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# China: Creating a Legal System for a Market Economy

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# CHINA: CREATING A LEGAL SYSTEM FOR A MARKET ECONOMY

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## 1 INTRODUCTION

This report presents a brief overview of a broad topic: the set of laws and legal institutions needed for a market economy, and China's recent progress toward such a set. It begins by presenting the general consensus view on the legal prerequisites for a market economy. It then presents a brief chronology of legal developments related to economic reforms since 1978, focusing particularly on the late 1990s to the present.<sup>1</sup> The chronology is followed by a fuller discussion of the way Chinese current legal institutions do or do not meet the needs of a market economy, with some suggestions for further reform measures. In particular, this report will discuss the degrees to which various Chinese legal institutions are hospitable to certain kinds of rulemaking.

## 2 WHAT LAWS ARE NEEDED FOR A MARKET ECONOMY?

### 2.1 *Why the Question?*

Why should we care about what laws are needed for a market economy? In general, this question is asked not because a market economy is deemed good for its own sake, but because it can generate growth, and growth is desired because it generally enhances the welfare of a country's citizens. Thus, where growth as conventionally measured does not enhance welfare—for example, where the cost in environmental damage is too high—or where the application of market principles hampers growth—for example, by permitting cartels—the single-minded pursuit of laws and institutions that promote a market economy should be adjusted in view of the ultimate goal of enhanced welfare.

While this report is primarily about legal institutions and the market economy, therefore, it must be borne in mind that it does not deal with certain essentially political questions—for example, the proper trade-off between economic growth and environmental protection or other difficult-to-quantify social objectives. Such trade-offs can only be made within the Chinese political process.

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<sup>1</sup> This report covers developments through June 2007. It was prepared for the Asian Development Bank, which is not responsible for its contents. The views expressed herein are those of the author, not necessarily those of the Bank. A shorter, reorganized, and revised version of this report appears as Donald Clarke, "Legislating for a Market Economy in China," *China Quarterly*, no. 191 (Sept. 2007): 567-585.

## 2.2 *Is Law the Answer?*

Bearing in mind the above caveats, and assuming that the goal is a market economy, the key policy question is: what *institutions*, legal or otherwise, are necessary for a market economy. There is no particular reason, and indeed it would be counterproductive, for government policy to confine itself to the consideration of *legal* institutions. Laws and legal institutions are part of a social fabric; they generally function successfully only within a particular context of non-legal institutions, and in many cases a particular policy goal may be more successfully achieved through non-legal institutions and measures than through legal ones.<sup>2</sup> Thus, the focus should be on creating institutions that effectively serve the needs of a market economy, whether or not they happen to be legal.

Just as importantly, this focus should not assume that such institutions will or can be created by state policy. Just as international donor agencies should not, for example, attempt to force a blueprint for institutional reform on governments, so too should governments not attempt to monopolize the creation of market-friendly institutions. What governments can do is to create an environment that makes possible a market response to a demand for institutions, while continuing of course to suppress undesirable institutions such as organized crime.

## 2.3 *The Relationship Between Legal Institutions and Growth*

An important school of thought in institutional economics (the “Rights Hypothesis”) originating with Max Weber (Rheinstein 1954) and more recently associated with Douglass North (North 1990) holds that economic growth requires a legal order offering stable and predictable rights of property and contract because the absence of such rights discourages investment and specialization. Without the security of expectations offered by such a legal order, according to the Rights Hypothesis, the risks of a great number of otherwise beneficial transactions far outweigh their expected return, and as a result such transactions simply do not occur. Society is mired in an economy of short-term deals between actors bound by non-legal ties such as family solidarity which by their nature cannot bind large numbers of strangers (Knack and Keefer 1995).

The Rights Hypothesis is intuitively appealing and seems to be supported by a number of theoretical, historical, and empirical studies.<sup>3</sup> Nevertheless, it has its skeptics.<sup>4</sup> The relationship between law and economic development is, to say the least, not simple, as shown by the growth

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<sup>2</sup> Amartya Sen, for example, cites a study showing that the key determinants of fertility rates in India are women’s literacy and employment opportunities (Sen 2003).

<sup>3</sup> The literature is vast. Influential or representative works include Weingast (1993), North and Weingast (1989), La Porta et al. (1997), La Porta et al. (1998), Scully (1988) (“Politically open societies, which bind themselves to the rule of law, to private property, and to the market allocation of resources, grow at three times . . . the rate and are two and one-half times as efficient as societies in which these freedoms are circumscribed or proscribed.”), and Demirguc-Kunt and Maksimovic (1998) (“[B]oth an active stock market and a well-developed legal system are important in facilitating firm growth.”).

<sup>4</sup> For good reviews of the literature and the evidence, see Davis and Trebilcock (2001), Ginsburg (2000), Messick (1999).

of China and other countries that typically score (or in the past scored) low on various rule-of-law indices.<sup>5</sup> Economies can achieve significant growth at least to a point without well functioning markets—consider, for example, the Soviet Union and China itself prior to reform—and informal institutions can make up to a considerable extent for the lack of a well functioning legal system. One study documents a thriving private sector in Vietnam, although virtually none of the enterprise managers interviewed believed that courts were of any value in dispute resolution (McMillan and Woodruff 1999), and Richard Posner points out that many American states have successful economies despite having courts staffed by politically-appointed judges of questionable competence (Posner 1998). Informal and social sanctions, repeated games, and self-enforcement mechanisms can go a long way.<sup>6</sup>

On the other hand, perhaps they cannot go the whole way. A study of entrepreneurs in transition economies argues that the scope of transactions beyond what can be achieved through reliance on non-legal institutions is substantial and important (McMillan & Woodruff 2002). Even weak courts can play an important role in facilitating economic activity; ease of entry, for example, has been critical to economic success in transition economies, and entrepreneurs in transition economies who believe that courts are effective offer more trade credit and are more willing to take on new trading partners, thus lowering barriers to entry (Johnson et al. 2002, Dakolias 1996). Although much of the literature on informal business networks exalts them, Raja Kali has argued that while networks of relationships can arise in response to inadequate legal institutions and even do a good job in replacing them, their negative effects on non-members could outweigh their beneficial effects on members, and thus, from an economy-wide standpoint, reduce overall economic efficiency (Kali 2001). Social networks cost resources to establish; trusted middlemen may facilitate transactions but don't work for free; and the ostracism of defectors doesn't work once the community becomes sufficiently large.

A problem with the Rights Hypothesis literature, and one that is of critical practical importance for legal system reformers, is that while it is plausible that legal institutions matter, so far it is not clear what their exact shape should be. For example, everyone agrees that arbitrariness in the application of law is bad; but arbitrariness is always a danger whenever there is discretion, and discretion is a necessary part of flexibility, which is good. Institutions that make it difficult for government to change policy rapidly may help economic development by making government commitments credible; they may also hurt it by hindering the government's ability to respond effectively to economic crises or rapid change (Zhang 2006, Stephenson 2001, Olson 1982). Nor can there be a single right answer: particularly in some developing countries, maintaining credibility may be worth paying a price in terms of flexibility, but the right balance will always be context-dependent.

It is not even clear that more judicial independence is always a good thing. In English history, a high degree of discretion for independent judges served the development of the market

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<sup>5</sup> See, for example, Table 1 in Matsuo (2003). Consider also the cases of Japan, South Korea, and Taiwan (Milhaupt 2000; Ohnesorge 2006).

