1. Introduction

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1. REGULATORY REFORM IN CHINA AND THE EU

China has achieved spectacular economic achievements since the 1990s with a GDP growth rate of around 10 per cent per year on average. It has rapidly changed from an agricultural to an industrialized country. A strategy of incremental reform has been adopted, rather than the ‘shock therapy’ applied by former Eastern European socialist economies. To stimulate incentives for regional executives, China has enforced a ‘regionally decentralized authoritarian regime’, which combines the political centralization of political appointment and promotion structures, and economic decentralization, whereby regional governments are deeply involved in economic development within their own jurisdiction.¹

Consequently, both central and regional governments have maintained significant influence during the development and reform process. Public fixed investments and exports have always been two important engines leading economic growth at the expense of domestic consumption. To fuel the economic success, factor prices of, for example, land, labour and capital have been (and still are) distorted and repressed.² In some cases, inefficient state-owned enterprises have enjoyed the low-cost inputs and resources that could have been channelled to more efficient private firms. According to many commentators, this model is unsustainable.³

This volume proposes to analyse Chinese regulation from a comparative (mainly EU) and law and economics (‘regulatory state’ and economics of regulation) perspective to set out a reform agenda in selected legal areas including financial, administrative and environmental law and regulation.

¹ Xu (2011), 1078. In the literature this is also referred to as ‘governance structures’.
² Xu (2014), 141–68.
³ Cull and Xu (2003).
of contracts. This is particularly important considering that the Chinese government recently launched a national project to comprehensively deepen its regulatory reform that only sets out general principles.\(^4\) Many details of the reform plan need to be fleshed out, and the EU and US experience is likely to contribute to this process.

We will continue this introductory chapter by first providing a short overview of the relevant economic literature on the regulatory state and economics of regulation (section 2). After that, we will introduce the structure of the book (section 3), its origins (section 4) and contributors (section 5).

2. **A LAW AND ECONOMICS PERSPECTIVE**

This section provides a brief introduction to the literature on the regulatory state and economics of regulation and is not meant to be all-encompassing.\(^5\) It is the object and purpose of this section to present the relevant conceptual framework that is employed in later chapters of this book.

The concept of the ‘regulatory state’ is used inter alia by Shleifer, who notes that different governance models can be chosen and ranked according to the degree of public involvement in the governance structures for attaining a multitude of objectives including the minimization of social harm from market activities.\(^6\) Such models include ‘laissez-faire’ government, regulatory interventions by the state (the ‘regulatory state’) and (complete) state ownership. The laissez-faire government does very little besides offering an essential legal framework, and relies largely on private enforcement action (litigation) to solve conflicts. The regulatory state is characterized by independent regulatory agencies overseeing specific areas of the economy, ex ante designing of regulatory rules, and ex post public enforcement by public agencies and private enforcement via litigation. Not surprisingly, the concept of complete state ownership is characterized by full state control of industries.


\(^5\) See Deller and Vantaggiato (2015) for a comprehensive survey of the legal and economic literature. It should be noticed that there is also an extensive political science literature on the regulatory state: see Majone (1994).

\(^6\) Schleifer (2005).
Each of these governance models has its own comparative advantages in controlling society; the specific conditions in a given country are crucial determinants of the optimal strategies for social control of business. For example, in a country with a highly efficient court system, the laissez-faire model, relying solely on private litigation, would generate the most efficient outcome. However, both the American and European societies today are more regulated than before. From an efficiency perspective, there are three potential justifications for the increasing reliance on regulations. First, regulators are specialized; second, regulators as central representatives could overcome free-rider problems; third, the ex ante regulatory rules could reduce the costs of identification of violations.

These notions of the role of the regulatory state by Shleifer and his many co-authors are in line with the so-called ‘public interest’ theory of regulation. This theory puts forward market failure as the only (potential) justification for regulatory intervention when the goal of the legislator is to maximize efficiency. Information asymmetry, market power, externalities and free-rider problems are the main causes of market failure that are discussed in the law and economics literature. The term ‘regulatory state’ has also been used by others, including Susan Rose-Ackerman. In her book Rethinking the Progressive Agenda (1992), she discusses the possibilities of a progressive public agenda that combines active government and market competition.

