Legislating for a Market Economy in China

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ABSTRACT Since the early 1990s, China has come a long way in legislating the foundational rules for its reformed economy. Virtually all of the important areas – contracts, business organizations, securities, bankruptcy and secured transactions, to name a few – are now covered by national legislation as well as lower-level regulations. Yet an important feature of a legal structure suited to a market economy is missing: the ability of the system to generate from below solutions to problems not adequately dealt with by existing legislation. The top-down model that has dominated Chinese law reform efforts to date can only do so much. What is needed now is a more welcoming attitude to market-generated solutions to the gaps and other problems that will invariably exist in legislation. The state's distrust of civil-society institutions and other bottom-up initiatives suggests, however, that this different approach will not come easily.

This article aims to provide a review and assessment of developments since the early 1990s in the realm of legal regulation of economic activity in China. This regulation has two aspects: first, the substantive content of the rules themselves (for example, norms that discourage monopoly and promote competition), and second, the institutions, both legal and non-legal, that make state rulemaking effective or obviate the need for it through alternative mechanisms. The main thesis of this article is that in the era under review, China has accomplished far more by way of rulemaking than it has by way of institution-building.

In assessing developments in any realm of activity, one must have a standard against which to measure those developments. One cannot speak of incompleteness or gaps without having a picture of completeness or gaplessness, but where does the picture come from? When economic reform began, it is unlikely that Deng Xiaoping or anyone else in the Chinese leadership imagined what China some three decades later would look like; it is not plausible to posit today's China as a goal of economic reform from the very beginning.

Yet it seems that certain goals have developed in the course of economic reform itself. While it would be difficult at present to identify a single goal for economic and institutional reform held by virtually all China's leaders, it is probably safe to say that most would support further marketization of the economy and greater scope for China's private sector, at least to the extent that it did not affect the Party's political monopoly. Thus, this article will look at developments in the legal regulation of economic activity primarily through that

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lens: how they have promoted or obstructed the further development of China's market economy and opened up space for its private sector. It will also assess China's approach generally to promotion of the market economy through legal institution-building. The focus will be on developments since 1992, because that year marked the end of the post-June 4th retrenchment and the beginning of a new period of economic reform that is still with us.

A useful way of thinking about government's involvement in economic development is via the models of state-driven and market-driven development.[1] In 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 market-driven development, the state establishes the initial conditions necessary to promote the development of the market economy – such as 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 framework at the beginning of the reform process, and stresses gradual, piecemeal approval by courts and legislatures of privately created norms.[2] Moreover, it is not law-centred. 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 favour of or against them. In the concluding section of this article, I will argue that China's path so far has been almost exclusively that of the model of state-driven development, and that more balance is desirable.

Finally, it must be noted that there are perspectives other than that of market economy development from which one could assess changes in the economic legal regime in the era under examination. From the perspective of market economy development, I conclude that while a few gaps remain, and complaints could be made about specific provisions in various statutes and regulations, the work of foundational legislating is almost complete (certainly more so than the work of institution-building). Ironically, however, the growth of the market economy has exposed a number of gaps in other areas of the legal system, such as labour and environmental protection and the social safety net. These gaps mattered little in the pre-reform era because they could be addressed, at least in theory, through bureaucratic directives internal to the state-owned economy without the need for a legal system external to the actors. Market-oriented reform has arguably heightened the need for regulation at the same time that it has made regulation by traditional methods ineffective.

1 These models are based on Cooter's models of political modernization and market modernization. The former term does not mean modernization of the political system. See Robert D. Cooter, "Market modernization of law: economic development through decentralized law," in Jagdeep S. Bhandari and Alan O. Sykes (eds.), *Economic Dimensions in International Law: Comparative and Empirical Perspectives* (Cambridge: Cambridge University Press, 1997), pp. 275–316.

2 See William E. Kovacic, "Institutional foundations for economic legal reform in transition economies: the case of competition policy and antitrust enforcement," *Chicago-Kent Law Review*, Vol. 77, No. 1 (2001), p. 265.