<sup>6</sup> See, e.g., Bull (1987), Greif (1993), Telser (1980), and Winn (1994). Some scholars such as Jones (1994) have argued that such relationships can in fact be a complete substitute for legal institutions.

economy because the judiciary, at least at the senior level, by and large understood the functioning of that economy. In France, by contrast, the post-revolutionary state was attempting to eliminate traditional constraints on the market, often against the will of the incumbent judiciary, and in such circumstances constraining judicial discretion was necessary (Arruñada and Andonova 2005). Thus, even if it could be convincingly demonstrated that common law systems outperform civil law systems, it would not follow that a common law system, if adopted in a particular country, would generate more economic growth than a civil law system in the same country, given that country's particular history and institutions.

Finally, policymaking can be hampered by an unrealistic understanding of how the legal systems of advanced Western economies really operate. The importance of courts and law is often overstated, while political factors are overlooked. For example, one scholar recently wrote:

In most developed countries, the risk of expropriation is reduced by constitutional guarantees and powerful courts. For example, in the United States, the Takings Clause prevents the government from seizing property without compensation, and this protection is enforced by courts with the power to enjoin government action or award compensation. (Klerman 2006)

This greatly overstates the protection offered by law and overlooks the protection offered by political processes. In the United States, a series of Supreme Court decisions have established that the government may, consistent with the U.S. constitution, adopt measures that effect an uncompensated taking in all but name,<sup>7</sup> and may also take property for the purpose of private development if a public benefit can be shown<sup>8</sup> (as it almost always could be) (Keane 2006, Cohen 2006). On the other hand, governments at various levels in the United States in fact rarely exercise their taking power to the fullest; property owners receive far more protection from their collective political clout than they do from the U.S. constitution.

#### 2.4 *Creating Flexible Institutions*

Given the variety of local circumstances and institutions, while policymakers should certainly be aware of what are generally considered international “best practices” in many areas of law, they should also be sensitive to local conditions. Moreover, the key is less getting the rules and institutions right at any given time than having a system that allows institutions to change and adapt over time to meet new circumstances:

In the historical perspective what matters for growth is not having a good set of economic policies or commercial laws at any one point in time but having a flexible political and legal system that is capable of adapting to the demands of a changing economic environment. (Davis 2005: 2)<sup>9</sup>

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<sup>7</sup> See *Lucas v. South Carolina Coast Council*, 505 U.S. 1003 (1992); *Penn Central Transportation Company vs. New York City*, 438 U.S. 104 (1978).

<sup>8</sup> See *Kelo vs. New London*, 125 S. Ct. 2655 (2005).

<sup>9</sup> Douglass North (1995) makes a similar point: “Allocative efficiency is a static concept with a given set of institutions; the key to continuing good economic performance is a flexible institutional matrix that will adjust in the context of evolving technological and demographic changes.”

Thus, while Chinese policymakers on the one hand must think about which particular laws and institutions are the right ones for China at any given moment, they must also think about how to create an environment that will allow new institutions to be created and existing institutions to adapt or to disappear.

### 3 CHRONOLOGY

As is by now well known, the post-Mao era of economic reform began with the December 1978 decision of the Third Plenum of the 11th Central Committee of the Communist Party of China to jettison class struggle as the main task of the Party and to adopt a program of economic reform in its place. The government reoriented its development strategy to reduce investment in heavy industry and to shift resources to agriculture and consumption.

The first phase of economic reform, lasting from 1979 until approximately 1984, did not involve a commitment to markets. Instead, it was essentially an attempt to make the planning system work better. A new Constitution, adopted in December 1984, was a complete reworking of its 1978 predecessor, but contained no radical innovations in the realm of economic policy. It 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 of the economy. The "individual economy"—i.e., economic activities by self-employed individual entrepreneurs with fewer than eight employees—was called a "supplement" (*buchong*) to the socialist publicly owned economy (Article 11); market activities were ad hoc and provisional. Socialist public property was declared sacred and inviolable, but there was no parallel declaration respecting private property.

Not surprisingly, market-oriented legislation was sparse in this period. The Economic Contract Law was adopted in December 1981, but it was intended largely to regulate relations between state-owned enterprises. Indeed, contracts between individuals were specifically excluded from its ambit. Foreign investment was officially welcomed with the adoption of the Law on Sino-Foreign Equity Joint Ventures (EJV Law) in July 1979, but this very short law is better understood as a policy statement for the guidance of foreign investors than as part of a market-oriented legal system. Its rules functioned more as starting points for negotiation than as mandatory norms.

Despite the general dearth of market-oriented legislation, progress was made in the area of intellectual property. Trademark protection, because it prevents competitors from free-riding on the reputation of a supplier of goods and services, is critical to the encouragement of investment in the quality of those goods and services where that quality is not immediately apparent to the purchaser. China adopted a Trademark Law as early as 1982. Patent law is of course important for the protection of the fruits of useful innovations, and China adopted a Patent Law in 1984.

By 1984, the success of agricultural reforms was clear to all, whereas reforms in the state sector had been much less successful. State-owned enterprise (SOE) behavior remained essentially unchanged. Although reforms continued in the SOE sector, and sometimes took the form of legal enactments, they do not represent legal reform as such and so are not discussed at length here.

From 1985 to 1989, China saw a second stage of economic reform in which the market was more fully and openly embraced as a critical component of the economy. This stage also saw the emergence of the private sector as an important supplement to the public sector, with a rise in the number of privately-run and "red hat" enterprises: business formally registered as collective

(typically paying a “management fee” to local government) instead of private in order to qualify for benefits available only to the public sector and for protection against local government predation (Krug and Hendrischke 2002). In October 1987, the 13th Congress of the CCP recognized the private economy (not just the economy of individual entrepreneurs) as a necessary supplement to the state sector, and in 1988 the Constitution was revised: to the existing acceptance of the “individual” economy was added the acceptance of the “private” (*siying*) economy.

A flow of high quality information is an important part of a well functioning economy under any system, but consistency and transparency are especially valuable in the decentralized environment of the market economy. In January 1985, China began to take steps down this road with the adoption of an Accounting Law. This law was subsequently amended a number of times, most recently in August 2004. In addition, the Ministry of Finance has been active in promulgating specific accounting principles, issuing its first general set (applicable to all Chinese enterprises) in November 1992.<sup>10</sup>

In 1986, the General Principles of Civil Law were adopted. This statute was an important contribution to the provision of basic legal principles for the operation of a market economy, since it presupposes a universe of individual actors making decisions based upon free will—the antithesis of the universe of the planned economy. It did not, however, contain detailed rules in important areas such as contract, tort, and property. The legal regime in those areas continues to be composed of separate regulations promulgated by various bodies.

Contract law continued to develop with the adoption in March 1985 of the Foreign Economic Contract Law (FECL), which covered contracts between Chinese entities and foreign parties. The following year saw the adoption of the Law on Wholly Foreign-Owned Enterprises (WFOE Law), which for the first time allowed an enterprise organized under Chinese law to be wholly owned by one or more foreign investors, with no Chinese equity participation. In 1988, the legal framework for foreign-invested enterprises was basically completed with the adoption of the Law on Sino-Foreign Cooperative Joint Ventures (CJV Law), which allowed for a joint venture with more flexible features than those allowed under the EJV Law.

Like the FECL and the EJV Law, the WFOE Law and the CJV Law represented a policy of attempting to establish a separate legal regime for foreigners and foreign-related transactions. In some cases, this system allowed for experiments in policy that could later be implemented in the domestic economy at large. The WFOE Law, for example, allows for single-shareholder companies. Until the implementation of the revised Company Law in January 2006, it was not possible for any Chinese investor other than a governmental entity to be the sole shareholder in a Chinese company, and even today single-shareholder companies under the Company Law are given discriminatory treatment in that it is simpler for corporate creditors to reach the assets of the shareholder. And the CJV Law provides for a flexibility in management structure and distribution of profits that to this day cannot be achieved through the Company Law.

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<sup>10</sup> Ministry of Finance, *Qiyè kuaijì zhūnzé* (Principles of Accounting for Enterprises), adopted Nov. 30, 1992, effective July 1, 1993.

