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The Role of Law in China's Economic Development

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INTRODUCTION

Economic growth requires economic agents to believe that political, social, and economic conditions are such that they can expect a reasonable return from their investments in property and from the agreements they make with others. Where such beliefs exist, they can arise as a result of many different mechanisms. Property owners might view government as constrained by law within a democracy or believe that a particular autocratic government has an interest in not expropriating property. Promisees might have blind trust in their fellow citizens or know that the court system will make appropriate judgments in case of a breach of contract. Therefore, in exploring the determinants of a country's growth performance, it is critical to understand which mechanisms fostered expectations among property owners and among those making agreements.

The emphasis in the recent economics literature, echoed in the pronouncements of the World Bank and similar organizations, is on formal institutions or the rule of law as crucial in fostering the appropriate expectations (Hall and Jones, 1999; Acemoglu, Johnson, and Robinson, 2001; Rodrik, Subramanian, and Trebbi, 2004). Such emphasis follows an important line of thought in institutional economics dating back to Max Weber and carried forth by Douglass North (1990), which we call here the rights hypothesis (Clarke, 2003b). This holds that economic growth requires a legal order offering stable and predictable rights of property and contract. In this chapter we assess the development of the formal legal system in China and analyze its role in the economy, examining the degree to which the rights hypothesis is borne out by China's experience in the post-Mao reform era.

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The assessment begins in “The Development of Law during the Era of Economic Reform” with an extended analysis of the development of China’s legal system in the era of reform. We first characterize the role of law at the beginning of reform, a role that focused on running the state sector rather than on private economic activity. As reforms gradually altered the mix of economic agents within the economy and increased the importance of activities outside the supervision of government administrators, the need arose for a set of rules and institutions that could govern relations between agents who were not under a common superior. The legal system, tentatively and incompletely, began to fill this need. In “The Development of Law during the Era of Economic Reform,” we provide a timeline of the changes in the legal system that constituted this process. These changes allowed broader scope for different types of economic agents and different types of economic activities, and provided some support for these activities, stimulating the need for further legal reform. Hence, the relationship between legal and economic development was bidirectional – a coevolutionary process. We close the section with an analysis of the current status of the legal system in the economic sphere and its problems.

Our discussion of the interaction between economic and legal developments sets the stage for an examination of the role of law in three prominent spheres of activity – property rights, agreements to trade goods and services, and corporate governance – in “Are Property Rights Secure? Do They Matter?,” “Transactions in Goods and Services,” and “Corporate Governance.” The questions motivating the discussion in all three areas are whether law plays an important role, how that role has changed over time, and what the current problems are. The conclusions differ across areas. For example, the legal system currently plays a less important role in property rights than in agreements to trade. Indeed, it is impossible to make the case that the legal system has been crucial in protecting property rights. In contrast, in the area of transactions of goods and services, we present new data showing that the legal system is more important than might be assumed, given the enormous emphasis that personal and social relationships have played in the literature discussing markets in China. Nevertheless, one common theme in all areas is that the rights hypothesis, as traditionally interpreted, provides little explanatory power for China.

This conclusion, however, leaves open the question of the source of the expectations of reasonable returns from investments in property and from agreements that are universally assumed to be necessary for the success of a market economy. We address this question in “Are Property Rights Secure? Do They Matter?,” “Transactions in Goods and Services,” and “Corporate Governance,” reflecting on the role of mechanisms other than law that might produce such expectations. There are many possibilities, such as a stable growth-oriented governmental administration, social relationships, a culture of trustworthiness, and so on.²

² See Murrell (2003) for a much fuller cataloging of these mechanisms in transition economies and a discussion of their relevance.

Indeed, one way to view development is as the process of generating functional substitutes for the formal institutions that are the focus of the rights hypothesis.³ However, information on the relative importance of these substitutes in China is limited, as everywhere. We briefly summarize the information where it exists, focusing on some major examples, such as the role of local government in property rights and the dual-track reforms in transactions. But given the lack of knowledge about the mechanisms driving the expectations that must have underpinned China's growth, a major subject for future research must be the pursuit of more detailed and concrete information on how these expectations were generated.

THE DEVELOPMENT OF LAW DURING THE ERA OF ECONOMIC REFORM

In this section, we chronicle the changes that have taken place in the legal framework in the nearly three decades of economic reform. We document how the role of law shifted over time, beginning as a tool to manage the state sector and then taking on the more recognizable function of providing the rules and processes that govern, however incompletely and imperfectly, the interactions of independent economic agents. This process of change has been gradual, coevolving with economic reforms, and it is very much still in process. Therefore, we also discuss what is missing in the current legal framework.⁴

The Place of Law in the Early Years of Reform

Economic reform in China was marked from the beginning by a recognition that law had a new and important role to play. Yet this role was not at first the one contemplated by those who stress the importance of formal institutions in the process of economic development, which is essentially a claim about how healthy private economic activity is fostered. Early reform policy did not contemplate a major role for the private sector. It was about running the state sector better and therefore was not concerned with what might encourage entrepreneurship.

The early reform-era role for the legal system can perhaps be best understood by seeing what it was intended to replace: the discredited ideological controls of the past and a system of internal bureaucratic communication where the authoritativeness of particular documents was often unclear. The old system was incapable of imposing unity and order upon the processes of government, and so a new system was sought. In particular, a key ambition of those promoting legal reform was to bring regularity to government operations and to policymaking as a cure for the excessive devolution of power from the center and the resultant policy inconsistencies (Clarke, 1992).

³ See, in particular, Qian (2003) on China.

⁴ As throughout this chapter, we stick with legal issues directly relevant to economic matters.

In the economic realm, law was intended to be a mechanism for regulating the operation of state-owned enterprises (SOEs), replacing the particularistic bargaining regime of the past with a regime of strict, impersonal, and universalistic rules that would impose discipline on enterprise managers and encourage efficiency. A prime example of this type of mechanism was the Bankruptcy Law (1986), passed in 1986. According to contemporary commentary, “[T]he threat of bankruptcy urges all enterprises and people on and will turn muddleheaded people into shrewd ones and lazy people into diligent ones” (Hu, 1986). Prior to the Bankruptcy Law, however, the state already had the power to close down loss-making enterprises. Thus, this law and similar enactments were as much efforts by the state to effect policy in a new way as they were new policies.

To assess whether law in this sense, as a form of policymaking, could be successful in promoting economic development, or indeed in affecting anyone in any way, requires an understanding of the associated institutions available for making its rules meaningful. To return to the Bankruptcy Law as an example, we must ask whether there were any actors in the system who had both the means to put loss-making SOEs into bankruptcy and the incentives to do so. In fact, creditors who did have incentives to bring court proceedings found that the process remained under the control of the enterprise’s administrative superior. Of course, that superior department could choose to put the enterprise through bankruptcy proceedings and close it down, but it could have chosen to do the same thing before the enactment of the Bankruptcy Law.

The Economy and the Law Coevolve

The effects of China’s economic reforms gradually made this early approach to law less viable. The movement from planning to the market entails a reduction in the role of the individualized judgments of bureaucrats and an increase in the importance of universally applicable rules. Decentralization reinforces this process. The devolution of effective enterprise ownership and decision-making power to local governments, if it is genuine, necessarily means that the central government can no longer resolve disputes simply by issuing commands. The alternative to specific commands is a set of generally applicable rules. The growth of the private sector has the same consequence. Enterprises outside the bureaucratic system have no common superior; some other body must resolve their disputes with reference to a preexisting body of rules. Of course, decentralization, the market, and a private sector do not make these changes inevitable, but they do create demands that can be addressed by legal reforms.

A sea change in the relationship between the legal and the economic systems did indeed occur. The amount of important economic legislation passed by the National People’s Congress (NPC) – the body with (at least theoretically) the authority to pass rules that bind all citizens and governmental actors – has

mushroomed. The role of the courts has expanded considerably, and at least in the cities the salaries and benefits enjoyed by judges have been enhanced greatly through court fees.⁵ Perhaps most symptomatic of the change in the role of law has been the change in the role of lawyers. In 1983, five years into the reform era, China had only 8,600 full-time lawyers (Chen, 2004). By 2005, that number had increased to well over 100,000,⁶ and the year 2004 saw over 40,000 new LL.B. graduates (China School Net, 2005). There is no reason to doubt that this is a supply response to income opportunities, which in turn suggests that what lawyers do has much more value than before. Of course, some of this work may be old-fashioned “fixing.” But it is fixing within an increasingly dense web of rules that barely existed at the outset of reform.

Just as Naughton (1995) has characterized the economic reform process as “growing out of the plan,” so may the process of legal reform be described as growing out of the system of administrative directives. Unlike in the states of the former Soviet Union and Eastern Europe, in China the planned economy was not suddenly abolished. Within the Chinese state sector, the replacement of administrative directives with legal methods of supervision and control has been very gradual. Even today the senior management of enterprises in which the state has an important stake are selected and vetted through the Communist Party personnel system, with the board of directors merely supplying legitimacy.⁷ Yet the operations of state enterprises are increasingly subject to legal instead of administrative regulation. For example, contract disputes with nonstate suppliers and customers cannot be resolved administratively, because there is no common superior.

The great expansion in the number and importance of economic actors that are not core parts of the traditional state system reinforced the process of growing out of the system of administrative directives. Privately owned enterprises have had to rely largely on the legal system for organizational vehicles⁸ and remedies for wrongs suffered. Early on, the legal system did not provide much, but over time it became more responsive. For example, article 31 of the 1986 General Principles of Civil Law (GPCL) requires a written agreement for a partnership. However, just one year

⁵ As of 2004, for example, an experienced senior judge in Shanghai could have annual earnings of 110,000 yuan (Gechlik, 2005).

⁶ The exact number depends on whom you count. There were more than 103,000 full-time lawyers in law firms, but another 16,000 working part-time or in government, the military, companies, or legal aid services (Ministry of Justice, 2005).

⁷ In November 2004, for example, the Chinese government undertook a remarkable reshuffling of top executives in its majority-owned, but ostensibly independent, telecommunications companies, with the executive vice president of China Mobile becoming the president of China Telecom, the executive vice president of China Telecom becoming the president of China Unicom, and the president of China Unicom becoming the president of China Mobile (*Financial Times*, 2004).

⁸ By contrast, state-owned enterprises, for example, existed for decades before the promulgation in 1988 of a law providing for their existence and organization.

after the GPCL came into effect, the Supreme People's Court issued a document allowing courts to treat associations with the characteristics of a partnership as if they were partnerships, even if there was nothing in writing (Supreme People's Court, 1988).

This coevolution of economics and the law is nicely exemplified in the sphere of foreign economic interactions. Although the main motor of change in the Chinese legal system has been domestic developments, the policy of opening up to foreign trade and investment has had an unmistakable impact on both substance and procedure. At the outset of the reform era and for many years afterward, the Chinese government, recognizing that the domestic legal system was in many ways unattractive for foreign investors, attempted to establish a special, separate legal system for foreigners. As reforms in China's domestic economy progressed, however, it became increasingly apparent that the segregated legal system did not make sense over the long term. The effect of unifying the separate legal regimes has generally been to make the regime for Chinese parties look more like the one for foreigners, not the other way around.

A good example of the foreign regime leading the way in substantive law is that of the promise within the 1979 Equity Joint Venture Law that joint ventures would not be nationalized or expropriated and that if expropriated, "appropriate" (*xiangying*) compensation⁹ would be paid. To this day, the Chinese legal system does not provide for compensation for lawful takings in general.¹⁰ The desirability of this principle, however, was recognized in March 2004 via an amendment to the constitution, and enabling legislation (constitutional provisions are not self-executing in the Chinese legal system) is expected soon.

The Development of Economic Law: A Timeline

The whole period of economic reform saw a continuing succession of changes in formal law and legal processes, sometimes following economic change and sometimes spurring it. This subsection describes those legal changes. The description is complemented by Table 11.1, which lays out these changes in a schematic chronology.

⁹ "Appropriate" compensation is a term of art in the international lexicon of governmental expropriations; it is understood to mean something less than the alternative formulation of "prompt, adequate, and effective" compensation, which in turn means the fair market value of the expropriated investment immediately before the expropriation (Jarreau, 2004, pp. 474–475).

¹⁰ The State Compensation Law and other regulations do provide for compensation when government organs cause loss through *unlawful* actions, but do not make the uncompensated taking of assets per se unlawful. Otherwise taxation would be prohibited. Individual regulations may provide for some compensation for specific types of takings – for example, those involving real property.

Table 11.1. A Timeline of legal developments, 1978–2004

Periods	Dates	Item	Comment
Pre-1979	December 1978	Third Plenum of Eleventh Central Committee	Official jettisoning of class struggle as main task of the Party; adoption of goal of economic reform and development. Reorientation of development strategy to reduce heavy industry investment, shift resources to agriculture and consumption.
1979–1984		First stage of economic reform: attempts to rationalize the state sector	This phase saw no commitment to markets; it was largely an attempt to make the planning system work better in the end. The individual economic sector (i.e., economic activities by self-employed individual entrepreneurs with fewer than eight employees) was called a necessary “supplement” to the state and collective sectors of the economy. Market activities were <i>ad hoc</i> and provisional. By 1984, the success of agricultural reforms was clear to all, while reforms in the urban state sector were much less successful; SOE behavior remained unchanged.
	July 1, 1979	Law on Sino-Foreign Equity Joint Ventures passed	This landmark piece of legislation marked the official welcoming of foreign investment to China, as well as a decision to put such policy in the form of an NPC statute. This law is quite short and is more of a general policy statement than a detailed set of rules; it has required considerable supplementation in the ensuing quarter century.
	August 23, 1982	Trademark Law passed	
	December 4, 1982	Constitution passed	This is the initial version of the current constitution. It is a complete reworking of the previous 1978 constitution and is not considered a mere amendment. This constitution declared that the basis of China’s economic system was socialist public ownership of the means of production and that the state sector was to be the leading sector in the economy. The individual economy (i.e., very small scale businesses of fewer than eight employees) was declared to be a “complement” to the socialist public economy. Socialist public property was declared sacred and inviolable, but there was no parallel declaration respecting private property.
	December 13, 1981	Economic Contract Law passed	This statute covered contracts between domestic entities other than individuals. It was intended largely to regularize relations between SOEs.

