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The China puzzle: Opportunities for accounting research ☆

Suresh Radhakrishnan

Jindal School of Management, University of Texas at Dallas, USA

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ABSTRACT

How can China achieve phenomenal economic growth despite what is considered as "weak" institutions in market-based economies? Xu (2011) provides a framework to understand this puzzle. Specifically, he suggests that China's institutional framework of Regionally Decentralized Authoritarian regime was likely responsible for the phenomenal economic growth despite what is considered "weak" institutions for market-based economies. While recent accounting research provides insights into the relationship between agency issues, and accounting and control systems in the China context, accounting researchers can use the institutional feature of RDAs to provide insights into the role of accounting and control systems in non-market-based settings.

1. Introduction

Accounting research in the context/setting of China has increased in the last decade. This reflects both the importance of China as a global economic force and China being an interesting setting for providing insights into the role of accounting. The call for papers for this symposium nicely summarizes the latter point by stating: "Ownership structure, the incentives of managers and auditors, board monitoring, enforcement, and other institutional features of the economy all have an important impact on financial reporting outcomes. It is also conceivable that accounting standards and these institutional features complement each other in determining accounting quality. Asian-Pacific economies, including China, offer an ideal setting to examine these important issues given the relatively weak legal protection and enforcement in these economies." In

E-mail address: sradhakr@utdallas.edu

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short, China provides an interesting setting because examining its evolution from a presumably "weak" institutional and market-based regime to strong, one can provide important insights into accounting issues. My objective in this article is to broaden this perspective by directing attention to the fact that mechanisms that enabled China to succeed economically, did so despite what we term as "weak" institutions. The institutional features that enabled such phenomenal economic growth would have necessarily relied on accounting and control systems. As such, examining the role of accounting and control systems in the institutional framework prior to and during China's transition to a market-based economy would help expand our insights. For this purpose, I draw on the framework in the economics literature that shows the unique institutional features in China that possibly contributed to its economic success (Xu, 2011).

2. The China puzzle

China's GDP has grown from US$ 1325 Billion in 2001 to US$ 7318 billion in 2011, which represents a year-over-year growth rate of roughly 19%; the stock market capitalization increased from US$ 524 Billion in 2001 to US$ 3389 in 2011, representing a year-over-year growth rate of 21%; the value of stocks traded increased from US$ 449 Billion in 2001 to US$ 7671 in 2011, representing a year-over-year growth rate of 33% (see Table 1). These statistics indicate not only a tremendous growth in economic activity, but also a concerted move toward a market-based economy.

Conventional wisdom in economics suggests that the government should protect private property rights, enforce contracts, and separate itself from business enterprise (North, 1990; Acemoglu and Robinson, 2012). In contrast to this conventional wisdom, the Chinese government conducts and directs business development. Not surprisingly, China ranks below average on its institutional makeup of rule of law and governance quality (Allen et al., 2005). Thus, based on conventional wisdom, China's institutions are weak, so much so that the institutional infrastructure should not have supported the phenomenal economic growth and the move toward a market-based economy. This is a seeming puzzle that is referred to as the China puzzle by Xu (2011) who states, "This incredible contrast between poor institutions and China's spectacular performance challenges our general understanding of the mechanics of institutions and our understanding of institutional quality."

3. The institutional structure of China's economic success

Broadly speaking, institutions refer to mechanisms that coordinate economic activities and thus govern the incentives of agents (Coase, 1992; Stiglitz, 2002; Hurwicz, 2007). North (1990) defines institutions as "rules of the game in a society or, more formally, the humanly devised constraints that shape human interaction." The key aspects embedded in these definitions are that institutions are a set of rules chosen by society, and in an economic sense, these rules facilitate exchange. Coase (1937, 1991, 1992) in his discourse on the boundaries of the firm and markets – where do firms end and markets begin – proposes that institutions act as coordination mechanisms to facilitate exchange; when markets cannot do the job of coordination well enough, then the coordination occurs in firms (see also Williamson, 1985, 2002). As to which coordination mechanism is better suited for a particular activity is referred to, under the omnibus fuzzy terminology of "transactions costs." Under this broad view of institutions, Xu (2011) argues that it would not have been possible for China to achieve such phenomenal growth without effective coordination mechanisms or institutions. What was the institutional structure that enabled China's phenomenal growth? Xu (2011) outlines the salient aspects of China's institutional feature that enabled the phenomenal economic growth.

While institutions in most parts of the world – the Americas, Africa, Australia, South, and Far East Asia – are greatly influenced by the Western governance systems due to colonization, China has a 2000 year-old imperial history that was not directly influenced by the European institutions. The structure that prevailed during the imperial regime provides the pillars of the institutional framework that guided the transition to China's market-based economy. Xu (2011) refers to the institutional structure as the Regionally Decentralized Authoritarian (RDA) regime. The RDA regime features a combination of a highly decentralized decision-making with respect to economic resources; a highly centralized decision-making with respect to policy and personnel.