In the realm of domestic enterprise law, in December 1986 China adopted the Enterprise Bankruptcy Law (EBL) (effective in 1988). Despite its name, the EBL is better seen as a statement of policy about closing down SOEs in certain circumstances. The main purpose of the EBL, as contemporary commentary made clear, was not to protect creditors or to assist in the reallocation of inefficiently used capital, but to improve SOE performance through the threat of closing. (After many years of controversy and false starts, the EBL was substantially revised in August 2006; the revisions are discussed further below.)

Whether this law represented a change in state policy toward SOEs is one thing, but its legal insignificance is clear when one recalls that government departments in charge of SOEs had the power to close them down prior to the adoption of the EBL and retain the power to keep money-losing SOEs operating after it. Because the policy regime underwent no significant change, the corporate landscape remains heavily populated with money-losing enterprises who creditors cannot (or for various reasons connected with the particular incentives facing certain types of creditors, will not) seize and sell off under this law.

By the same token, the 1988 adoption of the Law on Industrial Enterprises Owned by the Whole People did not represent a fundamental advance in legal reform. The statute was intended to operate as a formal organizational and regulatory statute governing industrial SOEs. Needless to say, such SOEs had been organized and regulated prior to 1988, so clearly a statute was not required for their existence. (Non-industrial SOEs in traditional form still exist today without the benefit of any organizational statute.) Thus, the statute represented less in new substance than it did the idea that SOEs *should* be governed by legislation issuing from the NPC, and not simply by State Council and ministry-level regulations.

On the other hand, an important legislative step was made in improving the business environment for private entrepreneurship with the adoption in August 1987 of the Provisional Regulations on the Administration of Urban and Township Individual Industrial and Commercial Households. These regulations provided some legal form to small sole proprietorships in addition to signifying state approval of their existence. In addition to stipulating some limitations in the form of needed permits, the regulations also provided some protections.

In addition, June 1988 saw the adoption by the State Council of the Provisional Regulations on Private Enterprises. These regulations, still in effect today although seriously dated, legitimize sole proprietorships, partnerships, and limited liability companies having eight or more employees. However, only a limited class of persons is eligible to form such enterprises: farmers, the urban unemployed, retired persons, etc. Over the years, local implementing regulations have for all practical purposes largely abolished the limitations on who may form such enterprises. At the time of their adoption, however, the regulations reflected a view that private enterprises are not a normal part of economic life, but a supplementary part of the economy to be operated by those who are not fully participating members of the urban socialist economy. Thus, their organizational problems were not seen as the concern of a major legislative body such as the National People's Congress; they were more of a technical problem to be solved by administrators at the State Council.

An important step in marketization of the economy, from both a legal-system and a policy perspective, came with the April 1988 amendment of the Constitution to sanction the granting of long-term land leases in state-owned land. This 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.

Finally, a reform in the principles of the legal system of great potential significance to market actors was the adoption in April 1989 of the Administration Litigation Law. This law established the critical principle that government agencies must justify their actions by reference to published laws and regulations. The law is not a complete administrative procedure law; only the implementation of rules, and not the rulemaking procedure itself, is covered.

The third stage of economic reform, from 1989 to 1992, is in fact less a stage of economic reform than a period of post-June 4th retrenchment. This period saw an attempt to undertake a significant rollback of economic reforms, recentralize, and strengthen economic planning. The attempt did not last long, however, and momentum for reform had begun to build anew by the end of 1990.

Already in May of 1990, the Provisional Regulations on the Grant and Transfer of Use Rights in Urban Land provided the statutory framework for the commodification of urban land. The regulations provided that long-term leases from the state of up to 70 years could be granted and subsequently transferred relatively freely. In September 1990, the third leg of the intellectual property protection tripod was completed with the adoption of the Copyright Law. Finally, in December 1990, trading began on the newly-established Shanghai and Shenzhen stock exchanges—less a legal phenomenon than a policy phenomenon, to be sure, but an important symbol of the irrepressibility of the tide of economic reform.

The fourth and current stage of economic reform dates from the end of the retrenchment period, marked most explicitly by Deng Xiaoping's Southern Tour in early 1992. During this period, economic reform and markets were fully embraced once more, and China began to create an economic and legal system that fully and explicitly embraced the private sector as an important component of the economy. This system envisages a rules-based market operating through the institutionalization of property rights, and this period saw the rapid development of private firms and the building of market institutions and associated laws. The tenor of this period was aptly symbolized by the CCP's endorsement of the "socialist market economy" at its 14th Congress in October 1992 and by the March 1993 amendment of Article 15 of the Constitution, which replaced the reference to the "supplementary role" of the market with the straightforward declaration that "[t]he 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. While these constitutional duties had never been legally binding in a realistic sense, their elimination was nevertheless symbolically important.

The Constitution was further revised in March 1999 in two symbolically important ways. First, the concept of "rule of law" was written into it. The words, of course, do not by themselves mean any change in the role of the legal system. But they do represent a policy declaration by the government that the legal system is to be given greater weight as a technique of governing.

Second, Article 6 was amended to acknowledge the contribution of "diverse sectors" of the economy in addition to the publicly-owned sector. 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 was amended to label the private, individual, and other non-public sectors “major components” of the socialist market economy.

In addition to having a more welcoming attitude toward the private sector—perhaps symbolized most strongly by Jiang Zemin’s announcement in 2001 that private entrepreneurs could become Party members—legal reform in this and the current era has been distinctive in that it has seen the construction of the legal infrastructure of a rules-based market system in which distinctions state and non-state actors, as well as between Chinese and foreign actors, are gradually being eroded.

In May 1992, China took an important step forward in the law of business organization when the State Commission on Reform of the Economic System (SCRES) adopted its Normative Opinion on Joint Stock Companies (JSC Opinion). This document was in effect 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. It is important to note, however, that this document was more a tool of SOE reform than a general enabling statute for enterprises in a market economy. It was intended largely to facilitate the restructuring of existing SOEs, not to facilitate the formation of new enterprises. One year later, in April 1993, the State Council issued the Provisional Regulations on the Administration of the Issuance and Trading of Stock, in effect China’s first law on securities—a necessary complement to the JSC Opinion. The Provisional Regulations were supplemented, but (rather curiously) not abolished by the Securities Law, adopted in December 1998 and substantially revised in October 2005.

The second half of China’s proto-company law was the Normative Opinion on Limited Liability Companies adopted by SCRES at the same time. This document provided an organizational vehicle for enterprises that wished to restructure into companies with investors holding equity shares, but did not wish to list on the stock exchanges. Both Normative Opinions were superseded by the Company Law, adopted in December 1993 and substantially amended in October 2005. This law formalized the classification of companies into two types: the joint stock company (*gufen youxian gongsi*), intended for large pools of assets with liquid and tradeable equity interests, and the limited liability company (*youxian zeren gongsi*), intended for smaller entities in which the investors may bear a stronger resemblance to partners than to mutually anonymous shareholders.

The Company Law was followed in February 1997 by the Law on Partnership Enterprises (Partnership Law). Partnership law has an important role to play in an economy that wishes to encourage entrepreneurship and small business. First, it provides a set of default rules for the type of informal organization that springs up any time two or more people decide to go into business together when they have neither the time nor the expertise to think hard about the precise governance rules they desire. Second, it protects creditors of the business by looking beyond the individual who actually created the contract or tort obligation and requiring those who benefited by the act—the other partners—to bear the costs as well.

The 1997 Partnership Law was not business-friendly. It contemplated partnerships as relatively formal organizations, and its provisions tended to be mandatory rules instead of default rules that could be changed at the will of the partners. It was never clear whether entities other than

natural persons could be partners,<sup>11</sup> and partnerships were taxed like corporations until 2000 (State Council 2000).<sup>12</sup> Perhaps as a result, as of early 2006 only some 60,000 partnerships had been formed since the law came into effect in August 1997 (Zhu 2006).