(continued)

Table 11.1 (continued)

Periods	Dates	Item	Comment
1985–1989	March 12, 1984	Patent Law passed	
		<i>Second stage of economic reform: the embrace of the market</i>	<i>This stage saw the open embrace of markets as a critical component of the economy. It also saw the emergence of the private sector as a supplement to the public sector, with a rise in the number of privately run and “red-hat” enterprises.</i>
	March 21, 1985	Foreign Economic Contract Law passed	This statute covered contracts between Chinese entities and foreign parties, and was part of the policy of the era that aimed at providing separate legal regimes for foreigners and foreign-related transactions.
	April 12, 1986	Law on Wholly Foreign-Owned Enterprises passed	This statute allowed for the first time an enterprise organized under Chinese law to be wholly owned by one or more foreign investors, with no Chinese equity participation. Only in 2006 did it become possible for a Chinese investor other than a governmental entity to be the sole founding shareholder in a Chinese limited-liability entity; multiple shareholders were required.
	April 12, 1986	General Principles of Civil Law passed	This statute was intended to provide the basic legal principles for the operation of a market economy populated by individual actors making decisions based upon free will. It did not, however, contain detailed rules in important areas, such as contract, tort, and property.
	December 12, 1986	Enterprise Bankruptcy Law passed	This law should really be named the “SOE Closing Law.” It was intended not to protect creditors, or even to assist in the reallocation of inefficiently used capital, but to improve SOE performance through the threat of closing. As government departments had already had the power to close an SOE prior to this law, and retained the power to keep money-losing SOEs operating after it, the law has unsurprisingly not had a great effect on the economy. The corporate landscape remains heavily populated with money-losing enterprises, whose assets creditors cannot (or for various reasons connected with the peculiar incentives facing certain types of creditors, will not) seize and sell off under this law.
	October 1987	Thirteenth Congress of CCP recognizes “private economic sector” as necessary supplement to state sector	

August 5, 1987	Provisional Regulations on the Administration of Urban and Township Individual Industrial and Commercial Households passed	These regulations provided some legal form to small sole proprietorships. In addition to stipulating some limitations in the form of needed permits, it also provided some protections.
April 13, 1988	Law on Sino-Foreign Cooperative Joint Ventures passed	This statute allowed for a joint venture with more flexible features that allowed under the Law on Sino-Foreign Equity Joint Ventures.
April 13, 1988	Law on Industrial Enterprises Owned by the Whole People passed	This statute was intended to operate as a formal organizational and regulatory statute governing SOEs. Of course, SOEs had been organized and regulated prior to this statute, so the statute represented less in new substance than it did the idea that SOEs <i>should</i> be governed by legislation issuing from the NPC.
April 12, 1988	Constitution amended to acknowledge the private sector as a “complement” to the socialist public economy that is allowed to develop “within the limits prescribed by law”	Somewhat grudging acceptance of role of private sector. Constitutional amendment still stipulates that state exercises “guidance, supervision, and control” over private sector.
April 12, 1988	Constitution amended to allow land leasing	This amendment, in giving legal sanction to the granting and subsequent transfer of long-term leases, was a key step in the commodification of land and allowed governments at various levels to reap significant revenues. At the same time, it made land use more subject to market forces and less subject to bureaucratic priorities.
June 25, 1988	Provisional Regulations on Private Enterprises passed	These regulations, still in effect today although seriously dated, legitimize sole proprietorships, partnerships, and limited liability companies having eight or more employees. However, the regulations allow only a limited class of persons to form such enterprises: farmers, the urban unemployed, retired persons, and so on. The regulations contemplate business formation as a supplementary activity by those not connected to the urban socialist economy, not as a normal part of economic life.
April 4, 1989	Administrative Litigation Law passed	Established principle that government agencies must justify their actions by reference to published laws and regulations. Only the execution of rules, however, and not the rule-making process itself, is covered.
1989–1992	Post-June 4 retrenchment	<i>This period saw an attempt by the post-Zhao Ziyang leadership to undertake a significant rollback of economic reforms, recentralize, and strengthen planning. This attempt did not last long, however, and momentum for reform had begun to build anew by the end of 1990.</i>

Table 11.1 (continued)

Periods	Dates	Item	Comment
	May 19, 1990	Provisional Regulations on the Grant and Transfer of Use Rights in Urban Land passed	These regulations made the commodification of urban land possible. They provide for long-term leases from the state of up to seventy years that may be transferred relatively freely.
	September 7, 1990	Copyright Law passed	
1992–2001		<i>Economic reform and markets fully embraced once more</i>	<i>Beginning of creation of system that explicitly embraces private sector as an important component of the economy; looks to rules-based market system through institutionalization of property rights and markets. Rapid development of private firms, building of market institutions and associated laws.</i>
	January 1992	Deng Xiaoping's Southern Tour	Gives a decisive push to renewed reform momentum.
	May 15, 1992	Normative opinion on Joint-Stock Companies passed	This document, passed by the State Commission on Reform of the Economic System, served as one half of China's first post-1949 general Company Law, and provided an organizational vehicle for enterprises that wished to restructure and list shares on the stock exchanges. This document was intended largely to facilitate restructuring by existing enterprises, not to facilitate the formation of new enterprises.
	May 15, 1992	Normative opinion on Limited Liability Companies passed	This document, passed by the State Commission on Reform of the Economic System, served as the other half of China's first post-1949 general Company Law, and provided an organizational vehicle for enterprises that wished to restructure into companies with investors holding equity shares, but not to list on the stock exchanges.
	October 1992	Fourteenth Congress of CCP endorses "socialist market economy" as goal of reform	

March 29, 1993	Constitution amended to demote planning and promote the market	The amended article 15 had read, "The state practices economic planning on the basis of socialist public ownership" and referred to the "supplementary role" of the market. The amended article 15 states, "The state practices the socialist market economy." Articles 16 and 17 were also amended to eliminate the duty of SOEs and collective enterprises to fulfill the state plan.
April 22, 1993	Provisional Regulations on the Administration of Issuance and Trading of Stock passed	This State Council regulation was in effect China's first law on securities.
September 2, 1993	Law against Unfair Competition passed	The amendment brought contracts signed by individual industrial and commercial households (<i>getihu</i>) under its ambit. Contracts signed by individuals in other capacities remained outside, covered by the GPCL. Since <i>getihu</i> contracting had been since 1986 covered by the looser GPCL, bringing them under the Contract Law may not have been a liberalization.
September 2, 1993	Economic Contract Law amended	This law, effective in 1994, formalized in NPC legislation the limited liability company and the joint stock company previously sanctioned under the 1992 Normative Opinions issued by the State Commission on Reform of the Economic System.
December 29, 1993	Company Law passed	Provided default rule that any good was tradable unless regulations provided otherwise. (This default rule did not apply to trade in services.) Prohibited natural persons from engaging in trade. Authorized various restrictions on imports and exports, some GATT compatible and some not. Also provided in principle for antidumping and countervailing duties procedures, but without any details as to procedure.
May 12, 1994	Foreign Trade Law passed	This law was intended to make payments by checks and other methods easier. To date, however, checks are not widely used in China. There is no central institution similar to the Federal Reserve Bank that guarantees checks to its member banks. Thus, checks take much longer to clear.
May 10, 1995	Negotiable Instruments Law passed	

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Table 11.1 (continued)

Periods	Dates	Item	Comment
	June 30, 1995	Security Law passed	This law made secured lending possible. There have, however, been a number of problems in implementation.
	February 23, 1997	Partnership Law passed	This law was intended to provide a new organizational vehicle for certain small businesses carried on by a group of individuals.
	March 25, 1997	Antidumping and Antisubsidy Regulations passed	These regulations contained some WTO-incompatible elements and were superseded by later regulations in late 2001, just before China's entry into the WTO.
	September 1997	Fifteenth Congress of CCP recognizes private sector as important component of the economy	
	December 29, 1997	Price Law passed	This law was part of an effort to reform the pricing system. It established the principle that the great majority of prices should be set by the market, that is, decided by producers themselves. However, it still contained provisions designed to prevent prices deemed excessively high or low.
	December 29, 1998	Securities Law passed	Although China had previously had lower-level regulations on securities, this statute finally provided NPC-level rules.
	March 15, 1999	Constitution amended to upgrade role of law	Article 5 supplemented to read, "The People's Republic of China practices ruling the country in accordance with the law and building a socialist rule-of-law state." These words by themselves do not of course mean any change in the role of the legal system. They represent a policy declaration by the government that the legal system is to be given greater weight as a technique of governing.
	March 15, 1999	Constitution amended to sanction larger role for nonpublic sector and nonwage income	Article 6 describes the economic system of the state. Originally mentioning only public ownership, it was amended to acknowledge "diverse sectors" of the economy developing side by side with the publicly owned sector (which was to remain dominant). The amendment also blessed "a variety of modes of distribution" in addition to distribution according to work; this legitimized income such as interest and dividends (which had not been unlawful before, but lacked such high-level sanction). Article 11 amended to call the private, individual, and other nonpublic sectors "major components" of the socialist market economy.

March 15, 1999	Contract Law passed	This law replaced three prior laws, thus providing significant unity to the contract law regime. The replaced laws were the Economic Contract Law (covering contracts between domestic businesses, but not individuals), the Foreign Economic Contract Law (covering contracts in which one party was a foreigner), and the Technology Contract Law (covering technology transfers such as licensing).
August 30, 1999	Law on Individual Wholly Owned Enterprises	Provided sounder organizational vehicle for small business. A complement to the Partnership Law, which provided a form for groups. Like the Partnership Law, this law specifies that the investors shall <i>not</i> enjoy limited liability.
2000–2001	Passage of several laws and regulations aimed at regularizing the lawmaking procedure itself	Law on Legislation (2000); Regulations on the Procedure for Formulating Administrative Regulations (2001); Regulations on the Procedure for Formulating Departmental Regulations (2001).
April 28, 2001	Trust Law passed	
July 1, 2001	Jiang Zemin announces that private entrepreneurs can become party members	Questionable results. So far entrepreneur members seem to have been Party officials first, who then went into business. As far as is known, there are relatively few entrepreneurs who then become Party members.
November 26, 2001	Antidumping Regulations and Antisubsidy Regulations passed	These regulations were designed to fit WTO requirements.
December 11, 2001	China joins WTO	
August 27, 2003	Administrative Licensing Law passed	Established the principle that licensing of business activities should be justified only by public necessity.
March 14, 2004	Constitution amended to specify that compensation must be paid for expropriation of land and other property; also provides further sanction for nonstate economy	Article 11 was revised yet again to include the term “nonpublicly owned economy” and to provide that the nonstate sector was not only permitted, but encouraged. Further rhetorical protection for private property was provided.

1978–1984

Economic reform and concomitant legal reform began with the watershed Third Plenum of the Eleventh Central Committee of the Communist Party of China, which officially jettisoned class struggle as the main task of the Party and embraced the goal of economic development. The first stage, from late 1978 until about 1984, saw the effort to introduce efficiency-enhancing incentives to the rural sector in the form of the household responsibility system in agriculture and to rationalize the state sector so that planning of industry and commerce could work better. Neither of these changes, however, took the form of laws; the major rural reforms, for example, took the form of a series of Communist Party Central Committee and State Council documents. By contrast, foreign investment was officially sanctioned with the adoption of the Law on Sino-Foreign Equity Joint Ventures in 1979, but the policy behind this law marked only a very modest liberalization. Chinese parties to such joint ventures were contemplated to be SOEs – individuals were not allowed to be parties at all – and the state attempted to keep such joint ventures, and their foreign investors, within a special legal regime that was segregated from the domestic system.

This first stage of reform created a small but significant opening for the non-state sector outside of agriculture. Nonstate enterprises with public investment such as township and village enterprises (TVEs) (formerly commune and brigade enterprises) were successful in the early reform period in part because they were unconstrained by formal plan obligations and yet were partially integrated into the planned economy and had politically acceptable collective status. The State Council issued a major document in 1979 affirming the significance of TVEs and calling for their continued rapid development (State Council, 1979); subsequent documents called for the closer integration of TVEs into the state planning system (CCP Central Committee and State Council, 1984). Although the first draft of the Law on Township and Village Enterprises was circulated in 1984, it was not to be passed by the NPC until 1996 (*Township and Village Enterprise Yearbook*, 1997, p. 87).

