance. Fan et al. (2005) also examine the pyramiding behavior of entrepreneur-controlled listed firms and find evidence that it is mainly driven by their lack of access to external funds. Clearly, different institutional constraints shape the Chinese firms' ownership structure in different ways.

As federalism (decentralization), corporatization, and lack of efficient institutional infrastructure will likely remain for the next decade, it is interesting to study how they will continue to interact and impact on the Chinese firms. To a certain extent, the corporate governance practice employed in China is just an amalgamation of various considerations discussed above.

5 Concluding Remarks — The Challenges

While we are writing this paper, the Shanghai benchmark index has dropped to close to 1,100 points, a record low in six years. Meanwhile, the investors' confidence level has dropped to almost zero. What happens in the stock market contrasts strikingly with China's strong performance in the real sectors. Ironically, the Chinese government had set improving corporate governance as the top priority in its stock market development as early as year 2000. Four years have since then passed, but little progress has been made. Put aside all of the finger pointings, people wonders why the task has been so challenging.

Our paper overviews the practices currently employed in China, examines their various economic effects, and more important, explores the institutional determinants underneath. Our main thesis, based on our survey on the related research, is the following: *the current corporate governance*

practices are hurting the further development of China's stock market; however, this control-based governance model roots itself in China's institutional setting; thus, improving corporate governance is not just a firm-level initiative, and it cannot just be done within the stock market; focusing on the macro-level institutional factors is a must, and will pay off.

Since the research on the Chinese corporate governance is just emerging, our knowledge about the governance practices employed in China, and how to improve these practices, is very limited. Now we understand that the improvement of corporate governance practices in China crucially hinges on whether the overall institutional infrastructure can be further improved in the future. Towards this goal, we need to confront the following pending challenges:

1. What exactly does stock market do? It has been proved that only using the stock market as a source of capital for the state-run enterprises to relax their external financing constraints does not work. However, this mentality is still dominant and has predetermined many policy initiatives. How to change this mind-set among the regulators, investors, and listed firms poses a big challenge going forward.
2. It is getting clear that a market-oriented governance model should be eventually put in place in China. But how can China migrate its corporate governance practices from a control-based model to a market-oriented model? A road map, and more importantly, a carefully designed execution plan, is yet to come by.
3. While the administrative governance is phasing out, how can China establish a governance framework that is soundly built on the basis of the 'fairness, justice, and open access' principles. The causality and dynamics between corporate governance practices and institutional constraints are not fully understood, and yet to map out.

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Table 1 Summary of China's Stock Market, 1992-2002

This table provides the summary information of China's stock market over the period 1992-2002. The data source is the China Securities Regulatory Commission (CSRC).

	Total raised capital through IPOs (A- and B-shares, RMB bn)	Total raised capital through oversea issuance (RMB, bn)	Market Cap. (RMB billion)	Market cap. as % GCP	Tradable market cap. (RMB billion)	Tradable market cap. as % of GDP
1992	9.4	-	104.8	3.9	86.2	3.2
1993	23.3	6.1	353.3	10.2	96.9	2.8
1994	8.8	18.9	369.1	7.9	96.5	2.1
1995	5.6	3.2	347.4	5.9	93.8	1.6
1996	27.2	8.4	984.2	14.5	286.7	4.2
1997	73.6	36.0	1,752.9	23.4	520.4	7.0
1998	46.9	3.8	1,950.6	24.5	574.5	7.2
1999	57.7	4.7	2,647.1	31.8	821.4	9.9
2000	102.1	56.2	4,809.1	53.8	1,608.8	18.0
2001	75.2	7.0	4,352.2	45.4	1,446.3	15.1
2002	68.1	18.2	3,832.9	37.0	1,248.5	12.0

Table 2 Summary Statistics of Corporate Governance Variables in China, 1999-2001

This table provides the summary statistics of the eight corporate governance variables in China over the period 1999-2001, which capture various aspects of the Chinese listed firms' current corporate governance practices (see Bai, Liu, Lu, Song, and Zhang, 2004; and Liu and Lu, 2004).