In response to the market's lack of enthusiasm, the Partnership Law was substantially revised in August 2006. The revisions clarify that legal persons can indeed be partners and that partnership income shall be taxable only to the partners and not to the partnership. Perhaps more importantly, the revisions allow for limited partnerships<sup>13</sup> and, in certain sectors, something akin to a limited liability partnership.<sup>14</sup> In short, the new law is clearly an attempt to foster business activity through providing a larger menu of organizational forms (Wang 2006).

China also adopted a Law on Individual Wholly-Owned Enterprises in August 1999 in order to provide a legal framework for certain types of sole proprietorships. Like the Partnership Law, this law specifies that investors shall *not* enjoy limited liability. Also like the Partnership Law, it seems designed more to regulate than to enable, and it is not clear that it fills a pressing business need.

An important legal institution in promoting flexibility in private and business relationships is the trust. The law of trusts provides a set of background rules when for various reasons it makes sense to have assets legally owned by one person but managed for the benefit of another. Those dealing with the trustee need not worry about issues of unauthorized agency, for example, while the trustee need not seek the approval of the beneficiary for various transactions. China began building this institution in April 2001 with the adoption of the Law on Trusts. While the law leaves some important questions unanswered—who, for example, is responsible for taxes on income earned by trust assets?—and is necessarily vague with respect to fiduciary standards, nevertheless it represents an important foundation that can be built on through subsequent rulemaking and jurisprudence.

During this period China also adopted a number of laws and regulations establishing some basic market institutions and rules of the game. In September 1993, the Economic Contract Law (ECL) was amended to bring contracts signed by individual industrial and commercial households (*getihu*) within its ambit. Other contracts signed by individuals on their own behalf, however, still remained outside and therefore under the default coverage of the General Principles of Civil Law (GPCL). Perhaps unintentionally, expanding the reach of the ECL to *getihu* contracts may not have

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<sup>11</sup> Although the original Partnership Law was not unambiguously clear on this point, the consensus of subsequent practice was that partners had to be natural persons. See Zhu (2006) and Wang (2006).

<sup>12</sup> In the United States and many other jurisdictions, partnership income is taxed once, directly to the partners, and not also at the partnership level. In the United States and China, corporate income is generally taxed once when received by the corporation and again when it is distributed to shareholders as a dividend.

<sup>13</sup> A limited partnership consists of general partners (although there is usually only one) and limited partners. The general partner exercises management power and bears unlimited liability for partnership obligations; the limited partners are passive investors similar to corporate stockholders who are not liable for partnership obligations.

<sup>14</sup> A limited liability partnership is internally like an ordinary partnership, but the partners are not liable for the debts of the partnership.

been a business-friendly move: the ECL did not sanction oral contracts of the kind no doubt common among *getihu* and other small businesses, whereas such contracts are permitted under the GPCL.

In March 1999, Chinese contract law was finally unified with the adoption of the Contract Law. This law superseded three prior laws: 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). The Contract Law by and large follows international practice; as with many other Chinese statutes, the problem areas are less in the content of the norms than in their implementation.

In May 1995, a Negotiable Instruments Law was passed. Such a law is absolutely critical to the smooth functioning of a market economy, since it establishes the rules without which payment systems such as checks cannot function, thereby reducing the transaction cost of commerce. On the other hand, such a law alone is not sufficient to induce the widespread use of checks, as their continued relative rarity in China demonstrates. The appropriate accompanying institutions are also needed, such as a central bank like the Federal Reserve Bank that guarantees checks to its member banks. Because no bank performs this function in China, checks take much longer to clear.

Further legal support for modern methods of financing was provided by the Security Law, adopted in June 1995. This law made secured lending possible. As with negotiable instruments, however, a law alone is not sufficient. There have been a number of problems with the implementation of the Security Law. Because borrowers may attempt to secure many loans with the same asset, a secured lending regime must provide a means for prior lenders to give, and subsequent lenders to receive, fair notice of the prior lender's interest in the asset so that the prior lender can enjoy priority in repayment. China does not yet have a uniform and unambiguous system for doing this.

Some progress in institution-building came in May 1995 with the adoption of the Commercial Bank Law. This law provided for a number of restrictions on the activities of commercial banks, however, and did little if anything to ease the problems faced by non-state enterprises in obtaining credit. While it required banks to maintain a minimum 8% capital adequacy ratio, methods for calculating capital adequacy were not promulgated until 2004,<sup>15</sup> and the ratio was not enforced (DeSombre and Chen 2004).

Price reform was advanced by the Price Law, adopted in December 1997. It established the principle that the great majority of prices should be set by the market—i.e., decided by producers themselves. At the same time, however, the Price Law retains significant vestiges of the producer-oriented planned economy: it contains provisions designed not just to regulate the process by which prices come to be set (as any antimonopoly law might be said to do), but to ensure that prices are neither too high nor too low. Because it is only government administrative agencies, and not

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<sup>15</sup> China Banking Regulatory Commission, *Shangye yinhang ziben chongzulü guanli banfa* (Administrative Measures on Commercial Bank Capital Adequacy Ratios), issued Feb. 23, 2004, effective Mar. 1, 2004.

courts, that can as a practical matter have the power to decide the standard against which “too high” or “too low” should be measured, as a matter of legal reform the Price Law does little. As a symbol of the state’s intention to decontrol prices significantly, of course, it is important.

China also passed several regulations in the field of foreign trade. In May 1994, the Foreign Trade Law was adopted. It provided an important default rule that any good was tradeable unless regulations provided otherwise, but was still restrictive in prohibiting natural persons from engaging in foreign trade. It authorized various restrictions on imports and exports, some GATT-compatible and some not. It also provided in principle for antidumping and countervailing duties, but with details as to procedure. Regulations on antidumping and countervailing duties were not passed until March 1997; they contained some WTO-incompatible elements and were superseded by WTO-compatible regulations in November 2001, just before China’s entry into the WTO in December 2001.

On the eve of WTO entry, China also passed several laws and regulations aimed at regularizing the lawmaking procedure itself. In 2000, the Law on Legislation was adopted; this law established in statutory form a hierarchy of legal norms as well as certain procedures. At the level of the State Council, the Regulations on the Procedure for Formulating Administrative Regulations were adopted in 2001. Finally, Regulations on the Procedural for Formulating Departmental Regulations, covering regulations issued by ministries and commissions under the State Council, were adopted in 2001.

In December 2001, China finally entered the World Trade Organization. Although some analysts view WTO entry as a major driver of further economic and legal reform in China, it is perhaps better seen as a manifestation or effect of China’s ongoing economic and legal reforms. Virtually all of these reforms—for example, the opening of certain markets—would quite possibly have taken place even without WTO membership, because they represent not concessions to foreigners but policies viewed as sound in themselves. On the other hand, WTO requirements of market opening and non-discrimination have been useful for domestic reformers as an additional argument in favor of their agenda and certainly accession was a symbolically important event.<sup>16</sup>

WTO accession has also affected patterns of business organization and foreign investment, even though neither subject is covered *per se* by China’s commitments. Requirements for local

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<sup>16</sup> Ferrantino (2006: 11-12) provides a good account of the relationship between WTO accession and domestic legal and policy reform:

China’s lengthy and elaborate WTO accession process, extending from 1986 through 2001, encompasses a very substantial portion of the history of China’s economic reforms beginning in 1979. China’s case illustrates the point that substantial domestic policy change can take place without an external anchor. . . . Nonetheless, one can make a reasonable case that the trajectory of China’s reforms, in specific areas such as services and intellectual property as well as the massive unilateral tariff reduction undergone by China during the early 1990s (made even greater by special policies relating to FDI and economic zones), was conditioned by the external anchoring effect of repeated engagement with the WTO Working Party, including bilateral engagement with large members such as the United States, EU, and Japan. Indeed, WTO commitments have even been portrayed as a tool Beijing could use to obtain consistency and uniformity from increasingly independent provincial and local governments.

sourcing and export orientation applicable to WFOEs but not to joint ventures had to be dropped, with the result that WFOEs now dominate new foreign investment projects (OECD 2005: 85).