In 1981, the State Council established provisions governing private investment in the form of individual household firms (*getihu*) in cities and towns, limiting the number of employees to seven (State Council, 1981). The 1982 Constitution declared that the basis of China's economic system was socialist public ownership of the means of production and that the state sector was to be the leading sector in the economy. The individual economy was declared to be a "complement" to the socialist public economy. Central Party Document No. 1 of 1983 extended the provisions on the individual economy to rural areas (CCP Central Committee, 1983). This was the most legitimation the private sector received at that time. Neither policy nor law provided an organizational vehicle for larger private enterprises. The only way for such enterprises to exist was as "red-hat" enterprises: businesses formally registered as collective instead of private in exchange for a fee paid to

the local government for protection against predation and to qualify for various benefits available only to the public sector.

In the pre-reform planned economy, contracts were simply a means of implementing the plan. Beginning in 1979, the State Administration for Industry and Commerce was established and charged with overseeing economic contracts. In the same year, economic divisions were put in place in the court system to hear economic disputes (Ling, 2002). But the system was still state-centered. The People's Republic of China (PRC)'s first contract law, the Economic Contract Law (ECL) of 1981, perpetuated into the reform era the Soviet concept of economic contract – primarily a means of implementing the plan. Its terms applied only to contracts between “legal persons” (i.e., enterprises and organizations) and excluded individuals from its ambit. The intent of the law was that only enterprises “subject to state control could enter into meaningful economic activity” (Potter, 1992, p. 32). There was to be no contract law covering individuals until 1986.

1985–1989

The second stage of reform, from 1985 until 1989, saw the abandonment of the effort to make the planning system work better and marked an open embrace of the principle of market allocation. This was perhaps best symbolized by the adoption in 1986 of the GPCL. The GPCL are modeled on the German Civil Code and contemplate a universe of equal actors, forming and altering legal relationships by acts of free will. This is a very different universe from that of the planned socialist economy (Jones, 1987). The other major legal contribution to marketization lay in the 1988 amendment of the constitution that legitimized land leasing. In giving legal sanction to the granting and subsequent transfer of long-term leases, this amendment was a key step in the commodification of land, making land use more subject to market forces and less subject to bureaucratic priorities.

The status of the private sector was enhanced during this second stage of reform. Whereas the 1982 Constitution had recognized only the individual sector, the Thirteenth Congress of the Chinese Communist Party in 1987 recognized more generally the private sector as a necessary supplement to the state sector. The constitution was amended in 1988 to reflect this change, and the State Council passed the Provisional Regulations on Private Enterprises later the same year. These regulations, still in effect today, legitimize sole proprietorships, partnerships, and limited liability companies having eight or more employees.

However, the embrace of the market was by no means unqualified. In recognizing the private sector, the 1988 amendment to the constitution still placed that sector under the “guidance, supervision, and control” of the state. Under the terms of the Provisional Regulations on Private Enterprises, only a limited class of persons is eligible to form such enterprises: farmers, the urban unemployed, retired

persons, and so on.¹¹ The drafters of the regulations, which are still in effect today, apparently contemplated business formation as a supplementary activity for those unconnected to the urban socialist economy, not as a normal part of economic life. Moreover, a “private enterprise” under the 1988 Provisional Regulations remained the sole organizational vehicle available – to the extent it was available – to privately owned limited liability businesses of any size. Although this period saw a significant rise in the number of private businesses, many still preferred to remain “red-hat” enterprises or to adopt alternative organizational forms, such as shareholding cooperative enterprises (*gufen hezuo qiye*), which afforded collective status (Ministry of Agriculture, 1990).

The focus of government lawmaking still remained on the public sector, with the problems of the private sector deemed not really the concern of a major legislative body such as the NPC but rather a technical issue to be handled by administrators at the State Council. The Law on Industrial Enterprises Owned by the Whole People was passed, providing a statute-based organizational form to SOEs. As SOEs had of course existed prior to the passage of this law, the real change was in implementation of the idea that business organization should be governed by NPC-level statutes. The Enterprise Bankruptcy Law (passed in 1986 but not in effect until 1988) was mostly a procedure for closing down SOEs (as opposed to one for dealing with the effects of insolvency): losses due to bad management, not adverse changes in the market, were to be the basis for closure. In a similar vein, while the basic elements of the legal regime for foreign trade and investment regime were completed in this period, there was no change in the basic principle of keeping foreigners in a separate legal regime. This principle was reflected in the passage of the Foreign Economic Contract Law, the Law on Wholly Foreign-Owned Enterprises, and the Sino-Foreign Cooperative Joint Venture Law.

The period closed with the passage of the Administrative Litigation Law. This law was of great symbolic importance, since it enshrined the principle that the acts of government agencies had to have a legal basis, and that if challenged by citizens aggrieved by a specific administrative act, such agencies would be required to show that legal basis. The law did not, however, cover the rulemaking process itself, which has remained above citizen challenge.

1989–1992

The third period of the reform era was the brief interlude between the June 4, 1989, crackdown and Deng Xiaoping’s “Southern Tour” (*nanxun*) in early 1992. This period saw a brief attempt by the leadership under Li Peng to roll back reform, recentralize, and strengthen central planning, but the logic of reform soon reasserted itself. As early as 1990, for example, the Provisional Regulations on the Grant

¹¹ It should be noted that many cities have over the years passed their own regulations on private enterprises that are less restrictive. Such local regulations in practice provide reasonably sufficient security for entrepreneurs despite whatever the national regulations might say.

and Transfer of Use Rights in Urban Land provided concrete procedures for the commodification and leasing of urban land.

1992–present

What might be called the beginning of the fourth and current stage of reform was marked by Deng Xiaoping's famous Southern Tour in January 1992, during which he gave speeches supporting economic reform. The next decade saw a series of measures successively expressing greater acceptance of the market. The Fourteenth Congress of the Chinese Communist Party in 1992 endorsed the "socialist market economy" as the goal of reform, and the constitution was amended in 1993 to replace a reference to "economic planning on the basis of socialist public ownership," with a reference to "the socialist market economy." Here again, law followed rather than led the market. In 1996, the NPC passed the law on TVEs, just as this sector began to face significant competition from private firms.

By 1997, the Communist Party was ready at its fifteenth congress to recognize the private sector as an "important" (not just supplemental) component of the economy; amendments to the constitution in 1999 did the same, pronouncing a blessing on "diverse sectors" of the economy. Another amendment sanctioned "a variety of modes of distribution" in addition to distribution according to work, meaning that interest and dividends were now recognized as fully legitimate. In 2001, Jiang Zemin announced that private entrepreneurs could become Party members. Further constitutional amendments in 2004 provided that the "nonpublicly owned" sector was not only permitted but encouraged, and gave more rhetorical protection to private property.

The same period saw the construction of the legal infrastructure of a rule-based market system, in which distinctions between state and nonstate actors, as well as between Chinese and foreign actors, were gradually eroded. A much fuller range of vehicles for business organization became available to both public and private investors. In 1992, the State Commission on Reform of the Economic System promulgated a proto-Company Law in the form of two "normative opinions" on joint-stock companies and limited liability companies, and these vehicles were formalized in the Company Law passed the following year (Company Law, 1993). While the business vehicles of the Company Law were largely designed for restructuring SOEs, they were also intended to be used by private businesses. Changes in China's foreign investment regime have gradually opened up these business forms to foreign investors, who are no longer confined to joint ventures and wholly foreign-owned enterprises. Regulations on stock issuance and trading were promulgated in 1993, followed by the higher-status Securities Law in 1998. A Partnership Law was also passed in 1997, providing an additional vehicle for small businesses, as did the 1999 Law on Individual Wholly Owned Enterprises, although neither law provided limited liability for investors.

The legal regime governing business organization was substantially revised in the middle of the current decade. Both the Company Law and the Securities Law

were substantially revised in October 2005, as were the Partnership Law and the Bankruptcy Law in August 2006.

Several laws governing market behavior were also passed. The Law against Unfair Competition of 1993 was followed in 1997 by the Price Law, which established the principle that the great majority of prices should be set by the market while still containing provisions designed to control prices deemed excessively high or excessively low. The ECL was amended in 1993 to cover almost all domestic contracting parties except individuals. Essentially any properly registered and licensed business entity could now enter into legal contracts. The Economic Contract Law, together with the Foreign Economic Contract Law, was replaced in 1999 by a unified Contract Law, designed to cover contracts by individuals and enterprises alike, regardless of ownership or nationality.

A series of laws and regulations marked China's increasing integration into the world trading system. The Foreign Trade Law of 1994, while specifically prohibiting natural persons from engaging in trade, provided a default rule that any good was tradable unless regulations provided otherwise. It authorized various restrictions on imports and exports, some compatible with the General Agreement on Tariffs and Trade (GATT) and some not. That law also provided in principle for antidumping and countervailing duties procedures, which were given concrete form for the first time in the 1997 Antidumping and Antisubsidy Regulations. These were revised for World Trade Organization (WTO) compatibility and reissued in 2001. China's full engagement with the world trading system was, of course, symbolized by its formal accession to the WTO in December 2001. Although some analysts have viewed WTO accession as the start of a new stage in China's economic reform process, it is better seen less as a driver of further reform than as a manifestation of the stage reached by China's ongoing reform process.

Finally, the current reform era has seen the passage of legislation regularizing the operation of the legal system itself, again with generally market-friendly results. In 1999, the constitution was amended to give formal recognition to the value of the legal system in governance. The years 2000 and 2001 saw the passage of the Law on Legislation and two regulations on the procedure for formulating administrative regulations at various levels of government. In 2003, the Administrative Licensing Law was passed, which established the principle that licensing schemes could be imposed only for reasons of public necessity. As with many other statutes, the principles set out in this law may not be readily enforceable to the benefit of business operators, but they represent a policy orientation and discourse that may be expected to work its way gradually into governmental practice.

The Formal Legal System Today and Its Problems

Enormous changes have occurred in the role envisioned for law in the economy: contrast the measures discussed in the previous paragraphs with the baseline from which the legal system began at the time of the Third Plenum of the Eleventh

Central Committee in 1978. At that time, the NPC and its local counterparts played a very small role in rulemaking. The vast majority of the rules that counted were made by the central Party apparatus or the State Council and its ministries and commissions and were of limited effect outside the bureaucratic reach of the body that promulgated them. Since 1979, a mountain of laws and regulations has been enacted at the central and local levels (Pei, 2001).

In the planned economy, legal institutions were not needed to resolve disputes. The role of the courts in 1978 was largely to carry out sentencing in criminal matters and to handle disputes involving individual citizens in civil matters. Economic change and legislation has vastly expanded the set of activities over which courts have jurisdiction, and as is documented in later sections of the chapter, businesses are going to the courts in increasing numbers.

Despite considerable legislative activity, significant gaps have persisted in China's legal structure governing economic activity. China long lacked a systematic statement of the law of property – that is, the law governing rights of ownership as opposed to rights of contract. Promulgation of such a law was delayed for years because of the sensitive political questions involved; for example, how farmers' rights over “contracted” land should be characterized and what remedies would be available against state infringements of property. This lacuna was filled only in March 2007 with the passage of the Property Law (2007). Another important item of legislation that has been delayed for years is the Antimonopoly Law. At the time of the writing of this chapter, a final version seems close, but the issue of state monopolies has proved difficult to resolve. Finally, and especially significant given the pervasiveness and importance of administrative regulations, which in practice often trump NPC legislation, a law on administrative procedure still seems far away. China currently has a law governing citizen litigation against administrative agencies (the Administrative Litigation Law) that allows challenges for the misapplication of administrative rules. It does not, however, have a law requiring such things as notice to affected parties and hearings when administrative rules are being drafted, and there is no procedure for challenging the rules themselves in court.

Crucially, the system lacks a number of institutional features that could be effective in identifying and reducing the inevitable gaps and ambiguities that occur in any legal system. On the level of substantive law, there is no good system for authoritatively resolving conflicts between different rules. Although both the constitution and the Law on Legislation prescribe a hierarchy, regulations promulgated by lower levels of government seem often in practice to trump theoretically superior regulations promulgated by higher levels. Long-term land leasing, for example, was first permitted under local rules in Shenzhen at a time when it was forbidden by national statute and the constitution.¹² The mechanisms provided by

¹² There are many other examples too numerous to mention. In the late 1990s, the State Council issued documents essentially stripping secured creditors of their rights under the Security Law in certain circumstances, despite dubious legal authority to do so in the technical sense (Clarke, 1997). The Seed Law case, discussed elsewhere in this chapter, is another example.

statute for resolving conflicts – a report to the appropriate legislative or government body followed by action by that body – have not worked in practice. The mechanism that would advance legal development best – allowing courts, in specific disputes, to acknowledge the conflict and resolve it one way or the other – is not permitted.¹³

This lacuna is doubly important because of the bewildering array of bodies that have the right or the practical power to make rules of varying degrees of binding effect. The formal lawmaking structure of the Chinese legal system is set forth primarily in the constitution (1982), the Law on Legislation (2000), and the State Council's Regulations on the Procedure for the Enactment of Administrative Regulations (State Council, 2001). The NPC and its Standing Committee stand at the apex of the system. Both have the power to pass statutes (*falü*), which are more authoritative than any kind of rule other than the constitution.¹⁴ The constitution and certain statutes themselves reserve certain exercises of state power (such as the deprivation of personal freedom) to those that are authorized by statute; institutions such as the State Council or local governments, for example, have no formal power in such cases. The State Council may enact what are called "administrative regulations" (*xingzheng fagui*) in furtherance of constitutional and legislative objectives. People's Congresses at the provincial level, as well as in certain large cities, may enact "local regulations" (*difangxing fagui*) to govern local issues. All the preceding enactments have the formal status of law within the Chinese legal system and are, at least in theory, enforceable by courts (Keller, 1994; Peerenboom, 2002; Chen, 2004). Even more problematic are rules enacted by ministries of the State Council and by local governments, generally known as *guizhang* and labeled "tertiary" rules by Keller (1994), which are not generally enforceable by courts¹⁵ but which can substantially alter the rights of individuals and could well be appealed to by one party in private litigation against another (see the discussion later in "Are Property Rights Secure? Do They Matter?").