Variable	Mean	S. D.	Minimum	Median	Maximum
Percent of shares by the largest shareholders	44.8	17.9	1.9	44.3	88.6
Dummy the listed firm has a parent firm	0.789	0.408	0	1	1
Dummy the CEO is also the chair of board	0.346	0.476	0	0	1
Ratio of outside directors to inside directors	0.722	0.174	0	0.727	1
Portion of shares held by top management	0.001	0.005	0	0.000	0.149
Dummy a firm has H- and B shares	0.099	0.299	0	0	1
Sum of shares by the 2 nd -10 th large shareholders	0.1693	0.1352	0.1357	0.0022	0.6197
The concentration of shares held by top ten shareholders except the largest one	-5.975	2.723	-14.434	-5.416	-1.771
Dummy the largest shareholder is the state	0.556	0.497	0	1	1

Table 3 The Different Ownership Types of China's Publicly Listed Companies

The table presents the ownership types of China's publicly listed company over the period from 1993 to 2001. The data source is Fan and Wong (2004), and Fan, Wong, and Zhang (2005). Here the ownership is judged based on the status of the controlling shareholders.

YEAR	Number of listed companies	Local government (%)	Central government (%)	Privately-controlled firms (%)	Collective (%)	Widely-held (%)	Miscellaneous (%)	Unidentified (%)
1993	166	77.71	6.63	3.01	3.01	1.81	3.61	4.22
1994	285	75.44	6.32	3.86	4.21	1.05	4.56	4.56
1995	309	75.73	7.12	3.88	3.88	0.97	3.88	4.53
1996	486	73.05	9.67	4.94	3.91	0.41	4.32	3.70
1997	719	70.93	11.68	5.29	4.45	0.14	4.45	3.06
1998	825	68.97	12.73	7.15	4.12	0.12	4.48	2.42
1999	923	65.44	13.76	8.99	4.33	0.22	4.88	2.38
2000	1,060	63.11	14.62	10.85	3.87	0.19	5.66	1.70
2001	1,134	61.38	15.26	12.79	3.44	0.09	5.82	1.23
Total	5,907	67.39	12.56	8.38	3.96	0.30	4.94	2.51

Table 4 Corporate Governance Ranking – International Comparison

Panel A: IMD 2004, 60 economies surveyed

	Average Rank	Corporate Board	Shareholder Value	Insider Trading	Shareholder Right
Singapore	7.5	5	13	3	9
Hong Kong	16.0	9	8	22	25
Malaysia	16.3	10	12	25	18
Sweden	18.8	38	14	17	6
UK	22.5	22	30	16	22
Germany	23.5	44	31	7	12
USA	23.5	35	17	29	13
Taiwan	23.8	12	21	34	28
India	37.0	29	35	49	35
Thailand	37.3	27	28	55	39
China	41.5	25	40	57	44
Japan	45.3	50	59	13	59
Philippines	45.8	37	42	54	50
Korea	50.5	53	53	41	55
Indonesia	55.3	56	52	59	54

Panel B World Economic Forum 2003, 49 economies surveyed

Rank	Economy	Score
1	United Kingdom	6.34
6	Sweden	5.98
7	USA	5.94
8	Singapore	5.91
9	Germany	5.78
13	Hong Kong	5.59
21	Malaysia	5.27
23	Taiwan	4.96
28	Thailand	4.72
31	Japan	4.59
32	India	4.59
33	Korea	4.59
43	Philippines	3.89
44	China	3.80
46	Indonesia	3.62

Figure 1, The Mean Values of *Tobin's q* for Each Grade

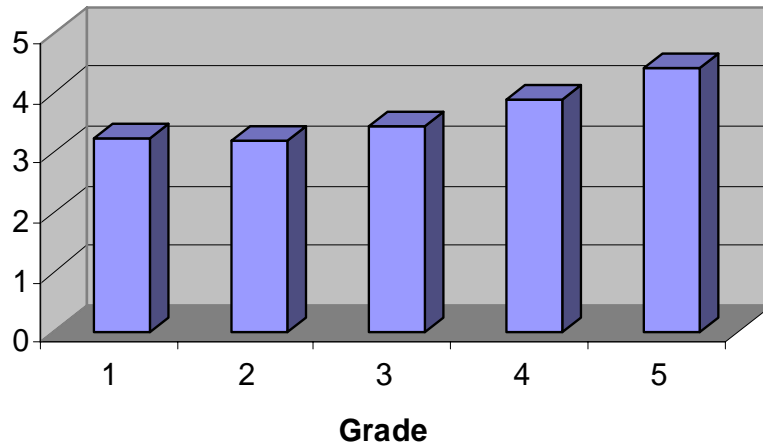


Figure 2: Histogram of ROE for China's Listed Companies From 1999 to 2001