However, the regulatory capture theories warn that government regulations run the risk of being sought by private interest groups in order to increase their own benefits. The starting point of these theories, which are based on empirical findings from the United States, is that there is a market (supply and demand) for regulation, just as for other types of goods and services. Politicians, maximizing their own utility in terms of number of votes, size of bureaucracy or power, for example, may be tempted to respond to requests for regulatory favours from special interest groups.

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7 Djankov et al. (2003).
8 Glaeser and Shleifer (2003).
9 Shleifer (2005). A growing literature also identifies China as a regulatory state: see Du et al. (2009).
10 Glaeser and Shleifer (2003).
11 Of course, public interest theory recognizes that there are many other policy goals besides efficiency, such as income distribution, fairness, non-discrimination, preventing climate change, and so on. On the discussion of different policy goals, see the chapter by Philipsen in this volume.
12 For a more elaborate discussion see e.g. Ogus (1994), Philipsen (2009) and Cooter and Ulen (2012), 38–42.
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groups that do not (necessarily) correspond to the public interest. Whether such interest groups are successful, according to Olson, will depend on both the transaction costs of organizing as an interest group and on information asymmetries between the ‘insiders’ and the public at large. In the law and economics literature, this view on regulation has also been termed the ‘private interest’ approach to regulation. There is obviously a strong overlap with the ‘public choice’ literature, in which topics such as corruption, voting behaviour and political decision-making are discussed by the likes of Buchanan, Tullock, Mueller and others.

Sunstein argues that a centralized review of agency rule-making is necessary to minimize the adverse effect of rent-seeking behaviour. It can be seen that cost–benefit analysis (CBA) and regulatory impact assessments are among the most popular instruments governing the process of rule-making. They are employed to control and monitor subordinate public agencies because they reduce the asymmetry of information between the principals and these agencies.

In addition to the process of rule-making, it is crucial for the regulatory state to also have an enforcement strategy that transfers ‘black letter law’ to de facto deterrence. Both public and private enforcement strategies have their comparative advantages. Public enforcement relies on public agencies, which have limited resources for enforcing the law. Civil servants generally lack appropriate incentives and tend to shirk their responsibilities, which may result in an undersupply of law enforcement. However, public enforcement benefits from economies of scale and could overcome the collective action problem (‘rational apathy’), which can be a major problem in discouraging private enforcement.

In contrast, private enforcement relies on private parties, which usually enforce the rules through civil litigations. The law and economics analysis of private enforcement of law dates back to at least Becker and Stigler.

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14 Olson (1965).
15 See again Ogus (1994), Philipsen (2009), and the sources quoted therein.
16 For references, see e.g. Boehm (2007) and Philipsen (2009).
19 The seminal paper of Becker (1968) argues that the expected cost of crimes, which is determined by the size of the sanction and the enforcement intensity (probability of detection), determines criminals’ choices. Building on his work, scholars have pointed out that the enforcement intensity also depends on the probability of being prosecuted and convicted. See Faure et al. (2009).
20 See the survey article by Polinsky and Shavell (2000) on the literature of public enforcement.
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and Landes and Posner. Even if private parties have sufficient incentives to bring suits, private enforcement could lead to inefficient outcomes if the private and social payoffs are not identical. When the net social benefits of law enforcement are greater than the net private benefits, dispersed affected parties face severe problems in bringing collective actions, whereas if net private benefits are greater than net social benefits, private parties tend to bring frivolous suits.

3. OUTLINE OF THE BOOK

After this introduction, which discusses the analytical framework and the relevant law and economics literature, subsequent chapters present case studies from diverse regulatory experiences in the EU and China, and assess these from a regulatory state/economics of regulation perspective. The concluding chapter reflects on the lessons learnt in those chapters.

The book has three parts addressing financial markets, social and administrative regulation and the environment. Each of these parts consists of independent but related chapters. In the fourth and final part of this book, we provide conclusions, as well as an essay by Jonathan Klick on the empirical analysis of regulation, with a particular focus on field experiments in China.

Part 1 consists of four chapters on regulatory reform in financial markets. The first chapter is devoted to a discussion of the reform in the banking sector, which is the major source of financing for undertakings. The saving and borrowing rates in China are regulated and repressed in order to direct cheap credits to the state sector, but private enterprises have difficulty in obtaining loans from the banking system and are hence driven to the informal financing market. Tao Xi analyses the commercial banking system from the perspective of asymmetric information and proposes a new framework for reforming the Law of the People’s Republic of China on Commercial Banks.