In all cases, the constitution and relevant statutes are clear that rules of lower status must yield before rules of higher status. The problem is that there is no

¹³ See the discussion of the Seed Law case elsewhere in this chapter.

¹⁴ In practice, the constitution has marginal status as a strictly *legal* document. Institutions of legal interpretation and enforcement such as courts would not give priority to a constitutional rule over a clearly conflicting statutory rule.

¹⁵ However, in administrative litigation cases courts may "refer" to tertiary rules where they do not clearly conflict with higher-level rules (Administrative Litigation Law, 1989). In Chinese legal discourse, for a court to decide "with reference to" some rule is different from its deciding "according to" some rule; the former rule is thought of as somewhat less authoritative. As a practical matter, the distinction seems to boil down to the court's having more discretion to ignore the former kind of rule. At the same time, however, a court's decision whether to apply a certain rule is supposed itself to be rule based. Here, we can only note, and not solve, this conundrum. For more on the theory and practice of "with reference to," see Wu (2003) and Zou and Zhang (2003).

effective system either for enforcing jurisdictional and subject-matter limitations on any particular body's lawmaking power or for resolving the conflicts that must invariably arise. Various bodies such as the NPC, its Standing Committee, and the State Council may review and invalidate legislation passed by lower-level bodies. To date, however, the NPC Standing Committee is not known to have overturned a single administrative or local regulation (Chen, 2004, p. 114).

The institution that would appear ideally suited to examine conflicting rules and overambitious claims of jurisdiction in concrete situations, the court system, is unsuited for the task. Although Chinese courts are to prefer a higher-level rule over a conflicting lower-level one, they are at the same time prohibited from invalidating legislation. This prohibition is generally (but not unanimously) interpreted to mean that courts must in practice uphold conflicting lower-level rules, at least when they issue from the level of government that controls the court in question. In short, courts must either seek a resolution of the conflict from a higher-level *legislative* body or rule in accordance with the *lower-level* rule. This principle works against unity within the legal system.¹⁶

An important feature of the Chinese judicial system that works against unity and consistent enforcement is the dependence of courts on local government. The power of appointment and dismissal of a court's leadership rests formally with the People's Congress at the same administrative level; in practice, it is in the hands of the local Communist Party organizational department. Local governments also control court finances, material supplies, and other welfare benefits for court officials and their families. Thus, it is very difficult for courts to go against the wishes of local government even should they wish to do so.¹⁷

In fact, courts are recognizably the same institution they were at the outset of reform. Courts are a key institution in turning the law into social reality, but they remain weak and have low status in the political system. The general level of legal training of judges remains low, although it is significantly higher than before in

¹⁶ In a recent case, a judge in Luoyang in Henan Province, faced with provisions of a regulation passed by the Henan Provincial People's Congress that conflicted with the national Seed Law, ruled the provincial regulation invalid on the grounds that it conflicted with a higher law. The ruling elicited a major controversy, with the Henan People's Congress Standing Committee issuing a notice claiming that the ruling was an "illegal review of the local regulation in nature and encroachment on the functions of the legislative body" (Meng, 2003). Contemporary commentary suggests that the judge might have avoided much of the controversy by simply ruling in accordance with the national Seed Law, while taking no stand on the validity of – indeed, perhaps not even mentioning – the provincial regulation (see Guo, 2003 (overview); He, 2003 (commentary by Beijing University law professor He Weifang); Cai, 2003 (commentary by Beijing University adjunct law professor Cai Dingjian); Han, 2004 (follow-up); Li, 2004 (same)). Indeed, this is exactly what a higher court was subsequently reported to have done (*New York Times*, 2005). But such invalidation by stealth does not contribute to transparency or to a body of practical jurisprudence that would help in resolving future conflicts of law.

¹⁷ Numerous sources discuss this issue. See, for example, Zhang (2003, pp. 80–82) and Peerenboom (2002, pp. 310–312).

large cities (Clarke, 2003a).¹⁸ Very often, other government agencies may ignore courts with impunity, and they remain subject to the general principle that the rank of the chief officer determines the rank of the institution he or she heads. The application of this principle to the court system illustrates vividly the relative importance of the courts in the political structure. Although the president of a court at any given level of government is not technically subordinate to the head of government at the same level and is appointed by the same body as that head, the court president's official rank is typically just below, and not equal to, that of the head of government.

Courts remain not a source of overarching authority, but simply one bureaucracy among many. When the Supreme People's Court issues an instruction to lower courts on matters such as enforcement of judgments where the cooperation of banks is needed, the instruction must be co-signed by the regulator of the banking system (formerly, the People's Bank of China, now the China Banking Regulatory Commission) if it is to have any hope of being effective.¹⁹ Courts have their own particular sphere of competence and jurisdiction, but it cannot be assumed that any particular law contemplates court involvement in case of violation, or that court involvement would be effective even if contemplated.

More broadly, Chinese legislation is often remarkable for its lack of institutional anchoring. Like the policy documents it has come largely to replace, it appears expected to be read as a set of hortatory instructions by those it regulates (and not just their lawyers), and continues, more than a quarter of a century into the reform era, to contain broad statements of policy and legally unenforceable norms. The substantially revised Company Law of 2005, for example, provides more duties for directors and officers than its 1993 predecessor, but little more by way of remedies for shareholders and others injured by a breach of those duties (Company Law, 2005).

The fundamental view of the state and its officials toward the legal system remains much the same as it was: the legal system is a tool of governance and control and is essentially the property of government, not the citizenry. This view is manifested most prominently in the principle that the operation of the legal system should be secret unless (and sometimes even although) specific rules provide otherwise.²⁰ Its

¹⁸ For an argument that in many courts, especially in rural areas, the importance of formal legal training is vastly overestimated, see Su (2000).

¹⁹ For an extreme example of the need for cosignatures, see People's Bank of China, Supreme People's Court, Supreme People's Procuracy, Ministry of Public Security, Ministry of Justice (1980).

²⁰ There is no principle of open access to court documents. In most courts it would be difficult for a Chinese, and impossible for a foreigner, to arrive unannounced and ask to sit in on a trial in progress. Although company registration records are supposed to be public, in practice the State Administration of Industry and Commerce will permit only licensed lawyers to review them. And law firm personnel seeking clarification of regulatory issues from government departments – attempting to assist their clients in following the law – must pretend to be calling from a regulated firm, as officials seem to view such efforts by law firms as illegitimate attempts to get free information.

institutions remain government-driven, and not citizen-driven or litigant-driven. Whether and to what degree legal institutions will be used to resolve problems is, to a greater degree than in many other jurisdictions, a government decision. Therefore, the system has limited potential for incorporating and making good use of information from diverse sources to identify and resolve problems.

On the rule-making side, legislative and regulatory drafting remains a secretive process. The bureaucracy in charge of drafting any particular piece of legislation may release draft versions to selected audiences for comment if it so chooses, but there is no general obligation to do so. As a result, avoidable problems can continue uncorrected. On the rule-implementation side, the state remains highly nervous about excessive citizen litigation. Thus, many ostensibly mandatory norms in legislation can be enforced only, if at all, through action by the appropriate governmental agency, and do not confer a private right of action. Even in places where a private right of action might seem to be conferred by law, as for example in suits for misleading disclosures under the Securities Law, the state in the form of the Supreme People's Court has stepped in to impose a nonstatutory requirement that all private suits be preceded by an adverse finding against the defendant in administrative or criminal proceedings (Supreme People's Court, 2003).

Lastly, corruption is an endemic problem in the Chinese legal system (Lubman, 1999; Gong, 2004). With the courts viewed as one bureaucracy among many, very much a part of the political system, and subject to the dictates of local authorities, there is little opportunity for judges to implement a set of ethics that stands above those of the society in general. An independent self-governing bar does not exist. As a result, it is commonly assumed that corruption is growing, with media reports reflecting a large variety of criminal violations of judicial ethics (Gong, 2004, p. 34).

Corruption is hardly unknown, however, in many countries that are at China's stage of development, and it is worthwhile reflecting on whether corruption in the legal system is a particular problem in China. The best evidence on this, although subject to many flaws, is from cross-country surveys. The World Business Environment Survey, conducted by the World Bank (n.d.), collected information on more than 10,000 firms in eighty countries during 1999–2000. One question asked, "In resolving business disputes, [do] you believe your country's court system to be honest/uncorrupt?" and allowed respondents to choose on a six-point scale. According to the respondents, China has less legal corruption than countries at similar levels of per capita income. Moreover, comparing data from a variety of surveys, there is no evidence suggesting that China's legal system is particularly corrupt, compared with other Chinese institutions.

The Future

Barring a political earthquake, the process of coevolution described in the preceding sections is likely to continue, with greater space for individual choice and market relationships, as opposed to state prescription. For example, we expect the

Company Law to move in the direction of being largely a set of default rules that parties may modify if they wish – a trend clearly evident in the 2005 revisions – and the Securities Law to increase its emphasis on disclosure instead of attempting to guarantee the investment quality of securities. Legal distinctions between individual and corporate economic actors, as well as between domestic and foreign economic actors, are also likely to decrease. On the institutional front, dramatic developments are unlikely. While the technical quality of legislation is likely to improve, there is little prospect of an early solution to the problem of conflicting laws and regulations. And while the experience of Meiji Japan demonstrates that a competent, professional, and reasonably independent judiciary is not incompatible with a highly authoritarian state (Teters, 1971), it is hard to see such a judiciary emerging in China soon.

Some scholars see in China's entry into the WTO a major spur for further legal development. In our view, however, WTO membership by itself – as distinct from ongoing economic reforms of which WTO accession was a part – will have a relatively modest effect on the domestic legal system. The WTO does not mandate a perfect legal system, or even a basically fair one, outside of a few specific areas. The only WTO agreement that comes close to a general requirement of fairness in the operation of the legal system is the Trade-Related Aspects of Intellectual Property Rights (TRIPS) Agreement. This agreement does indeed set forth a number of requirements for fair judicial proceedings for the protection of intellectual property rights (arts. 41–50). However, it is worth noting that article 41.5 specifically states,

[T]his Part [III] does not create any obligation to put in place a judicial system for the enforcement of intellectual property rights distinct from that for the enforcement of law in general, nor does it affect the capacity of Members to enforce their law in general.

It is hard to see a strong mandate here for institutional reforms.²¹

Other WTO agreements such as the GATT and the General Agreement on Trade in Services (GATS) also have provisions spelling out transparency requirements, but once again the obligation is limited. Article X of the GATT contains requirements respecting transparency and the impartial administration of law, but these apply only to a limited subset of China's laws: those affecting international trade in goods. Similarly, the corresponding provision of the GATS applies only to scheduled sectors – those that China has agreed to open up at least partially. In short, there is no general obligation under the WTO agreements to have a fair and well-functioning legal system.

²¹ Moreover, the TRIPS Agreement's obligations apply only to proceedings for the protection of intellectual property rights. These are a small part of the legal system's activity. Indeed, the very fact that the requirements of Part III are specifically listed in the TRIPS Agreement suggests that those requirements do not apply to the other WTO agreements and do not attach to WTO membership generally; they could almost be read as a list of features a country's judicial system does *not* need to have outside the realm of intellectual property.

ARE PROPERTY RIGHTS SECURE? DO THEY MATTER?

The developments in the legal system have been profound. But this is not the same as saying that they can account for the astounding economic growth of the reform era. Therefore, we now return to the basic question with which we opened this chapter: that of the relationship between the legal system and economic performance. At one level, the answer to the question is transparent from the chronology given earlier. China experienced very rapid growth throughout its reform period, but it was only in the 1990s that legal developments began to catch up with changes in the way that the economy was functioning and in the roles that economic agents were defining for themselves. Indeed, "The Development of Law during the Era of Economic Reform" contains more evidence for the proposition that economic change spurred legal change than for the opposite relation.

Certainly, as a careful reading of "The Development of Law during the Era of Economic Reform" makes clear, the Chinese legal system does not provide a secure system of property rights. Secure legal rights cannot exist when there is a bewildering array of bodies that have the right or the practical power to make overlapping rules of varying degrees of binding effect and no authoritative body to resolve conflicts. Indeed, the rules enacted by ministries of the State Council and by local governments, while officially inferior to higher-level rules, can affect "rights" considerably. For example, in the mid-1990s, the State Council enacted regulations that effectively negated creditor rights established by the Security Law, the Bankruptcy Law, and the Civil Procedure Law (Clarke, 1997). Similarly, in 2001, the Beijing municipal government issued regulations on limited partnerships that if effective would reverse rules on liability appearing in central-level statutes such as the General Principles of Civil Law (1986) and the Contract Law (1999).²² Such examples are inconsistent with the type of property rights envisaged by those who draw a close connection between growth and legal rights.