Chronology

1978–1992

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 programme 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 was adopted in December 1984 that 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" – that is, economic activities by self-employed individual entrepreneurs with fewer than eight employees – was called a "supplement" (补充 *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.[3]

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 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.

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, with a rise in the number of privately run and "red hat" enterprises.[4] 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* 私营) economy.

3 A great deal of controversy was caused by the 2007 Property Law's giving of equal status to public and private property.

4 Barbara Krug and Hans Hendrischke, "Entrepreneurship in China: institutions, organisational identity and survival. Empirical results from two provinces," *Erasmus Research Institute of Management Report Series*, Reference No. ERS-2002-14-ORG (January 2002), available on http://ssrn.com/abstract=370955.

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, which covered contracts between Chinese entities and foreign parties. The following year saw the adoption of the Law on Wholly Foreign-Owned Enterprises, 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 basic legal landscape for foreign-invested enterprises was completed with the adoption of the Law on Sino-Foreign Co-operative Joint Ventures, which allowed for a joint venture with more flexible features than were allowed under the Law on Sino-Foreign Equity Joint Ventures.

In the realm of domestic enterprise law, in December 1986 China adopted the Enterprise Bankruptcy Law (effective in 1988). Despite its name, this is less a law about bankruptcy than a statement of policy about closing down SOEs in certain circumstances. Its main purpose, 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 closure. After many years of controversy and false starts, this law was substantially revised in August 2006; the revisions are discussed further below.

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.

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 with eight or more employees. However, only a limited class of persons is eligible to form such enterprises, such as farmers, the urban unemployed and the retired. Over the years, local implementing regulations have for all practical purposes largely abolished these limitations. 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 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 the 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 commoditization 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.

The third stage of economic reform, from 1989 to 1992, is in fact more a period of post-June 4th retrenchment. This stage 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 1990, for example, the Provisional Regulations on the Grant and Transfer of Use Rights in Urban Land provided the statutory framework for the commoditization 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.

1992 to the present

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 have been fully embraced once more, and China has taken major steps to create an economic and legal system that fully and explicitly embraces the private sector as an important component of the economy. The system envisages a rules-based market operating through the institutionalization of property rights, and this period has seen the rapid development of private firms and the building of market institutions and associated laws. The tenor of the period is 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 "the state practises the socialist market economy." Articles 16 and 17 were also amended to eliminate the duty of SOEs and collective enterprises to fulfil 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 other 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 towards 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 era has been distinctive in that it has seen the construction of the legal infrastructure of a rules-based market system in which distinctions between 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. This document was in effect half of China's first post-1949 general company law, and provided an organizational vehicle for enterprises – SCRES had state-owned enterprises in mind – that wished to restructure and list shares on the stock exchanges. 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 and a necessary complement to the Normative 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* 股份有限公司), intended for large pools of assets with liquid and tradable equity interests, and the limited liability company (*youxian zeren gongsi* 有限责任公司), intended for smaller entities in which the investors could be more like partners than 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. Among other things, 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.

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,[5] and partnerships were taxed like corporations until 2000.[6] 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.[7]

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 and, in certain sectors, something akin to a limited liability partnership.[8] In short, the new law is clearly an attempt to foster business activity through providing a larger menu of organizational forms.[9]

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 original Partnership Law, it seems designed to regulate more 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. China adopted a Law on Trusts in April 2001; 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

5 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 Shaoping, "Tan hehuo qiye fa xiugai" ("A discussion of the revision of the Partnership Law"), *Zhongguo renda wang* (*China National People's Congress Net*), 26 April 2006, available on http://www.npc.gov.cn/zgrdw/common/zw.jsp?label=WXZLK&id=348775&pdmc=1131; see also Wang Xiang, "Hehuo qiye fa xiugai qingkuang jieshao" ("An introduction to the circumstances of the revision of the Partnership Law"), *Zhongguo renda wang* (*China National People's Congress Net*), 29 August 2006, available on http://www.npc.gov.cn/cwh/common/zw.jsp?label=WXZLK&id=352015&pdmc=hyjc?=undefined.