The remaining three chapters in Part 1 address stock markets. Regulators scrutinize firms applying for public equities offerings, closely control the number of newly listed firms and monitor their conduct. This process thus merits close examination. The market is underdeveloped and compromised by securities fraud, such as misrepresentation, insider trading

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23 Shavell (1993) points out that private parties in possession of information about the identity of those culpable should enforce regulations privately.
and market manipulation. Such practices harm the interests of investors significantly and undermine their confidence. A recent reform mandated deregulation of the stock markets and an increase in the proportion of direct financing to reduce leverages by domestic firms. Jiye Hu and Yang Chen use international panel data to show the importance of institutional investors in maintaining the development and stability of stock markets across China and OECD countries. In addition, it is widely accepted that enforcement of securities laws is crucial if the confidence of investors is to be restored. Tianshu Zhou and Wenjing Li collect cases and carry out an investigation of the insider trading rules in the stock market. Finally, Jiajia Dai, Shiting Feng and Wenming Xu provide an empirical analysis of the weakness of the private enforcement regime by addressing securities litigation.

Part 2 of this book addresses social and administrative regulation and contains two chapters. Qi Zhou analyses the potential benefits from collaborations between contract lawyers and law and economic scholars, and provides insights into improving contract law. Niels Philipsen critically assesses the changing goals of EU state aid policy, from market integration and equity to efficiency and fiscal discipline in the EU, and discusses the possibility of also including this type of control on local government spending in China’s Anti-Monopoly Law.

In Part 3, three chapters are devoted to the environmental problems in China. Because of an emphasis on economic growth, regulators in China have until recently to some extent overlooked the problem of environmental pollution. Industrial firms have been able to externalize many of their environmental costs and water, air and land pollution has increased dramatically. Michael Faure and Roy Partain discuss the regulatory strategies for reducing carbon dioxide emissions via offshore carbon capture and storage. Binwei Gui, Michael Faure and Guangdong Xu empirically estimate the environmental Kuznets curve, that is the relationship between environmental pollution and economic growth in China. Stefan Weishaar and Ruohong Chen discuss environmental standards as possible regulatory strategies for reduction of greenhouse gas emissions in China and the EU under World Trade Organization rules.

In Part 4 Jonathan Klick sets a law and economics research agenda by outlining the challenges of empirical analysis and by underlining the great potential of field experiments, particularly in China. A conclusion by the editors highlights the main contributions of this book.
4. ORIGINS OF THIS BOOK

This book originates from a long-standing cooperation between various Chinese and European institutions. The editors have worked together for a long time through collaboration between the School of Law and Economics (SLE) at the China University of Political Science and Law (CUPL) in Beijing, to which Wenming Xu is connected, the Maastricht European Institute for Transnational Legal Research (METRO), where Niels Philipsen is Vice-Director, and the Department of Law and Economics at the University of Groningen, to which Stefan Weishaar is affiliated. Both Niels Philipsen and Stefan Weishaar are teaching or have taught courses at the China–EU School of Law (CESL) at CUPL. Moreover, Niels Philipsen was recently appointed Adjunct Professor of the School of Law and Economics at CUPL.

5. CONTRIBUTORS

The contributors to this book are from various universities in China, Europe and the United States. Many of the Chinese contributors, including Binwei Gui, Jiye Hu, Wenjing Li, Guangdong Xu, Wenming Xu and Tianshu Zhou, are connected to the SLE of CUPL. Ruohong Chen is affiliated to the Beijing Foreign Studies University (Beiwai). Qi Zhou, one of the Chinese contributors, has resided abroad for many years. He is associated with the University of Leeds (UK).

The European contributors have either Belgian, Dutch and/or German nationalities and include Stefan Weishaar from the University of Groningen (the Netherlands) as well as Michael Faure and Niels Philipsen, who are both associated with Maastricht University and the Erasmus University Rotterdam (the Netherlands). Jonathan Klick is affiliated to the University of Pennsylvania (USA) and Erasmus University Rotterdam (the Netherlands). Roy Partain is affiliated to the University of Aberdeen (UK).

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