The current era saw another revision to the Constitution in March 2004 giving yet more ideological protection to markets: Article 11 was revised to include the term “non-publicly-owned economy” and to provide that this sector was not only permitted, but encouraged. Further rhetorical protection for private property was also provided. Nevertheless, further progress in the realm of legal acknowledgment and protection of private property rights has been slow. Constitutional provisions mean little in the Chinese legal system unless implemented through legislation.

A Rural Land Contracting Law was passed in August 2002. This law—long overdue in a realm that had previously been governed by policy pronouncements—is important both as a policy document and as an element of legal system reform. In terms of policy, it strengthened considerably the rights of farmers against ad hoc readjustments of their contracted land holdings by local officials. In terms of market-oriented legal system reform, its significance lies in furthering the commodification of rural land by making it easier for farmers to transfer their contract rights. While such contract rights were not, until the passage of the Property Law in March 2007, viewed by the legal system as unambiguous and robust real rights, and land use rights transferred by farmers must still be used for agricultural purposes, the law still increases the potential for circulation of land use rights in a way that will encourage their flow to the highest-value user.

Further progress in the commodification of urban industrial assets was achieved with the establishment in 2003 of the State Asset Supervision and Administration Commission (SASAC) and the adoption by the State Council in March 2003 of the Provisional Regulations on the Supervision and Administration of Enterprise State-Owned Assets. These regulations established rules about central and local SASACs and their responsibilities. As a policy matter, the establishment of SASAC was an important step because it represented the furthest step yet taken in bringing under a single administrative umbrella the state’s activities as enterprise owner (as opposed to economic regulator). At the central level, SASAC started out with control over 196 non-financial SOEs with almost 20,000 subsidiaries (OECD 2005: 106) although this number has since been modestly reduced.

Although the government has made it abundantly clear that it intends to stay in the business of enterprise ownership, and SASAC is unlikely ever to recommend its own abolition, the new structure makes it possible for the state to deal in a more flexible way with its ownership stakes in various enterprises. In particular, the establishment of SASAC and the system that it represents marks an increasing concern with the financial aspects of state ownership of enterprises, and not simply the control aspects.

In December 2003, the government made important progress in the realm of banking sector reform with the adoption of three laws (two of which were revisions of existing laws). The Banking Regulation Law established the China Bank Regulatory Commission (CBRC) as the regulator for all banking activities within China. Amendments to the Commercial Banking Law provided for a modest expansion of permitted activities and extensively revised the provisions on punishments for negligence or malfeasance by banks or their officers. Amendments to the Central Banking Law recast the role of the People’s Bank of China, following transfer of its regulatory

power to the CBRC, as that of “setting and implementing monetary policy, preventing and resolving financial risk, and maintaining financial stability.”

In the realm of commercial regulation, the Administrative Licensing Law was passed in August 2003. This law established the important principle that the licensing of business activities should be justified only by public necessity—in other words, the mere existence of a business activity is no longer sufficient justification for requiring it to be licensed. Some public benefit from a licensing scheme must be shown.

While this principle is unquestionably important, there does not yet exist any institutional method of realistically challenging local government determinations that a particular licensing scheme has a public benefit. Chinese courts, for example, possess neither the power nor the expertise—and probably not the will—to effectively challenge administrative agency determinations of public necessity. Furthermore, it is as a practical matter impossible for a central law to dictate in detail what sort of licensing requirements local governments may impose on local businesses; such matters by their nature can be worked out only at the local level. Thus, local government cannot really be much constrained by law in this area, and because local officials answer to their superiors, it is not significantly constrained by accountability to local citizens either. While the law may in some sense over time change the general culture of administrative licensing, its immediate effects are likely to be small.

Important legislative support for the private sector came in February 2005 with the State Council’s Guidelines on Encouraging and Supporting the Development of the Non-Public Sector Including Individual and Private Enterprises. This policy document provides greater market access to private companies in previously restricted industries, including public utilities, financial services, social services, and national defense. In addition—and very importantly—it requires authorities to give equal access in financing to private enterprises.

On the other hand, economic liberalization suffered an important symbolic setback in August 2005, when the progress of the draft Property Law (*Wuquan Fa*) toward enactment was derailed following the publication on the Internet of an open letter to the Standing Committee of the National People’s Congress by Prof. Gong Xiantian of the Beijing University Faculty of Law (Gong 2005). Prof. Gong denounced the draft as unconstitutional and contrary to principles of socialism. Nevertheless, despite continuing opposition and controversy, the Property Law was finally passed at the March 2007 session of the National People’s Congress (Kahn 2007).

At the same time that the debate over the draft Property Law was occurring, voices calling for more controls over foreign investment were also getting a sympathetic hearing (Dickie 2006),<sup>17</sup> and in August 2006 the Ministry of Commerce published rules governing foreign takeovers of Chinese companies that provide for extensive review powers in the interest of protecting “national economic security” (Dickie and Tucker 2006, Li 2006, Guo et al. 2006).

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<sup>17</sup> The objections have been phrased in terms of preventing foreign control of strategic industrial sectors and use the language of national security. Ironically, however, the particular acquisition that was a focus of controversy involved a proposed acquisition by Carlyle, an American firm, of Xugong, a Chinese manufacturer of construction equipment—hardly a sector many would view as strategically critical (Dyer et al. 2006).

Taken together, these developments hint that it is too early to assume that the path to further reform is clear and largely uncontested. Opposition to further reforms in the direction of markets and increased openings for the private sector may be more deep-rooted than hitherto supposed, and this opposition might be able to link up with the strain of economic nationalism demonstrated in the controversy over foreign acquisitions of Chinese firms. At the time of this writing, these developments are little more than straws in the wind. But they bear further watching.

#### 4 ASSESSING CHINA'S PROGRESS TO DATE

Notwithstanding the lack of definitive guidelines offered by empirical research, few would disagree that a modern market economy generally requires the provision of a certain set of functions, whether or not such functions are provided by legal institutions. This section will examine particular areas of economic regulation discussed in the chronology and evaluate where China stands.

##### 4.1 *Government Institutions*

A central bank is needed to regulate the money supply, and regulatory bodies in certain sectors—particularly the financial sector—are generally thought desirable (Stiglitz 1994). The regulatory model appropriate for a particular developing country may not, of course, be the same as that used in advanced economies, and the existence of market failure does not always point to a regulatory solution, if state regulation would just make the problem even worse (Komesar 1994, Posner 1998).

In addition, any legal system with enforceable rules for transactions between market participants is going to need an institution such as courts to decide when the power of the state should be used to enforce a solution to a dispute.

By and large, the necessary complement of government institutions now exists in China—or will, once the issue of a competition policy regulator is settled.<sup>18</sup> Establishing the institutions does not, of course, by itself solve any problems, and optimally designing the tasks of each with attention to changing circumstances will remain a challenge.

##### 4.2 *Rules for the Operation of Government Institutions*

If government institutions are to play their role properly, some set of operating procedures as well as associated institutions is useful. For courts, this means not only rules of civil procedure, but also rules about judges and internal court procedures. For other government institutions, it means what is commonly known as administrative law.