6 State Council, "Guanyu geren duzi qiye he hehuo qiye zhengshou suodeshui wenti de tongzhi" ("Notice on the question of levying income tax on sole proprietorship enterprises and partnership enterprises"), 20 June 2000, available on http://www.law-lib.com/law/law_view.asp?id=72144. 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.

7 Zhu Shaoping, "Revision of the Partnership Law."

8 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. A limited liability partnership is internally like an ordinary partnership, but the partners are not liable for the debts of the partnership.

9 Wang Xiang, "Circumstances of the revision of the partnership law."

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 March 1999, Chinese contract law was finally unified with the adoption of the Contract Law. This 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 critical to the smooth functioning of a market economy, since it establishes the rules without which payment systems such as cheques 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 cheques, 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 cheques to its member banks. Because no bank performs this function in China, cheques 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 and 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.

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, that is, 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 anti-monopoly law might be said to do), but to ensure that prices are neither too high nor too low.

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 tradable 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 anti-dumping and countervailing duties, but with no details as to procedure. Regulations on anti-dumping 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, among them the 2000 Law on Legislation. This established in statutory form a hierarchy of legal norms as well as certain procedures.

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 has not been the occasion for major policy changes and is perhaps better seen as a manifestation or effect of China's ongoing economic and legal reforms. WTO accession has affected patterns of business organization and foreign investment, even though neither is covered *per se* by China's commitments. Requirements for local sourcing and export orientation applicable to wholly foreign-owned enterprises but not to joint ventures had to be dropped, with the result that wholly foreign-owned enterprises now dominate new foreign investment projects.[10]

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, progress in the realm of legal acknowledgment and protection of private property rights has been slow. Constitutional provisions by themselves mean little in the Chinese legal system; they are not directly enforceable against the government and are implemented, if at all, only 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 commoditization 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 increased the potential for circulation of land use rights in a way that encourages their flow to the highest-value user.

Further progress in the commoditization of urban industrial assets was achieved with the establishment in 2003 of the State Asset Supervision and Administration Commission and the adoption by the State Council in March

10 See Organization for Economic Co-operation and Development, *OECD Economic Surveys: China*, Vol. 2005, No. 13 (Paris: OECD Publishing, 2005), p. 85.

2003 of the Provisional Regulations on the Supervision and Administration of Enterprise State-Owned Assets. As a policy matter, the establishment of the Commission was important 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).

In December 2003, the government made important progress in the realm of banking sector reform. First, the Banking Regulation Law established the China Bank Regulatory Commission as the regulator for all banking activities within China. Second, amendments to the Central Banking Law recast the role of the People's Bank of China, following transfer of its regulatory power to the China Bank Regulatory Commission, 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. There does not yet exist, however, any institutional method of realistically challenging local government determinations that a particular licensing scheme has a public benefit. While the law may over time change the general culture of administrative licensing, then, 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 defence. 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* 物权法) towards enactment was derailed following the publication on the internet of an open letter to the Standing Committee of the National People's Congress by Gong Xiantian (巩献田) of the Beijing University Faculty of Law.[11] Professor 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.[12]

11 See Gong Xiantian, "Yibu weibei xianfa de 'wuquan fa (caoan)': wei 'xianfa' di 12 tiao he 86 nian 'minfa tongze' di 73 tiao de feichu xie de gongkai xin" ("A draft Property Law that violates the Constitution: open letter written upon the abolition of Article 12 of the Constitution and Article 73 of the 1986 General Principles of Civil Law"), 12 August 2005, available on http://www.chinaelections.org/NewsInfo.asp?NewsID=45986.

12 Joseph Kahn, "China approves property law, strengthening its middle class," *New York Times*, 16 March 2007, available on http://www.nytimes.com.

At the same time as the debate over the draft Property Law, voices calling for more controls over foreign investment were also getting a sympathetic hearing,[13] 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."[14]

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.