Nor can rights be said to be secured by law when the legislation in many cases does not say what is to happen if a particular norm is violated. The point is important because it means that the impressive volume of legislation discussed earlier does not necessarily correspond to an increased volume of legal rights, that is, the power of nonstate actors to put the coercive machinery of the state in motion in the service of their interests.²³

Nor are rights secured by law when the legal system is unable to resolve conflicts between the rights bestowed by different levels and different arms of government. As made clear in "The Development of Law during the Era of Economic Reform,"

²² These were regulations providing governance and liability rules for limited partnerships established in the Zhongguancun area of Beijing (Beijing Municipal People's Congress, 2000; Beijing Municipal Government, 2001).

²³ For example, see the discussion in the section "The Development of Law during the Era of Economic Reform" of the revised Company Law of 2005, which provides few remedies for shareholders injured by a breach of the law by company directors.

the courts are usually beholden to local politicians and have low status in the political system; often other government agencies can ignore them with impunity. The possibility of court involvement cannot be generally assumed when a law is violated, and even if the courts became involved, their effectiveness is highly uncertain. Thus, the courts in China do not play the role, nor do they have the power, that would be consonant with a legal regime that provided secure property rights, and there are no other governmental bodies that seem capable of playing this role.

In sum, the experience of the reform era in China seems to refute the proposition that a necessary condition for growth is that the legal system provide secure property and contract rights. Given the centrality of security of property and contract in current thinking on the determinants of economic growth, the obvious next question to ask is where such security could have come from, if not from the legal system. It could be that although courts and other formal legal institutions do not effectively enforce rights, security of property and contract is provided somewhere else in the system through some other mechanism. In “Transactions in Goods and Services,” we consider the many mechanisms for the vindication of claims arising out of contractual relationships both within and beyond the court system – for example, social or business networks. In the remainder of this section, we focus on property. We argue that the political structure itself has served as an alternative to the formal legal system in providing a reasonable degree of security to certain nonstate investors at the local level.

The notion of a political guarantee for property rights rests on an analysis of the interests of local officials who are part of the state administrative hierarchy. The interests guiding the actions of these officials are shaped by the incentives and constraints contained in the institutional environment. Local officials in reform-era China share an interest in promoting economic development. This interest stems from two noteworthy features of the institutional environment. The first is the cadre evaluation system that sets criteria for and monitors the performance of leading officials in the Party and government; these criteria are one important factor shaping officials’ opportunities for advancement as well as their remuneration. Several research findings support the view that officials in the state administrative hierarchy seek to maintain their positions of power and advance within the system.²⁴ The second institutional feature shaping cadres’ orientation toward economic development is the fiscal system. The fiscal contracting system in place until 1994 (the *caizheng baoganzhi*) featured high marginal revenue retention rates for local governments that encouraged local officials to promote economic activity within their jurisdictions. The fiscal contracting system was replaced in 1994 by a

²⁴ There is significant empirical support for this view (see Huang, 1990; Rozelle, 1994; Whiting, 2001). At the same time, however, to the extent that a career in the state apparatus ceases to offer professional rewards in some way commensurate with rewards in the private sector, officials may increasingly give priority to personal goals over officially defined goals.

tax-sharing system (*fen shui zhi*) that centralized control over revenue and increased intergovernmental fiscal transfers but that left local governments without adequate revenue to perform all the functions assigned to them (see Chapter 12).

The cadre evaluation system, which has been refined and developed since the early years of the reform era, sets specific performance criteria (*kaohe zhibiao*) across a range of policy arenas.²⁵ While criteria vary across jurisdictions, the most heavily weighted performance criteria typically focus on promoting economic growth and particularly since 1994, when the tax assignment system (*fen shui zhi*) was put into place, targets for the collection of particular tax revenues. Other critical targets focus on maintaining public order, which has often been interpreted by local officials as a mandate for generating employment opportunities, and on the provision of merit and public goods, such as primary education and basic infrastructure. Targets are often in effect unfunded mandates, a fact that reinforces the incentives contained in the fiscal system to promote the development of revenue sources at the local level.

During the early years of reform, choices of local officials about how to promote economic growth and employment to meet performance criteria and generate revenue were constrained by the nature of available resources and the broader political environment. Under the fiscal contracting system (*caizheng baoganzhi*), local governments were largely dependent on locally generated revenues and sought, other things being equal, to promote public-sector industrial enterprises from which they could more readily extract tax revenue as well as numerous fees and profit remittances, which were retained at the local level (Whiting, 2001). In areas with a significant legacy of state investment, therefore, local officials often sought to develop and protect local public firms – collectively owned TVEs – by channeling loan capital to them via the state-run banking system and refusing to license private firms. In most cases, cadres acting as representatives of local governments effectively exercised property rights over these firms, including the rights to make decisions about operations and personnel, to control residual income, and to dispose of assets. In areas with little legacy of state investment, by contrast, some local officials actively courted private investment, from which they could extract tax and fee revenue, thereby developing an interest in protecting private property rights. Thus, private investors could find certain jurisdictions in which local officials allowed them to gain a foothold in the local economy and exercise effective property rights over their assets, including the rights to make decisions about operations and personnel as well as to control residual income and dispose of assets. This framework explains the emergence and early growth of both the collective and private variants of the TVE sector in the first decade and a half of reform.

Both the local officials who sought to promote private investment and the private investors who sought guarantees of their claims were constrained by the larger

²⁵ See, for example, CCP Central Committee Organization Department (1979). More recently, see State Council (2000).

political environment, which for the first decade or more of reform sought to delegitimize private domestic investment and control foreign investment. However, the success of private and foreign investment in generating employment and, to a lesser extent, fiscal revenue at the local level eventually influenced the trends in national legislation documented in “The Development of Law during the Era of Economic Reform.” Once the broader political environment began to tolerate competition from the private sector, nonstate investment began to step beyond its initial foothold.

Given the conclusion that local officials had an interest in providing security for decentralized property rights, one must ask why China’s leaders chose to develop a system that created those interests. Certainly, there are many cases of autocratic governments that did not make this choice, but rather used the levers of power for the purposes of predation and corruption. The answer to this question remains largely beyond the scope of this chapter. The fact is that China’s leaders did want to pursue economic growth. Given this objective, if a government is not constrained by the legal system, it must find an alternative mechanism for guaranteeing some form of property rights. Che and Qian (1998) interpret local government ownership of TVEs as such a mechanism.²⁶ In their formal model, the central government finds that surrendering property rights to the local authorities is better than centralizing or privatizing them. Total revenues flowing to the central government can actually increase when the center surrenders its property rights. This can account for the observation that the property rights of local levels of government have been quite robust against possible infringements by superior levels of government.

The argument therefore is that although there was little capability within the legal system for defining and protecting anybody’s property rights in the early years of reform, the political–economic equilibrium was such that one set of actors, local government officials, could exercise property rights directly or bestow them on a specific set of investors within their own jurisdictions. This reasoning is consistent with a current trend in the economics literature, which emphasizes that successful developing countries are able to find some way to generate functional substitutes for the formal institutions that receive so much attention in the analysis of developed countries.

While the incentive structure for local officials led them to create various opportunities for investment in rural industry, the same incentive structure had the effect of reducing the security of land tenure for farm households in many locales. As Brandt, Rozelle, and Turner (2004) point out, local officials are responsible for promoting farm output growth and for ensuring the fulfillment of in-kind quotas.

²⁶ Jin and Qian (1998) explore this and other hypotheses on the TVEs in an empirical context. Their results are consistent with the Che–Qian theory, showing TVEs are more common where property rights are less secure and where the local governments provide more services. Their results suggest that private enterprises are more productive than TVEs, where they can function on an equal footing, but were less common because of the disadvantages of private enterprises in the institutional setting of the 1980s and the early 1990s.

These pressures, along with opportunities for rent seeking, have resulted – in certain places – in repeated administrative reallocations, despite government policy that ostensibly guarantees farm households the right to use the land for at least fifteen years. Markets for land rental and farm labor are thin, and therefore, with changes in family structure and outside labor opportunities, a rigid allocation of land to families would lead to accumulating inefficiencies. Village leaders appear to have had efficiency considerations very much in mind when making (the quite frequent) reallocations of land among villagers. Efficiency considerations dominate equity concerns. Political administration of land allocation appears to be a substitute for a well-functioning system of property rights and markets, which at this stage in China is not a viable alternative. This conclusion is consistent with observations made both above and below: that mechanisms existed in China that substituted for the formal market-aiding legal institutions that are the focus of the rights hypothesis.

In sum, our tentative conclusion is that passably secure property rights might have provided a basis for China's economic growth during the first two decades of reform, but the legal system probably had little to do with the creation and enforcement of these rights. The rights were a product of the political–economic equilibrium, in which important ingredients were the central government's transparent desire for a growing economy rather than class struggle, and decentralization, which was a natural product of both China's size and the events in the decades before reform. Our tentative conclusion is the one that is most clearly supported given both current thinking about the relationship between property rights and growth and our analysis of the legal system. However, our analysis is much less applicable to the current decade, where privatization and the continuing growth of the private sector have made the property rights of local governments less relevant. This highlights the importance of continuing research into the basis of the apparent relative security of property in China, which the continuing developments in the legal system cannot fully explain.

TRANSACTIONS IN GOODS AND SERVICES

In discussions of the institutional bases of economic success, it is standard to highlight two fundamental sets of rights, property and contract. One basis for distinguishing between these two is the differing availability of substitutes for the formal or governmental mechanisms that could produce such rights.²⁷ Effective property rights must reflect governmental behavior in some way: how can one

²⁷ This intuition finds empirical support in a recent paper by Acemoglu and Johnson (2005), who unbundle “institutions” into institutions that support contract rights and institutions that support property rights. Their ultimate finding is that while contracting institutions do affect some things such as the form of financial intermediation, it is property rights institutions that matter for investment and long-run economic growth.

protect one's self informally from a predatory government? However, there are many effective private mechanisms in the realm of contract: informal and social sanctions, trusted middlemen, networks, reputation (in a repeated-game context), and self-enforcement arrangements such as informal collateral. Thus, in examining the mechanisms that support agreements for the exchange of goods and services, the essential task is to understand the contribution of law relative to these substitutes. Moreover, in transition countries in particular, there is one mechanism that is neither informal nor legal: government bureaucracies can play a large role.

Early Reforms: Incremental Liberalization Supporting Exchange Relationships

The first decade of transition in Eastern Europe and the former Soviet Union (EEFSU) followed a very different path from that of China in the ten years after 1978. In EEFSU, the first few years of transition were characterized by the collapse of the old mechanisms of governance, sometimes deliberately aided by destructive reforms. In China, those old mechanisms were kept largely in place at the beginning of reforms, to wither gradually over the following decades, slowly losing their importance as incremental reforms and economic growth removed their domain and their purpose. Matching this contrast between EEFSU and China was a remarkable difference in economic performance: economic collapse in the first years of transition in the former and spectacular growth in the latter.

A leading candidate to explain the early economic collapse in the EEFSU is the rapid erosion in the authority of existing institutions in a time of liberalization (Murrell, 1992; Blanchard and Kremer, 1997). The idea is straightforward: the old system of economic administration enforced contracts, substituting for institutions that take years to develop in market economies.²⁸ As new users of industrial inputs emerged, the old mechanisms of enforcement lost their power and new institutions were only in their infancy. Moreover, the binding effects on present agreements of old ties and future opportunities were weakened by the uncertainty created by institutional revolution. Existing suppliers were tempted to break agreements, with reverberations throughout the economy.

In contrast, China began with liberalization at the margin in its dual-track system. Therefore, the old mechanisms of enforcement were automatically applied to old relationships, preventing the type of disruption in supplies that appeared across the whole of EEFSU. New relationships could emerge at the margin, but these were not allowed to undermine the existing flows of inputs between supplier and user. Those new relationships could develop incrementally in a relatively stable

²⁸ These were not contracts in the usual way that we understand them in market economies. They were formulated by the administration and the parties had to accept them, for the most part.

economic environment.²⁹ Each partner could gradually develop knowledge of the other, generating the experience and the information necessary to secure large-scale, long-term cooperation without recourse to formal institutions. By leaving the bureaucratic methods of enforcing agreements in place for the old patterns of input supplies, the dual-track method of incremental liberalization provided a substitute for more standard institutions that support agreements.³⁰

Evolution of Contract Law

The first reform-era laws governing contract – the 1981 Economic Contract Law, the 1985 Foreign Economic Contract Law, and the 1987 Technology Contract Law – had significant flaws when evaluated on the basis of standard criteria: does the legislation create a level playing field for all firms, does it enable parties injured by breaches to enforce the rules and receive compensation, and does it allow nonstate actors to put the coercive machinery of the state in motion in service of their legitimate interests? As “The Development of Law during the Era of Economic Reform” demonstrates, these weaknesses were ameliorated in part by the amendment of the ECL in 1993 and the promulgation in 1999 of a new, unified Contract Law, which was much better suited to a market economy characterized by a diversity of ownership forms.³¹

While prior to the early 1990s political and social substitutes for law created openings for both individuals and private enterprises that were not legal persons to enter into agreements, the absence of a basis in law still hindered the development of the nonstate economy during the first decade of reform (Clarke 1992; Whiting 2001). Although the literature provides only anecdotal and case-study evidence, one can surmise that the private sector might have grown more quickly under a more effective contract regime. Legal obstacles in the ECL were evident even in places like Wenzhou, where the private economy enjoyed strong local political support and extensive social networks. According to an official in Yueqing County, Wenzhou, before the amendment to the ECL in 1993, many firms outside of Wenzhou refused to enter into contracts with private enterprises there (Whiting, 2001). Furthermore, private enterprise owners felt they had no recourse when they encountered contract disputes, since courts were unwilling to recognize their claims. Informal solutions to these contracting problems were vulnerable during

²⁹ Lau, Qian, and Roland (2000) characterize the efficiency and political economy properties of the dual-track system. The argument here depends not on those properties but simply on the fact that the dual-track system maintained existing relationships.