While such rules are useful, their specific content cannot be abstractly prescribed in great detail. A key issue in the operation of both courts and government agencies is how much discretion shall be allowed to judges and government officials. The best balance in each case will vary not only across countries, but also over time within the same country.

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<sup>18</sup> Bush (2007) provides a good description of the rivalry between various government departments; the issue remained unresolved even after the passage of the Antimonopoly Law at the end of August 2007.



As shown in the chronology, in the realm of administrative law, China has now done most of what can be accomplished by law. It has adopted a law on administrative litigation and on administrative licensing. The main missing piece in the edifice of administrative law is a law on administrative procedure that would govern the rulemaking process.

In the realm of court procedures, the basic structure such as a law on civil procedure and rules on evidence is also present as well. As suggested earlier, it would be a mistake to attempt to prescribe in the abstract a particular degree of judicial independence without consideration of China's particular circumstances. These circumstances include the educational level of judges, particularly at lower levels; the dependence of courts upon local governments for financing and enforcement of judgments; and the problem of corruption. Some problems might be solved, but others exacerbated, by increased independence. What is needed in this respect is a willingness to experiment with different solutions and attention to the results instead of a single-minded drive for more independence at all costs.

Despite these uncertainties, one reform that would enable the more effective implementation of almost any desired mix of independence and supervision is further progress toward a career judiciary along Continental or Japanese lines. At present, while judges can be promoted within a particular court, the system lacks any good way of systematically identifying talented judges in lower courts and promoting them to higher courts (or more prestigious or important courts at the same level) (Zhou and Tian 2004).

#### 4.3 *Definition of Property Rights*

Because a market economy is about exchange between freely contracting parties, there must be a set of rules or common understandings governing what can be owned and exchanged. These rules include provisions on property in general, real estate, securities, corporate mergers and acquisitions, and intellectual property.

At the level of ordinary commodities, there is little confusion about what can or cannot be owned, and similarly China's laws on intellectual property establish an adequate definitional framework. On the other hand, there is still work to be done on rights over urban and rural land and over ownership rights in "collectively-owned" enterprises. Although the long-awaited Property Law was passed in 2007 and has been hailed as a milestone in the definition and protection of property rights, in fact it does remarkably little to resolve many of the problem areas of Chinese property law. While implicitly recharacterizing rural land contracting rights as rights *in rem*, it does not significantly alter the rules applicable to their transfer. It does not change the system of long-term use rights in urban state-owned land, nor deal with the confusion caused by the recognition of ownership in buildings (along with a right of occupancy) separate from ownership of land.

#### 4.4 *Reduction of Barriers to Entry and Exit*

A key step governments can take to promote a market economy is to promote competition by eliminating unnecessary barriers to entry in various sectors of the economy. A major obstacle to market entry appears to be the requirement that a business license be obtained (OECD 2005: 90 et seq.). While the administrative licensing procedure is now governed to a certain extent by the Administrative Licensing Law, that law does not (and could not) dictate all the details of licensing procedures. Top-down supervision of the licensing activities of administrative agencies is unlikely

to be effective; potentially more effective is some form of bottom-up supervision, through the Administrative Litigation Law, the Administrative Reconsideration Law, or some other non-litigious method.

Significant obstacles to entrepreneurship also exist in the form of high initial capitalization requirements for companies. Until the 2005 revisions to the Company Law, a joint stock company (*gufen youxian gongsi*) (the form required when there are more than fifty shareholders) was required to have registered capital (an initial equity investment that cannot be withdrawn) of at least ten million *yuan* (five million *yuan* following the revisions).<sup>19</sup> Although the law's goal of striking a balance between the interests of creditors and the facilitation of business activity is unexceptionable, this particular obstacle could be removed without damage to the interests of creditors because they are not in fact significantly protected by initial capitalization requirements (Macey and Enriques 2001).

#### 4.5 *Institutions Enabling Market Actors to Structure Transactions as They Desire*

No government or international agency can foresee the various forms that socially beneficial transactions might take, and therefore contract law, while providing some necessary default rules, should give as much flexibility to the parties as possible. Contract law is different from many other areas of law in that it can assist cooperation and not just resolve conflicts. At the time of contracting, the parties have a common interest in maximizing the size of the pie; their conflict of interest is over how to divide it. In tort law, by contrast, the law's concern is generally with the division of an existing pie (Rubin 2004: 4). Thus, there is a strong argument in favor of minimizing state interference in contracting activities if the goal is economic growth.

China has of course already adopted a Contract Law, and the consensus of experts is that it by and large follows international practice. It is not clear, however, that it makes sense for China to have a uniform law of contract applicable to all parts of the country in all circumstances, when the level of development (and the competence of courts) varies so widely. Of course, no country's contract law can be perfect; there are always trade-offs to be made. But an important way of minimizing problems in any system of contract law and enforcement is to encourage, or at least not restrict, the growth of non-legal institutions that promote the same beneficial exchanges contract law does by providing information and facilitating the free flow of capital, goods, and services.

As suggested in Section 2, such institutions can be established by government, and indeed government action may be helpful in overcoming certain market failures.<sup>20</sup> Governments generally should not, however, block the establishment of competing institutions by non-state actors. Important information, for example, can be provided by accountants and other gatekeepers; credit

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<sup>19</sup> At the exchange rate prevailing during the twelve years the provision was in effect, 10 million *yuan* amounted to about \$1.28 million. During this period, the minimum capitalization required for companies of this kind in the OECD countries was far less: about \$42,000 in Germany, and in Delaware, of course, nothing at all. About one third of OECD countries have no minimum capitalization requirements (OECD 2005: 91).

<sup>20</sup> On the potential for helpful government action in credit reporting, for example, see Messick (1999: 21) and the sources cited therein.

bureaus tell potential lenders about the reputation of borrowers; and media organizations can provide various kinds of useful information.

At present, the information industry in China is subject to considerable barriers to entry and restrictions on operations. The government has stopped, for example, issuing permits for new periodicals (i.e., periodical numbers) and a trade has thus sprung up in existing numbers. The limitation of supply, of course, raises costs. The courts have also tended to apply defamation law in a way unfriendly to the free flow of information. *Caijing*, a well known business journal, lost a libel suit after questioning a firm's accounting practices (Liebman 2006: 69), and a journalism professor recently won a case against a web site that published a blogger's unflattering opinion of him (Associated Press 2006).

The picture is not completely bleak—in a recent libel case based on unfavorable press coverage, the court found that journalists should be immune from suit if their reporting is backed by a source that is reasonable and credible and not based simply on rumors.<sup>21</sup> Nevertheless, while each country may make a different trade-off between the value of freely flowing information and the value of protecting reputation and dignity, courts and commentators in China continue to pay inadequate attention to the costs of a system that protects plaintiffs from the publication even of unflattering opinions (e.g., Xinhuanet 2006).

#### 4.6 *Institutions Imposing Standards on the Market in the Public Interest*

Not all market transactions serve the public interest. For example, agreements between producers not to compete are market transactions, but are prohibited in many jurisdictions. Or transaction costs may prohibit an orderly and value-maximizing liquidation procedure for insolvent enterprises that gives full respect to creditors' rights; in such a case, bankruptcy law can play an important role in reallocating assets with minimal waste (Jackson 1986).

As in many realms of market regulation, state prohibitions have a mix of costs and benefits that are unique to each country. Nevertheless, some clarity in the rules as well as adaptability to new circumstances would seem to have only benefits.