Assessment of Recent Developments

The relationship between legal institutions and economic development

Much of China's work in the establishment of laws and legal institutions related to the economy has doubtless been intended to promote economic growth. Although it has long been posited – since at least the time of Weber – that the right legal institutions promote growth,[15] it has proven surprisingly difficult to demonstrate a causal relationship through empirical research or to shed light on the specific details of what is required.[16]

The relationship between law and economic development is, to say the least, not simple, as the growth of China and other countries that typically score (or in

13 Mure Dickie, "China calls to restrict foreign takeovers," *Financial Times*, 3 August 2006, available on http://www.ft.com. 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 case 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. Geoff Dyer, Sundeep Tucker, and Tom Mitchell, "Foreign deals in China hit new resistance," *Financial Times*, 7 August 2006, available on http://www.ft.com.

14 Mure Dickie and Sundeep Tucker, "Beijing seeks to clarify foreign takeover rules," *Financial Times*, 11 August 2006, available on http://www.ft.com; Li Xiran, "New rule curbs mergers by foreign firms," *Shanghai Daily*, 10 August 2006, available on http://www.shanghaidaily.com/art/2006/08/10/288748/New_rule_curbs_mergers_by_foreign_firms.htm; Guo Qiong, Hu Wang, He Huafeng and Ning Yu, "Waizi bingguo xin gui chongjibo" ("The shock wave of the new rules on acquisitions by foreign investors"), *Caijing zazhi* (*Finance and Economy*), No. 16 (7 August 2006), pp. 80–82.

15 The literature is too vast to be fully cited here. See, among others, Max Rheinstein (ed.), *Max Weber on Law in Economy and Society* (Cambridge, MA: Harvard University Press, 1954), and Douglass C. North, *Institutions, Institutional Change and Economic Performance* (New York: Cambridge University Press, 1990).

16 For good reviews of the literature and the evidence, see Kevin E. Davis and Michael J. Trebilcock, "Legal reforms and development," *Third World Quarterly*, Vol. 22, No. 1 (2001), pp. 21–36; Tom Ginsburg, "Does law matter for economic development? Evidence from East Asia," *Law and Society Review*, Vol. 34, No. 3 (2000), pp. 829–56; and Richard E. Messick, "Judicial reform and economic development: a survey of the issues," *The World Bank Research Observer*, Vol. 14, No. 1 (1999), pp. 117–36.

the past scored) low on various rule-of-law indices demonstrates.[17] 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 go a long way towards making up for the lack of a well-functioning legal system.[18]

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.[19] Social networks cost resources to establish, and the trusted middlemen who facilitate transactions don't work for free.

A practical problem for legal system reformers is that while it is plausible that legal institutions matter, it is not clear what their exact shape should be. For example, arbitrariness is bad, but it is simply the other side of the coin of discretion and flexibility, which are often 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.[20] 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.

Given the variety of local circumstances and institutions, while policy makers 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.[21]

Thus, while we can of course assess China's current economic legislation and institution-building in terms of their current regulatory content, we should also contemplate whether China is creating an environment that will allow new institutions to arise and existing institutions to adapt or disappear.

17 See, for example, Table 1 in Hiroshi Matsuo, "The rule of law and economic development: a cause or a result?" 2003, available on http://cale.nomolog.nagoya-u.ac.jp/en/files/matsuo/en. Consider also the cases of Japan, South Korea and Taiwan; see Curtis J. Milhaupt, "Law, judicial systems, and economic growth: notes on the uneasy case of Japan," 2000, available on http://www.worldbank.org/wdr/2001/wkshppapers/summer/milhaupt.pdf; John K. Ohnesorge, "Developing development theory: law & development orthodoxies and northeast Asian experience," *University of Wisconsin Law School Legal Studies Research Paper Series*, Paper No. 1024 (2006), available on http://ssrn.com/abstract=916781.

18 See, for example, John McMillan and Christopher Woodruff, "Dispute prevention without courts in Vietnam," *Journal of Law, Economics, and Organization*, Vol. 15, No. 3 (1999), p. 637.

19 John McMillan and Christopher Woodruff, "The central role of entrepreneurs in transition economies," *Journal of Economic Perspectives*, Vol. 16, No. 3 (2002), pp. 153–70.