³⁰ Li (1999) argues that the dual-track system lessened the effects of the market power of existing producers. This even allows us to view the dual-track system as a substitute for antitrust institutions.

³¹ In addition, the new law addressed the inconsistencies and overlapping institutions created or codified by the three initial contract laws and the 1986 General Principles of Civil Law (Ling, 2002).

the 1980s to official crackdowns, like the closure of Wenzhou's informal commodities markets by the State Administration of Industry and Commerce, the state agency responsible for administering economic contracts (Whiting, 2001). Thus, under the ECL, private enterprises functioned only within the interstices, often illegal or only quasilegal, of the planned economy (Zhang and Qin, 1989).

Under the unified Contract Law of 1999, by contrast, natural individuals – not just legal persons – can enter into legally enforceable contracts, and oral contracts have been provided with a firmer statutory footing,³² significantly expanding the scope of contract. The principle of freedom of contract signals a definitive move away from the planned economy.³³ The law limits the scope of contracts to be monitored by administrative organs; for example, the State Administration of Industry and Commerce is now limited to administrative supervision over illegal acts (Ling, 2002).

These changes eroding the distinctions between state and nonstate actors are clearly reflected in a study of contract disputes in one court in Nanjing from 1999 to 2001.³⁴ In those cases in which the ownership form is reported, private enterprises are the plaintiffs in 34 percent of the cases and mixed public/private firms are the plaintiffs in another 15 percent. Thus, the records show private enterprises entering into legally enforceable contracts and enjoying recourse to the courts – features of the contract regime that were absent through the early 1990s. The records also show how the law served to foster transactions by recognizing oral contracts. In those cases where it is possible to identify the form of the contract, oral contracts are in dispute in 46 percent of cases. Moreover, reliance on oral contracts does not, in and of itself, appear to unduly prejudice the hearing a plaintiff can receive: the court found for the plaintiff and awarded compensation in 55 percent of the cases involving oral contracts.

Making Agreements

Despite these recent developments, it could be that Contract Law and the courts still play a minor role in underpinning exchange agreements. Scholars working in contexts as diverse as American and Chinese business communities have argued that exchange is anchored predominantly by informal social ties, and not by legal rules

³² Before the Contract Law came into effect, there were a number of cases and judicial interpretations indicating that as long as satisfactory evidence is provided showing the existence of a contract, the contract is enforceable despite the lack of a writing (see, e.g., Supreme People's Court, 1988).

³³ As Ling (2002) indicates, the principle put forward in the Contract Law is “voluntariness,” but the “substantive rights recognized under the principle of voluntariness are almost identical to those under the conventional notion of freedom of contract.”

³⁴ The research was conducted by Susan Whiting under the auspices of Hopkins-Nanjing Institute for International Research at Nanjing University in the fall of 2002. It reflects a representative sample ($n = 76$) of purchase and sales contract disputes from 1999 to 2001 gathered from one district court in Nanjing, the capital of Jiangsu Province.

and sanctions (Macaulay, 1963; Landa, 1994). Ultimately, however, the relative importance of formal institutions versus their informal substitutes is an empirical question, on which, unfortunately, only scattered evidence exists anywhere (Hendley and Murrell, 2003). In this and the subsequent section, we review that evidence for China, focusing first on the basis of agreements and then on dispute resolution.

The treatment of relational contracting in Chinese societies focuses on the concept of *guanxi*. As Chung and Hamilton (2001) indicate, "Chinese relational rules personalize transactions, making them part of the interpersonal social matrix of daily life" and "thereby increas[e] the calculability of economic outcomes."³⁵ In the context of the PRC in particular, the discussion of *guanxi* links not only relations among entrepreneurs but also relations between entrepreneurs and government officials. One explanation of the expansion of economic exchange even preceding significant legal change, then, centers on dense interpersonal networks that extend into the government apparatus. Nee and Su (1996) focus on "long-standing social ties based on frequent face-to-face interactions" as an important basis for trust and cooperation between entrepreneurs and the government. They emphasize that "transaction costs are lower in institutional settings where trust and cooperation flow from informal norms and established social relationships."³⁶

Interpersonal networks provide information as well as opportunities to impose sanctions that are important to the establishment of trust. In a similar vein, Lin and Chen (1999) emphasize thick relationships based on familial ties. King (1991) finds that "network building is used (consciously or unconsciously) by Chinese adults as a cultural strategy in mobilizing social resources for goal attainment in various spheres of social life. To a significant degree the cultural dynamic of *guanxi* building is a source of vitality in Chinese society." As this statement suggests, the social network explanation of trust in contractual relations is related to accounts of Chinese culture that emphasize the importance of networks of relations (*guanxi*) as a widespread sociocultural phenomenon (Whiting, 1998).

What do available data tell us about the social basis of contractual relations? Zhou et al. (2003) find that firms rely on a range of search channels to identify contractual partners.³⁷ Social networks (47.1 percent) and open information sources including advertisements, media, and trade information (47.0 percent) predominate, followed by self-initiative. They find that government sources play a minor role, accounting for only 6.6 percent of search. In a study of firms in Shanghai and Nanjing between 2002 and 2004, Whiting (2005) finds that professional ties predominate over social ones: in identifying suppliers, firms rely on business associates

³⁵ Chung and Hamilton (2001) provide a good review of the massive literature on this topic. With respect to the PRC, see especially Yan (1995), Yang (1994), and Guthrie (1999).

³⁶ It should be noted, however, that there can be costs to relationships based on informal norms and social relationships (McMillan and Woodruff, 1999; Kali, 2001).

³⁷ This study is based on a convenience (nonrandom) sampling method and includes 620 firms in Beijing and Guangzhou.

(41.4 percent), trade conferences (12.9 percent), advertising (11.4 percent), self-initiative (10 percent), government (8.6 percent), friends (8.6 percent), and trade associations (5.7 percent).³⁸ In identifying customers, firms report relying upon business associates (42.9 percent), competitors (21.4 percent), trade conferences (18.6 percent), advertising (14.3 percent), trade associations (11.4 percent), self-initiative, (10 percent), government contacts (10 percent), and contacts through friends (10 percent). Thus, social networks are only one of many search channels for contractual partners.

Moreover, despite the role of social networks, formal, written contract provisions have become the norm: more than 75 percent of firms in the study by Zhou et al. (2003) used such provisions to specify volume, quality, price, deadlines, and contractual safeguards. Written contracts appear even more pervasive in other studies. Whiting finds that firms use written contracts with suppliers in 90.5 percent of cases, while they use written contracts with customers in 98.6 percent of cases. Similarly, a World Bank (2001) study also shows that the use of written contracts is the norm, found in 90.1 percent of contracts with clients and 82.2 percent with suppliers. While Zhou et al. (2003) find that “contracts initiated through social networks have a higher probability of having informal provisions,” “network ties play a statistically significant but substantively minor role in the choice of contract forms and provisions.”

Dispute Resolution

According to data drawn from the World Bank (2001) survey of 1,500 Chinese firms, in 2000, 31.1 percent of firms had at least one major dispute with clients, while 21.9 percent of firms had at least one major dispute with suppliers.³⁹ Once enterprises encounter disputes, what mechanisms do they rely upon to resolve them? Theorists from Weber to North emphasize the importance of formal, state-sponsored legal institutions. Yet there is a large literature on contractual relations, spanning cases from the United States to Russia, indicating that contract disputes are often resolved without any recourse, explicit or implicit, to the law. This section examines the dispute resolution mechanisms used by Chinese firms and finds that the courts play a moderately important role in their strategies.

³⁸ This study is based on a survey of contracting and dispute resolution practices administered to seventy-six enterprise managers and owners in Shanghai and Nanjing between 2002 and 2004. The firms were identified through the alumni network of the Nanjing University Business School and the clients of the Economic Legal and Social Consultancy Center of the Shanghai Academy of Social Sciences.

³⁹ The data set was created from a firm-level survey conducted by the World Bank in 2001. The survey covered 1,500 Chinese firms evenly distributed across five big cities – Beijing, Chengdu, Guangzhou, Shanghai, and Tianjin – and from ten sectors, five in manufacturing and five in services.

Negotiation and Mediation

As in all market economies, negotiation directly between the contracting parties is used extensively for resolving contract disputes in China. In the World Bank (2001) survey, 87.1 percent of firms used negotiation in the final resolution of disputes with at least one client, while 93.2 percent used negotiation in the final resolution of disputes with at least one supplier. In Whiting's study (2005) of Shanghai and Nanjing firms, 92.8 percent of firms typically used direct negotiation in the process of resolving disputes. (The corresponding figures for litigation were 38.8 and 29.8 percent and for arbitration 12.1 and 12.5 percent, reflecting the dual reliance on litigation or arbitration in conjunction with direct negotiation.) That study distinguishes direct negotiation from negotiation using a third party; only 11.8 percent of firms typically turned to a third party.

Self-enforcement, in which two parties bargain to attain a long-term cooperative solution based on the anticipated value of future contracts, is an important mechanism in contractual relations with Chinese firms. In Whiting's study (2005), 90.6 percent of firms reported that in the event of a serious dispute, their *guanxi* (here, the long-term reciprocal relations grounded in social ties) with a supplier or contractor would be broken. Furthermore, reputation also functions within business circles to help police contractual relations. In Shanghai and Nanjing, 74.2 percent of firms said that other businesses would learn about any dispute that arose between the firm and one of its suppliers.

In many economies, trade associations provide transactional services, including dispute resolution. Most trade associations in China are set up by government and mainly perform the function of communicating government policy. In Whiting's study (2005), 67.1 percent of respondents were members of trade associations, yet respondents were very dismissive of them, and virtually no one said that they provided information on creditworthiness (4.3 percent) or contributed to dispute resolution (4.3 percent). In the World Bank study (2001), only 54.5 percent of firms were members of a business association. Of those, only 31.6 percent (17.2 percent of the full sample) agreed that the business association performed the function of "accrediting members to suppliers and customers." And of association members, only 19 percent agreed that the business association performed the function of "helping resolve disputes," which can be viewed as a substitute for transaction-cost-reducing institutions. This was much fewer than those agreeing that business associations represented members' views (46 percent) and stabilized competition (29 percent), which are not normally classified as functions in service of the market.

Arbitration

The Arbitration Law, which provided for the establishment of municipal arbitration commissions, went into effect in 1995; before that year, commercial arbitration functions were handled by local branches of the State Administration of Industry and Commerce. In the first five years following passage of the law,

Table 11.2. *Cases accepted by courts of first instance, 1983–2001*

Year	Economic	Civil	Administrative	Criminal
1983	44,080	756,436		
1984	85,796	838,307		
1985	226,695	846,391		
1986	322,153	989,409		299,720
1987	366,456	1,213,219	5,240	289,614
1988	508,965	1,455,130	8,573	313,306
1989	690,765	1,815,385	9,934	392,564
1990	588,143	1,851,897	13,006	459,656
1991	563,260	1,880,635	25,667	427,840
1992	652,150	1,948,786	27,125	422,991
1993	894,410	2,089,257	27,911	403,267
1994	1,053,701	2,383,764	35,083	482,927
1995	1,278,806	2,718,533	52,596	495,741
1996	1,519,793	3,093,995	79,966	618,826
1997	1,483,356	3,277,572	90,557	436,894
1998	1,455,215	3,375,069	98,463	482,164
1999	1,535,613	3,519,244	97,569	540,008
2000	1,297,843	3,412,259	85,760	560,432
2001	1,155,992	3,459,025	100,921	628,996
Average annual growth (%)	18.8	8.3	21.8	4.7

Sources: Judicial Statistics (2000); *Law Yearbook of China* (various years).

all domestic arbitration commissions accepted only 17,000 cases involving 25 billion yuan (He, 2002). This compares with 1,329,020 strictly economic contract disputes involving 413 billion yuan handled by courts in 1998 alone (Table 11.2). The average value of all arbitration cases is higher than that of litigated cases, however – more than 1.5 million yuan on average (1995–2000), compared with 0.3 million yuan in 1998, the last year for which data on value of litigation are available.

Survey data underscore the relative unimportance of arbitration among domestic Chinese enterprises through the first decades of reform. In the World Bank (2001) survey, of the firms having disputes, only 12 percent used arbitration even once and only 2 percent used it to resolve disputes at least half of the time. In Whiting's (2005) Nanjing/Shanghai survey, some respondents had arbitration clauses in their contracts, but only a few used them. In the Shanghai part of the sample, most respondents (domestic firms) had little awareness or understanding of the potential role for arbitration and perceived it as less authoritative than the courts despite the fact that they could apply for enforcement of arbitral decisions by the courts.

Litigation

Between 1983 and 2001, economic disputes accepted by courts of first instance increased at an average annual rate of 18.8 percent, peaking in 1999 (Table 11.2). Put in wider domestic context, civil disputes increased at less than half that rate on average – 8.3 percent per year over the same period – while the number of criminal cases grew only 4.7 percent per year on average (see Table 11.2). Data for administrative cases are available only for the period 1987–2001, and only administrative cases outpaced the growth of economic dispute cases, increasing at an average annual rate of 21.8 percent from a small base. Thus, the courts appear to play an increasingly significant role during the reform period.