In this realm, there is still a substantial amount of work to be done in lawmaking in China. In the realm of competition policy, several drafts of an Antimonopoly Law were circulated, and a final law ultimately promulgated on August 30, 2007. There was considerable disagreement—still unresolved in the law—about how the competition policy regulator should be constituted. There were disagreements in the realm of substantive policy as well. It may be that the law tries to do too much, and should instead start with basic problems such as collusion to fix prices before attempting to regulate more complex (and from a welfare standpoint more ambiguous) arrangements such as vertical restraints or price discrimination (Kovacic 2002). And the law retains provisions criticized in previous drafts by commentators for straying from a focus on competition and attempting to

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<sup>21</sup> The case in question pitted the Guangzhou Huaqiao Real Estate Development Company against the journal *China Reform*. 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>.

ensure “fair” prices (including prices that are not “too low”) and to achieve other social objectives that might be better accomplished through separate legislation (ABA 2003, ABA 2005).

While state policymakers naturally tend to think of lawmaking as a solution to problems, in fact many pro-competition objectives can be achieved without antimonopoly regulation and an enforcement bureaucracy at all. As discussed in Sections 4.4 and 4.5, trade liberalization measures such as reducing barriers to domestic entry and to imported goods and services, as well as enhancing the flow of information, will generally be far more effective than legal regulation through prohibitions and penalties.

Bankruptcy law was until recently mired in controversy, although in serious need of updating. A minimal set of rules was in place for several years: the Enterprise Bankruptcy Law, adopted in late 1986 and effective in 1988, covered state-owned enterprises, and a chapter of the Civil Procedure Law covered other legal persons. However, such laws did not appear to govern actual bankruptcies, which were governed far more by state policy than by legal rules.<sup>22</sup> In August 2006, a substantially revised Enterprise Bankruptcy Law was finally adopted by the NPC’s Standing Committee, to come into effect on January 1, 2007. Somewhat surprisingly, the final version of the law—contrary to provisions in preceding drafts—reaffirmed the principle of priority for secured creditors over claims for unpaid wages. Although this principle was also explicit in previously applicable NPC legislation, it had been seriously compromised through a series of State Council directives providing otherwise.<sup>23</sup> It is still too soon to know whether the new law will, like its predecessor, be overridden in practice by administrative directives and political imperatives.

Another type of mandatory law in the public interest is tort law. Although there are some very general provisions about tort liability in the 1986 General Principles of Civil Law as well as in scattered administrative regulations on various subjects such as automobile accidents, China has yet to provide this subject with a uniform legislative treatment.<sup>24</sup> Many modern societies with market economies, of course, have managed quite well without a unified statute on torts and arguably without great consistency in case law. And there does not appear to be evidence that China’s lack of a comprehensive statute on torts is holding back its development in any significant way. Thus, this must be considered one of the less urgent issues of legal system reform.

Two more types of mandatory regulation that should be discussed are the regulation of securities and organizational laws for business. Securities regulation could be handled entirely as a matter of contract between the seller of securities and the buyer, but no modern economy has taken this route. It is likely that securities regulation of various kinds can provide certain benefits that

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<sup>22</sup> In 1994 and 1997, the State Council issued two Notices, the collective effect of which was to override certain priorities and rights provided in the Bankruptcy Law and the Security Law. For a discussion of the issues presented by such a conflict, see Clarke (1997).

<sup>23</sup> In 1994 and 1997, the State Council issued two Notices, the collective effect of which was to override certain priorities and rights provided in the Bankruptcy Law and the Security Law. Although formally subordinate to NPC legislation, State Council directives will in practice override it in case of conflict. For a discussion of these issues, see Clarke (1997).

<sup>24</sup> For a translation of and commentary on a proposed tort code, see Conk (2007).

market actors dealing with each other solely on the basis of contract principles would be unable to achieve. For example, companies are free to disclose information about themselves, and might find it beneficial to do so, even in the absence of mandatory disclosure requirements. But the level of disclosure might from a social standpoint be suboptimal.

Similarly, empirical evidence suggests that the *enforcement* (not merely the existence) of laws against insider trading measurably reduces the cost of capital to corporations (Battacharya and Daouk 2002). A corporation could forbid its insiders from insider trading and enforce the prohibition as part of its employment contract, but a general state-enforced prohibition is likely more effective—state resources can go into detection and prosecution—and will relieve investors of the cost of distinguishing the various degrees to which different companies forbid insider trading.

For these reasons, China's Securities Law can be considered a useful framework for the regulation of securities. This report is not the place to discuss its virtues and shortcomings in detail. The main point to be made here is that China's securities regulatory regime is still heavily oriented to serving the interests of state-owned enterprises that convert to joint stock companies and list securities on one of China's two stock exchanges (Heilman 2002). Thus, an important even if unstated part of the mission of the China Securities Regulatory Commission is to keep stock prices up, and not simply to ensure the fair, orderly, and transparent operation of securities markets. But the former goal may conflict with the latter. While China need not import wholesale any country's model of securities regulation, its own model should indeed be about securities regulation, and not the quite different goal of facilitating the reform of state-owned enterprises. The institutions and policies that might serve the former goal well—for example, a relatively independent administrative agency, an emphasis on disclosure as opposed to substantive regulation, or decentralized enforcement through citizen lawsuits—might be quite unsuited to the latter goal.

Corporate law is also about more than simply voluntary associations among individuals; without state law, it would be impossible for the institution of limited liability to function as it does (Hansmann and Kraakman 2000). Moreover, law for business organizations—whether corporations, partnerships, or some other form—can reduce the transaction costs of organizing by providing a set of default rules of governance.

While China's Company Law provides limited liability to properly organized companies, China's legislation on business organizations generally—including laws on partnerships and other business forms—does less well in providing a low-cost vehicle for the conduct of business. As noted in Section 4.4, barriers to corporate formation are unnecessarily high. Creditors are protected by a business's current net assets and future success, not by the amount of cash originally invested. The August 2006 revisions to the Partnership Law, by providing for limited partnerships, do add to the menu of business vehicles and thus constitute progress from this perspective. But the general requirement of a formal written partnership agreement not only deprives many existing business arrangements of the benefit of the law's default rules, but also ironically fails to protect creditors as fully as a more informal requirement would. Only if a partnership exists can one person be deemed a partner and found liable for the debts of another; without a partnership, creditors of one person cannot look to the assets of anyone else.

## 5 KEY REMAINING OBSTACLES AND CHALLENGES

Section 4 has examined some specific areas of law and legal institutions. This section will summarize some of the key issues that bear on virtually all areas of law as it relates to the market economy.

### 5.1 *The Limitations of Top-Down Reform*

A useful way of thinking about government's involvement in economic development is via the models of state-driven development and market-driven development.<sup>25</sup> In the model of state-driven development, the state plays a leading role in law reform. It attempts to enact comprehensive laws, often with the advice of foreign experts. In the model of market-driven development, the state establishes the initial conditions necessary to promote the development of the market economy—for example, recognizing private property rights and liberalizing trade—but looks largely to non-governmental actors to devise specific legal principles and institutions that will serve the market. This model does not require state efforts to construct a comprehensive legal frameworks at the beginning of the reform process and stresses gradual, piecemeal approval by courts and legislatures of privately created norms (Kovacic 2002). Moreover, it is not law-centered. If legal institutions can perform some function more efficiently than non-legal institutions, then they may do so, but there is no inherent bias in favor of or against them.

Neither model in its extreme form is appropriate for China or any other country. At the same time, however, it must be recognized that in China the model of market-driven development has not been attempted at all. In both models, the goal is to serve the needs of the market economy. In the model of state-driven development, that is the whole point of seeking advice on lawmaking, and the Chinese government deserves credit for its willingness to listen to such advice. But as Alford (2000) points out,

[W]e need to inquire as to the extent to which one reasonably can expect that heavily top-down development will generate a legal framework sufficiently reflective of and responsive to the needs of merchants and the citizenry more generally. For some years now, multilateral financial institutions, multinational corporations, and developmental economists have tended to urge states with appreciably more liberal economies than China's to temper their inclinations to rely on a centralized direction of development in order that they might better accommodate the interests and initiative of merchants and others in civil society. . . . And yet, when it comes to China, whose leaders, however savvy, have had no direct experience working in a market economy and whose civil society continues to have very considerable difficulty either in influencing the direction of public policy or asserting its own independence from the state, the international development community seems to have a pervasive faith in the willingness and capacity of Chinese political and bureaucratic authorities to act in a more disinterested manner to advance the values of the market than economic analysis typically assumes is the case for their counterparts in more liberal societies.