Contract dispute litigation in particular, which accounts for the lion's share of all economic dispute cases accepted by the courts, increased at an average annual rate of 20.1 percent between 1983 and 2001 (see Table 11.3). Data on the average value of disputes are available only through 1998: from 1983 to 1998, the total value of disputes grew 40.9 percent per year on average, while the average value of disputes grew at 11.9 percent per year on average. In China, as elsewhere, litigation of contract disputes is rarely the first resort.⁴⁰ Nevertheless, in the World Bank (2001) survey of 1,500 firms in the year 2000, 38.8 percent of firms used litigation in the final resolution of disputes with at least one client, while 29.8 percent used litigation in the final resolution of disputes with at least one supplier.

As with litigation of economic disputes more broadly, litigation of contract disputes peaked in 1999 and has declined since. In interpreting the reasons for the peak and subsequent decline, judges in district and intermediate courts in Shanghai identified several factors operating with a lag. These include the changing prevalence of oral contracts, the tightness of macroeconomic policy, the pace of transition from plan to market, and the pace of transformation of SOEs. Oral contracts are more likely to end up in litigation and may have been more prevalent in the mid-1990s, preceding the active promotion of form contracts by industry associations, for example. Tight macroeconomic policies contributed to a high incidence of nonpayment disputes in the 1990s. The transition from plan to market, most notably in terms of the transformation of small- and medium-sized SOEs, generated a transitory wave of disputes. Indeed, anecdotal evidence suggests that nonpayment disputes may move from negotiation to litigation when new owners repudiate debt.

Judgments and Their Enforcement

Three major trends in the national data (1983–2001) on the disposition of economic contract disputes by the court bear on the issue of enforcement of court judgments⁴¹ (see Table 11.4). First, withdrawals of cases by the plaintiffs have

⁴⁰ Litigation of contract disputes in the United States commonly involves failed businesses, abandoned product lines, very high stakes, or extreme miscalculations (Keating, 1997).

⁴¹ Note that both court-sponsored mediation and court decisions are enforceable decisions.

Table 11.3. *Economic contract disputes handled by courts of first instance, 1983–2001*

Year	Number of cases accepted	Total value of contracts in dispute (billion yuan)	Average value of contracts in dispute (yuan)	Change in average value (percent)	Change in number of cases accepted (percent)
1983	36,274	1.711	51,541		
1984	69,204	1.497	24,443	−52.6	90.8
1985	206,582	8.978	48,611	98.9	198.5
1986	292,599	7.883	28,144	−42.1	41.6
1987	332,496	8.146	24,552	−12.8	13.6
1988	467,872	11.104	25,033	2.0	40.7
1989	634,941	19.351	31,426	25.5	35.7
1990	543,613	17.313	31,277	−0.5	−14.4
1991	516,507	19.879	37,101	18.6	−5.0
1992	598,610	29.703	49,878	34.4	15.9
1993	824,448	63.422	77,834	56.0	37.7
1994	971,432	97.274	100,875	29.6	17.8
1995	1,184,377	148.308	125,865	24.8	21.9
1996	1,404,921	214.064	153,641	22.1	18.6
1997	1,373,355	263.031	192,336	25.2	−2.2
1998	1,329,020	413.432	310,167	61.3	−3.2
1999	1,410,107	n.a.	n.a.	n.a.	6.1
2000	1,184,613	n.a.	n.a.	n.a.	−16.0
2001	1,062,302	n.a.	n.a.	n.a.	−10.3

Notes: As of 1998, statistics on economic contract disputes accepted by the courts include cases involving foreign entities; as of 1988, statistics on cases involving transport of goods were removed from the larger category of economic contract disputes.

Sources: Judicial Statistics (2000), *Law Yearbook of China* (various years).

increased from approximately 8 percent in the mid-1980s to more than 20 percent in 2001. Interviews with lawyers and enterprise managers suggest that the threat of litigation is just another step in the bargaining process; initiating litigation is one strategy to elicit performance from the contractual partner.

Second, a higher percentage of cases nationwide go all the way to judgment than in the past, increasing from roughly 5 percent in the 1980s to more than 40 percent in 2001. Third, and relatedly, the data show declines in the occurrence of court-mediated settlements from roughly 80 percent of the total in the mid-1980s to 30 percent as of 2001. The decline is significant, since official interference has often been reported to occur most frequently during court-sponsored mediation. According to Potter (1992, p. 99), “[T]he dominance of consensual methods of resolution [including court-sponsored mediation] permitted the personal and organizational relationships of the parties to affect the outcome, thus undermining

Table 11.4. Disposition of economic contract disputes by courts of first instance, 1983–2001

Year	Mediated by court	Decided by court	Transferred to relevant bureau	Appeal rejected	Withdrawn	Terminated ^a	Other	TOTAL
1983	79.3	5.5	4.2		8.5	2.4		100
1984	80.6	5.6	3.2		8.7	1.9		100
1985	81.8	5.7	3.1		8.5	0.9		100
1986	79.6	7.5	3.9		8.2	0.8		100
1987	77.3	9.5	2.8		9.6	0.8		100
1988	80.2	8.6	1.9	0.0	8.8	0.5		100
1989	76.8	10.5	2.0	0.0	10.2	0.5		100
1990	69.5	14.7	2.1	0.0	13.0	0.7		100
1991	61.6	20.0	2.2	0.0	14.7	1.5		100
1992	61.7	20.8	1.6	0.5	14.8	0.7		100
1993	63.1	19.5	1.5	0.3	14.9	0.6		100
1994	60.0	20.8	1.5	0.3	16.8	0.6		100
1995	57.7	22.1	1.3	0.3	17.9	0.6		100
1996	53.7	25.5	1.3	0.3	18.4	0.8		100
1997	49.9	29.1	1.5	0.4	18.3	0.8		100
1998	43.2	34.6	1.4	0.6	18.8	0.4	1.0	100
1999	41.3	35.5	0.0	0.8	19.3	0.0	3.1	100
2000	34.6	40.3	0.0	1.3	20.7	0.0	3.2	100
2001	30.8	43.8	0.0	1.4	21.3	0.0	2.7	100

Note: Values are in percent.

^a An economic contract dispute case would be terminated (*zhongjie*) under article 137 of the Civil Procedure Law when one party died leaving no successor or estate to serve respectively as plaintiff or defendant, thus making further prosecution of the suit impossible.

Sources: Judicial Statistics (2000), *Law Yearbook of China* (various years).

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contract autonomy.” Interviews with lawyers, judges, and enterprise owners and managers in Shanghai and Nanjing confirm this understanding. Court-sponsored mediation involving government officials occurs most commonly when fulfillment of unpaid contractual obligations may result in layoffs or nonpayment of wages by an enterprise in difficulty. In this situation, judges may proactively invite government officials to participate in court-sponsored mediation, pressuring the plaintiff to accept a smaller or delayed settlement to maintain the work force of the defendant.

Enforcement of judgments is a continuing problem, but this is hardly unique to China. In March 2004, Xiao Yang, president of the China's Supreme People's Court, stated in his work report to the NPC that “[t]he difficulty of executing civil and commercial judgments has become a major ‘chronic ailment,’ often leading to chaos in the enforcement process; there are few solutions to the problem” (China Law and Governance Review, 2004). According to Ge Xingjun, head of the Supreme

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People's Court's Judgment Enforcement Division, approximately 60 percent of civil and economic judgments were enforced at the basic-level court, 50 percent at the intermediate-level court, and 40 percent at the provincial high-level court (China Law and Governance Review, 2004).

In general, inadequate data are available to assess the nature of implementation of judgments (Clarke, 1996), but the Nanjing court sample sheds some light. Of the seventy-six cases in the sample, 29 percent were withdrawn by the plaintiff, court-sponsored mediation occurred in 21 percent of the cases, and cases went to judgment in 47 percent of the cases. The latter two types of cases are subject to enforcement by the courts. Of these, in only 3.8 percent of cases were judgments "automatically" implemented. In 52 percent of the cases subject to enforcement, plaintiffs applied for compulsory enforcement and the vast majority of these applications came from cases that went all the way to judgment.⁴² Of the twenty-five cases that indicated the results of compulsory enforcement, 55.5 percent were implemented successfully and 18.5 percent failed to be implemented. However, it must be noted that implementation of judgments is a difficult problem in even the most developed countries, and it is not clear that the 55.5 percent figure should be considered low.

Courts are increasingly used because they are seen as authoritative (despite problems with enforcement). According to one private business owner interviewed in Nanjing, "Going to court is not because it's fair but rather because it's authoritative." Strikingly, an intermediate court judge echoed this sentiment: "You need an authoritative person to handle [the dispute], and the resolution of the most authoritative person is the easiest to accept. It's not necessarily the fairest solution, but fairness isn't the standard. The key is whether it solves the problem." Somewhat surprisingly, attitudes of business people toward the legal system as a whole are solidly average: 56.3 percent of respondents in Shanghai and Nanjing rated the legal system as average, while 25.3 percent found it to be low or very low, and 18.3 percent found it to be high or very high. Fewer were positive about trustworthiness in contracting: 42.9 percent of respondents found it to be average, while 53 percent found it to be low or very low, and only 4.1 percent found it to be high or very high. Thus, there does appear to be a need for a neutral, third-party arbiter, yet such services appear to be undersupplied by informal and formal nonstate institutions. The formal legal system clearly plays an important role, albeit an imperfect one.

Summary

At the beginning of the reform era, contracts in China were little different from the orders given to two arms of a bureaucracy by their common superior, and contract law was oriented toward defining the rules relevant for such contracts. But

⁴² The court records suggest that the minimum fee for court-sponsored implementation was 150 yuan, but for larger awards, more typically approximately 1.25–1.5 percent of the award amount (a fee incurred by the winning side).

with the increasing latitude given to local government enterprises and nonstate economic agents, a host of economic relationships were developed outside this context, supported, by default, by informal arrangements. There followed, probably as a consequence, changes in formal contract law, which by 1999 gave broad range to freedom of contract and provided rules relevant to the vast majority of economic agreements. Twenty-five years after reforms began, courts, despite their many deficiencies, were playing a significant role in dispute resolution. Survey evidence indicates that this role is much greater than would have been imagined, given the emphasis placed in the literature on the pervasive role of *guanxi* in economic life. In the matter of the arrangements used to support agreements, China looks very much like a typical successful developing country, with the legal system playing a significant role, but one whose quantitative significance cannot be judged even in comparative terms because of the lack of systematic data.

CORPORATE GOVERNANCE

The primary function of corporate governance institutions is to reduce the transaction costs inherent in the agency relationship between owners of firms and their managers. The crucially important byproduct of this function is to facilitate the flow of finance, by giving investors confidence of a reasonable return on their investment in firm ownership. These institutions are of limited importance in the case of small- and medium-size private firms, where the transaction costs are reduced by the physical presence of owners exerting personal control. Moreover, as we have argued above, local governments were the effective owners of all but the largest government-owned enterprises (e.g., of “collective” TVEs) during the first two decades of reform. The problem of corporate governance in these cases was solved, to the extent it was solved, because “owners” had the ability to exert direct control.⁴³ Thus, discussion of corporate governance in China must focus on two types of very large firms: the very large SOEs inherited from the era of planning, which were directly under the supervision of national authorities, and the very large private and semiprivate firms that have become of major importance over the last decade.

The Early Years of Reform: State Ownership and Managerial Incentives

A universal economic problem is the dilution of managerial incentives arising from the separation of ownership and control that is almost inevitable in large economic entities. Reforming socialist economies faced this problem acutely, since SOEs were very large and liberalizing reforms gave managers greater latitude. Most of the transition countries in EEFSU dealt with this problem through rapid privatization,

⁴³ For these firms, the real issue was the incentives of the controlling officials, which space considerations prevent us from considering.

with the hope that corporate owners would quickly exert the pertinent discipline over managers. This worked in some countries, where the institutional support for mechanisms of corporate governance was better developed, but failed elsewhere, particularly in the former Soviet Union (Djankov and Murrell, 2002).

An alternative approach is to give managers of SOEs stronger incentives to pursue efficiency. This is the route that China took in the 1980s. A succession of papers shows that the stronger incentives had significant and positive effects on profitability, total factor productivity, and return on equity (Groves et al., 1995; Li, 1997; Chang, McCall, and Wang, 2003). The performance of the SOEs in China in the 1980s was far superior to that of the SOEs and former SOEs in EEFSU in the 1990s. However, the relatively poorer performance of the Chinese SOEs in the 1990s led to increasing skepticism about the effects of incentives, a change of views that was no doubt helped by the general impression that incentives had done nothing to solve the problems of inefficient SOEs in EEFSU (Qian, 2000).

These observations raise the possibility that improvements in managerial incentives are a substitute for improved corporate governance institutions in some environments but not in others, and might dominate privatization in those contexts. When seeking to reduce the problems arising from the separation of ownership and control in large SOEs, the strengthening of managerial incentives worked in the less liberalized context of the 1980s and early 1990s in China. This was a time when opportunities for asset stripping were much fewer because of tighter controls on the economy. Perhaps the incentives worked in the China of the 1980s exactly because of the unattractiveness of managerial strategies other than placing effort into improving enterprise efficiency. This stood in contrast to the first decade of reform in the Former Soviet Union (FSU) and later times in China, where more freewheeling economic environments opened up greater possibilities for managers to pursue increases in wealth at the expense of efficiency. These observations suggest that slow liberalization and heightened managerial incentives are a substitute for strong mechanisms of corporate governance, at least in addressing problems arising from the separation of ownership and control. Where institutional development is poor, this policy might be superior to one of rapid privatization, suggesting another reason why the first decade of reform in China had much higher growth rates than the first decade in the FSU.