China has so far followed the model of state-driven development almost exclusively. This model has by no means been a failure, in that it does not seem to have stifled growth significantly. But neither can it be conclusively be called a success, since the degree to which the laws passed and

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25. These models are based on Cooter's (1997) models of political modernization and market modernization. The former term does not mean modernization of the political system.

legal institutions established really mattered for China's development has not been demonstrated. The key challenge ahead for China is not simply to decide what laws are missing and to put them in place, but to establish a set of institutions—or more precisely, to *enable* the establishment of a set of institutions by state or non-state actors—that will be able to respond flexibly to the needs of the market economy. Many of these institutions almost by definition cannot be created by the state; they should be enabled and permitted, but not forced into existence.

## 5.2 *The Need for Flexible Institutions*

What concrete steps must China take? It is easy to say in the abstract that the system as a whole should allow for the flexible creation, adaptation, and elimination of institutions according to social and economic needs as determined through a bottom-up, not top-down approach. This section aims to provide some concrete examples relevant to China.

First, institutions that collect and disseminate information contribute to flexibility and adaptability in other institutions, since once cannot adjust to a change one cannot even observe. The unrestricted flow of information has costs—for example, privacy may be compromised. But the suppression of information also has costs. It is important in policymaking to recognize the costs as well as the benefits of restrictions on information. Thus (for example) the current rule of Article 113 of the Securities Law prohibiting all but the stock exchanges from circulating real-time price quotations does not seem to serve any purpose other than giving state protection to the exchanges' information monopoly. But no clear social interest is advanced by that monopoly. Whether institutions are being created from the top down or from the bottom up, in general they will function better if the supply of information is better. A policy of furthering information flow is consistent with either approach.

Second, Chinese legislators, legal officials, and academics need to be more willing to take local conditions into account. While government officials frequently speak of this need in many contexts, in the realm of lawmaking and legal institutions one often encounters an unwillingness to move beyond existing models. For example, it is sometimes said that Chinese courts cannot adopt a system of precedent because China's legal system is a civil law system. Not only does this view misunderstand the actual role of case law in European civil law systems, but it confuses means and ends. The purpose of China's legal system is to serve China's needs. A system of precedent may or may not function well in China, given its other institutions, but the question cannot be settled by reference to the abstract principles of a foreign model. China can have any legal system it wants; legal reforms in continental Europe or the United States are not discussed in terms of whether or not they conform to the civil law or the common law model, and there is no reason for Chinese policymakers to think about legal reforms in such terms, either.

Third, more flexibility in lawmaking would be helpful. At present, there are few if any good ways of discovering and rectifying problems in legislation. Courts in the course of their daily adjudication may discover conflicts between higher and lower norms, but are not permitted to address such conflicts openly and to apply the principles of the Constitution and the Law on Legislation.<sup>26</sup> Instead, such conflicts may as a formal matter be resolved only by a superior

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<sup>26</sup> See, for example, the Luoyang Seed Law case discussed in Clarke et al. (2006).

administrative or legislative body such as the National People's Congress Standing Committee. Yet in practice this kind of work simply does not get done. Moreover, legislation once passed is considered to have a kind of dignity that would make immediate amendment inappropriate, even if the problem is obvious. The result is that inappropriate and inefficient rules are not weeded out of the system. But because they are widely recognized as such, actors within the legal system tend simply to ignore them as meaningless.<sup>27</sup>

Although this kind of disobedience by consensus may help the system move forward despite its inefficiencies, it severely hampers the creation of a culture of legality. Thus, a high priority for the state should be the establishment of a system for effectively identifying and changing inappropriate rules within the legal system.

Fourth, greater scope should be allowed for contractually-agreed dispute settlement procedures between businesses and individuals. At present, dispute settlement is essentially monopolized by the state. Parties must use either courts or state-approved arbitration bodies; ad hoc arbitration bodies have no legal standing and their awards are not enforceable in courts.<sup>28</sup> But government and quasi-government institutions may not be the best fora for dispute settlement; indeed, the number of first-instance civil cases declined from 1999 to 2004, a trend Liebman (2007) plausibly attributes to the public's lack of confidence in courts and not to an increase in social harmony.

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<sup>27</sup> By way of example, Article 4 of the original Company Law stated that "ownership of state-owned assets in a company shall vest in the state." This provision is either tautological ("the state owns assets that the state owns") or inconsistent with the entire legal structure of a company, in which the company owns corporate assets and the shareholder owns an equity interest in the company, but does not directly own the assets used in production. It was ignored and never had any legal significance.

Two other examples are legislation by the Beijing municipal government permitting limited partnerships at a time when the national Partnership Law plainly stipulated that all partners had to be liable for the debts of the partnership—indeed, a proposal to allow limited partnerships was considered and rejected in the drafting process—and the decision of the Beijing Administration of Industry and Commerce to allow individual Chinese citizens to be the Chinese party to an equity joint venture with a foreign party, although the Law on Equity Joint Ventures explicitly forbids it.

Even the constitution, it is argued, can be ignored when its provisions are inappropriate. According to the theory of "benign violations of the constitution" (*liangxing weixian*), given the persistent and inevitable tensions between the rules of the constitution and the great changes taking place in China, certain constitutional violations should be countenanced where certain conditions are present: it promotes the development of the productive forces, or it is in the basic interests of the state and the people (Hao 1996). But who shall have the power to decide when these conditions are present? Taken seriously, this theory means reducing the entire constitution to two principles that can be stated in a single sentence—promote the development of productive forces and serve the basic interests of the state—with everything else handled by statute.

28. Article 14 of the Civil Procedure Law states that courts may enforce awards made by arbitration bodies established "according to law." Article 10 of the Arbitration Law requires in effect that arbitration bodies be state-certified.



If there is indeed a demand for non-court, and by extension non-state, dispute resolution institutions, is it sound policy to satisfy it? Given that the Chinese state (like other states) does not allow complete freedom of contract, it could be argued that state control over dispute resolution is necessary in order to ensure enforcement of substantive state contract norms. Otherwise, parties not allowed to agree on (for example) a wage below a state-mandated minimum could simply agree to a dispute resolution procedure that would not enforce the state prohibition. At the same time, however, there are probably many instances where there is no such policy cost to allowing market actors to decide for themselves—provided they agree—on the best way to resolve their disputes. If the state-sponsored institutions are the best venue, they will certainly be used; if they are not the best venue, it does not serve the market economy to force them to be used and to prohibit competition.

## 6 CONCLUSION

China has come an extraordinary distance—further than anyone could have foreseen—since the beginning of economic reform in the late 1970s. Its legislative and administrative bodies have shown remarkable diligence and energy in formulating and adopting rules on a wide variety of subjects, many technically complex. But precisely because of the vast amount of work that has already been done, the returns to yet more work of the same type—consulting with experts and enacting comprehensive statutes—are much less than they were. Many laws and institutions are now in place; what the state must do is to adopt “policies that will allow the law to evolve efficiently. In this scheme, no one need decide *ex ante* what the outcome of the process will be.” (Rubin 1994: 2) Of course, decisions about the content of state-enacted norms will still have to be made. But such decisions must be informed by an understanding of their effect in China, given local conditions, and not whether they represent international best practices. At the same time, space must be given to non-state institutions to develop in response to market demand.

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