This analysis reinforces the story of coevolution of the economy and the law that we have presented in “The Development of Law during the Era of Economic Reform.” The changing rules on SOE incentives improved economic performance, stimulating further decentralization and the growth of the private sector, which lessened governmental control of the economy, making direct incentives less productive, and therefore spurring the need for corporate governance rules pertinent to a highly decentralized economy. We review the status of those new rules in “The Role of Corporate Governance in Facilitating the Flow of Finance,” after discussing another temporary, early institutional substitute, anonymous banking.

The Early Years of Reform: Anonymous Banking and the Flow of Finance

The reasoning in the previous subsection is consistent with a current trend in the economics literature, which emphasizes that successful developing countries find some way to generate functional substitutes for the formal institutions that receive so much emphasis in the analysis of developed countries. One function performed by those formal institutions is to protect financial property rights and thus encourage the flow of finance. All developing countries face enormous problems in mobilizing savings to generate the financial resources for investment (Levine, 1997). These problems are especially severe when the accumulation of wealth is ideologically suspect and when a government pressed for revenues is not constrained by law from expropriating property. Yet Chinese growth does not seem to have been overly hampered by this problem.

Bai et al. (2004) argue that the institution of anonymous banking played an important role in solving this problem. They view the government as having the objectives of raising revenue and pursuing an egalitarian tax policy. An ideal policy would be a free market in secure financial assets, accompanied by higher taxes on the deposits of wealthier citizens. But the identification of depositors combined with a lack of trust in government would encourage households and small businesses to retreat from the financial system. This would be accompanied by a reduction in the incentives to accumulate wealth through productive activities and an increase in wasteful forms of wealth holding (e.g., foreign currencies or less productive durables). With anonymous deposits, the wealth of the holder is not observable to the state and the source of funds (perhaps illegal private market activity) is also unobservable. Punitive taxation of the deposits of the wealthier is prevented because the identity of the depositor is not revealed. Tax levels are then constrained by the politics or the ideology of not taxing the poor too heavily.

A corollary of using anonymous banking is that cash transactions have to be allowed because bank transfers identify firms. (Note that cash was not allowed for interfirm transactions in the early years of transition in many parts of the former Soviet Union.) If cash is used on a large scale, the government has poorer information on firms and a reduced ability to expropriate the revenue flows of firms on a selective basis. Thus, by reducing information flows, the practice of anonymous banking, which is inconsistent with notions of best practice institutions, can be understood as a crude substitute for the protection of financial property rights.

In 2000, the rules were changed and identification of the depositor was required on all new deposits. Of the official reasons offered for the change, the only one with real credibility is the desire to use tax instruments to narrow income gaps (Bai et al., 2004). With the successful growth of the private sector, perhaps political objectives have changed. There is now less emphasis on the effects of general distrust in the security of financial assets, compared with concern over the discontent stirred by the large inequalities generated under the market system. Hence, the anonymous

banking rules helped to bring about their own demise, by contributing to the development of the freewheeling semicapitalist system of today. But this system, in turn, generates demands for new institutions.

The Role of Corporate Governance in Facilitating the Flow of Finance

This section focuses on the current status of corporate governance institutions pertinent to publicly listed companies, since a major purpose of legal regulation of corporate governance is precisely to make possible the raising of investment funds from the public at large. While the discussion focuses on problems, since China has far to go, it is worth remembering the starting point, since much has changed. In 1978, all large enterprises were in the state sector, run by government-appointed managers, financed from the state budget, and limited to following plan instructions. Then, following a gradual but incomplete devolution of authority from governmental authorities, reforms led to more modern corporate structures, with boards of directors holding at least nominal authority to make major decisions.

Complaints about corporate governance in listed companies generally center around the nonaccountability of managers for actions that damage shareholders as a whole. Such actions can occur in a variety of ways. One is the misuse of information made possible by nontransparency. Despite a series of China Securities Regulatory Commission (CSRC) rules requiring disclosure of a large volume of information about each company's business, accounting problems undermine the completeness and the accuracy of disclosures. In addition, dominant shareholders are able to use their power over the company to conduct transactions favorable to themselves and disadvantageous to the company and its other shareholders. Such transactions can even include blatantly one-sided transactions such as the outright transfer of funds to the dominant shareholder, without any pretense of an economic *quid pro quo*.⁴⁴

Furthermore, even (and perhaps especially) when company management is not controlled by a dominant shareholder, it can still damage the company through negligence or deliberate misuse of corporate assets. In Chinese listed companies, this is possible less because of collective action problems facing widely dispersed shareholders – shareholding tends to be highly concentrated – than because of inadequate incentives to monitor on the part of officials representing the dominant (state) shareholder. Analysts have even coined a name for this phenomenon: the “absent owner” (*suoyouzhe quewei*).

Management malfeasance can, of course, occur anywhere. But particular forms flourish in China because of the institutional environment in which listed companies operate. In particular, the standard forms of institutional

⁴⁴ A 2005 CSRC notice required such funds to be returned by the end of 2006, but a supplemental notice issued in November 2006 by the CSRC and several other agencies made it clear that the problem remained unresolved (CSRC et al., 2006).

restraint – monitoring by government agencies, civil litigation by private parties who suffer damage, and various mechanisms based on the market and civil society (including information and monitoring services provided by intermediaries) – all suffer from serious defects.

The CSRC, for example, has very limited formal power other than that of approving share offerings. Its investigative powers are severely circumscribed: it may, for example, question executives of a listed company about a suspicious transaction, but not executives of the company on the other side of the transaction if the second company is not under the CSRC's jurisdiction. While the CSRC has, in the view of some, exceeded its jurisdiction over securities by attempting to regulate internal corporate governance matters such as the number of independent directors, its views on such matters must be issued in the form of "guidance opinions" and suggestions and must be enforced through the CSRC's power – sometimes effective, sometimes not – to withhold various approvals (e.g., for a stock offering) from offenders.

The stock exchanges – essentially branches of the CSRC and not true civil society organizations – offer even less of a deterrent. They do not have the power to set their own standards for listing and delisting (other than of a strictly technical nature); the delisting decision is made by the CSRC under articles 55 and 56 of the Securities Law (2005) (which spell out circumstances such as major violations of law or losses for three consecutive years).

Civil sanctions through private litigation are of little concern to managers. Both the Company Law and the Securities Law are very stingy in their grants of rights to shareholders, and the court system has proved very reluctant to help shareholders vindicate what rights they have. The Supreme People's Court, for example, has issued a regulation to lower courts under which they may not hear any cases involving claims for damages caused by insider trading or market manipulation and may hear cases involving misleading disclosures only when there has been a prior finding of such by an official body such as the CSRC (Chen, 2003; Hutchens, 2003).

Finally, monitoring by nongovernmental intermediaries such as auditing firms and the financial press⁴⁵ remains spotty. Favorable press coverage can often be obtained, and unfavorable coverage suppressed, for a price. Journals that do publish unfavorable stories may find themselves subject to libel suits. Recently, however, there are some grounds for thinking that courts may be coming to recognize the countervailing value of vigorous commentary in such matters. The Guangzhou Huaqiao Real Estate Development Company lost a libel case brought against the journal *China Reform* for having reported on asset stripping at the company. The court ruled that journalists enjoy immunity from suit if the news was backed

⁴⁵ Although China's press of course remains under significant state control, that control is sufficiently decentralized, and the gray areas sufficiently broad, that in this context it makes sense to think at least of the financial press as significantly more "nongovernmental" than, for example, the two stock exchanges.

up by a source that was reasonable and believable, and was not based simply on rumors.⁴⁶

The importance of these problems is less clear. While the Chinese stock market is, at the time of this writing, languishing, corporate governance, while poor today, is arguably better than in the past when the stock market was booming. One possibility is that instead of law driving market development, the market might be driving law. As argued by Chen (2003), recent scandals and the current market doldrums have awakened investors to the need for better regulation of the securities market and corporate governance, and they have begun to press for needed reforms – part of a “first crash then law” pattern observed in several countries by Coffee (2001). But this conclusion might be premature. Not only retail investors but also many government officials remain of the view that the proper function of securities markets is to go up: the CSRC has been criticized for causing markets to fall through overenthusiastic enforcement. Even the CSRC itself is wary of overregulation – not in the sense of making too many rules, but in the sense of enforcing existing rules – for precisely the same reason. Many in the financial services industry argue that a certain amount of willful blindness on the part of regulators is necessary, at least at the current stage, for public confidence to continue because that confidence is driven more by a continually rising market than by knowledge that corporate governance is sound.

Summary and Reflections

In this chapter we have assessed the development of law in China and analyzed its role in the economy, examining the degree to which China’s formal legal system offers stable and predictable rights of property and contract. Although the legal system has made great strides since the beginning of reforms and currently has a role of some significance in the economy, it is impossible to make the case that formal legal institutions have contributed in an important way to China’s remarkable economic success. If anything, economic success has fostered the development of law, rather than the reverse. This is not to say that expectations of reasonable and predictable returns from property and contract have been absent in China: it is very unlikely that high rates of investment and growth could have occurred unless investors, producers, and traders expected a reasonable return on their efforts. Rather, our conclusion is that the formal legal system did not play a large role in fostering such expectations.

In this chapter we approached the assessment of the role of law by examining the details of legal rules, the structure of the legal system, and case studies of very specific elements of economic activity. We have largely ignored evidence from the many

⁴⁶ Excerpts from the text of the judgment as well as commentary by prominent attorney Pu Zhiqiang, who appeared for the defendants, can be found at <http://www.epochtimes.com/gb/4/10/18/n694419.htm>.

countrywide measures of the strength of institutions developed by economists and political scientists. The reason for bypassing this evidence is that we have found that it is at variance with our detailed contextual analysis, in ways that lead us to doubt the validity of the countrywide measures. For example, on one widely used survey, the World Business Environment Survey (2005), company managers were asked, "To what degree do you agree that the legal system will uphold contract and property rights?" The percentage of Chinese respondents answering with agreement (rather than disagreement) was higher than that for the world as a whole, higher than the average for countries in China's income group, and also higher than that for many countries (such as the United States) with legal systems that most commentators would consider stronger than China's.

If one compares these survey results with our discussion in "Are Property Rights Secure? Do They Matter?," "Transactions in Goods and Services," and "Corporate Governance," then it is clear that respondents must have been interpreting the term "legal system" very differently from the way social scientists would.⁴⁷ Perhaps their responses were more visceral, suitable for the phrase "political, social, and economic equilibrium" with which we began this chapter. We view it as quite plausible that the equilibrium in China over the last two decades upheld contract and property rights to some reasonable degree. But the legal system was not by any means the central element supporting that equilibrium: the Weber-North rights hypothesis clearly fails in the case of China. This divergence between the role of the legal system and perceived contract and property rights underscores the importance of detailed study of those mechanisms that must have produced the expectations that drove China's growth performance.

Questions on which mechanisms drove expectations must go largely unanswered for lack of data on institutions and institutional substitutes and their effects, a lacuna that is by no means unique to China (Clarke, 2003b; Hendley and Murrell, 2003). Nevertheless, we were able in "Transactions in Goods and Services" to summarize the results of existing papers and new research, suggesting that courts are playing an increasingly significant role in dispute resolution and personal relationships are relatively less important at present. In sections "Are Property Rights Secure? Do They Matter?" and "Transactions in Goods and Services," we presented information suggesting that the presence of institutional substitutes is important: for example, the cadre system gives local officials certain incentives to respect property rights. Large questions remain. Thus, for example, there is no clear picture of the changing relative importance of political relationships and law in fostering property rights. Similarly, there is virtually no information relevant to China on whether gaps in the formal legal system are most crucial for small firms or large ones, for new firms or old ones, in finance or real property.

One can make only broad judgments about where the gaps in the legal system are really critical. One especially damaging lacuna – economically, politically, and

⁴⁷ We assume for now that they were being candid.

socially – is the absence of an effective system of rural land ownership, where farmers would have robust rights to land that they could then trade. This would mitigate the increasingly (socially and politically) disruptive process of removing farmers from their land for the purposes of redevelopment, without providing adequate compensation.⁴⁸ The tradability would allow land to be put to its most remunerative use. It would also allow for efficient combinations of landholdings.

The case of rural land ownership provides one example where limited legal development is genuinely costly and likely to increase in cost. This case exemplifies a more general phenomenon: China's lack of dispute resolution institutions beyond the control of the political powers whose actions they might be asked to overturn. The economic and social cost of not having such institutions is high now and will be much higher in the future. But the solution to this problem lies far outside the legal realm, in the domain of the political system, where economic arguments for profound legal changes are not likely to carry much weight while economic performance remains at the levels experienced in the reform years.

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⁴⁸ As the writing of this chapter was being completed, the critical need for some kind of reform in this area was dramatically illustrated when ten to twenty villagers in southern China were reported killed by gunfire from security forces as part of a conflict over land requisitioning (*Washington Post*, 2005).

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