20 Zhang Xiaobo, "Asymmetric property rights in China's economic growth," *DSGD Discussion Paper No. 28* (Washington, DC: International Food Policy Research Institute, 2006), available on http://ssrn.com/abstract-882446; Matthew Stephenson, "Economic development and the quality of legal institutions," *The World Bank Online*, 2001, available on www1.worldbank.org/publicsector/legal/institutional.htm; Mancur Olsen, *The Rise and Decline of Nations: Economic Growth, Stagflation, and Social Rigidities* (New Haven: Yale University Press, 1982).

21 Lewis S. Davis, "Institutional flexibility and economic growth," 5 December 2005, available on http://ssrn.com/abstract=871759.

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. The sections below examine particular areas of economic regulation discussed in the chronology and evaluate where China stands.

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; the long-awaited Property Law did little to clarify such rights.

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. Significant obstacles to entrepreneurship exist in the form of business licence requirements and high initial capitalization requirements for companies.[22] Until the 2005 revisions to the Company Law, a joint stock company (*gufen youxian gongsi* 股份有限公司) (the form required when there are more than 50 shareholders) was required to have an initial non-withdrawable investment of at least ten million yuan (five million yuan following the revisions).[23] 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.[24]

Institutions enabling market actors to structure transactions as they desire

No government can foresee the various forms that socially beneficial transactions might take, and therefore contract law, while providing some

22 *OECD Economic Surveys: China*, pp. 90 ff.

23 At the exchange rate prevailing during the 12 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. *Ibid*. p. 91.

24 Jonathan R. Macey and Luca Enriques, "Creditors versus capital formation: the case against the European legal capital rules," *Cornell Law Review*, Vol. 86, No. 6 (2001).

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 co-operation 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 property and tort law, by contrast, the law's concern at any given moment is with the division of an existing pie.[25] Thus there is a strong argument in favour of minimizing state interference in contracting activities if the goal is economic growth.

China's current Contract Law achieves a reasonable balance between flexibility and predictability. 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.

Such institutions can be established by government, and indeed government action may be helpful in overcoming certain market failures.[26] But there is no good economic reason for governments at the same time to block the establishment of competing institutions by non-state actors. Important information, for example, can be provided by accountants and other gate-keepers; credit 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 (that is, 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* (财经), a well-known business journal, lost a libel suit after questioning a firm's accounting practices,[27] and a journalism professor recently won a case against a website that published a blogger's unflattering opinion of him.[28]

The picture is not completely bleak: in a recent libel case based on unfavourable 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

25 Paul H. Rubin, "Growing a legal system in the post-communist economies," *Cornell International Law Journal*, Vol. 27, No. 1 (1994), p. 4. I am grateful to an anonymous reader for pointing out that property and tort law, properly designed, can spur activities that enlarge the social pie. The innovation encouraged by protection for intellectual property is one example.

26 On the potential for helpful government action in credit reporting, for example, see Messick, "Judicial reform and economic development," p. 21, and the sources cited therein.

27 Benjamin Liebman, "Innovation through intimidation: an empirical account of defamation litigation in China," *Harvard International Law Journal*, Vol. 47, No. 1 (2006), p. 69.

28 See "'Zhongguo boke di yi an': fu jiaoshou xiang wangluo manma xuanzhan" ("First Chinese blog case: assistant professor declares war on web vituperation"), *Xinhuanet*, 2 February 2006, available on http://news.xinhuanet.com/legal/2006-02/10/content_4161160.htm; "Professor wins suit against blog site," *Associated Press*, 4 August 2006, available on http://www.breitbart.com/news/2006/08/04/D8J9JK602.html; Donald C. Clarke, "Journalism professor wins defamation suit against blog host," *Chinese Law Prof Blog*, 10 November 2006, available on http://tinyurl.com/tc65s.

and not based simply on rumours.[29] Nevertheless, while different views may legitimately exist on the appropriate 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 merely unflattering opinions.

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. 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 Anti-Monopoly Law have been circulated but so far no final law has been promulgated. There is disagreement about how the competition policy regulator should be constituted as well as over substantive provisions in the law. It may be that it is trying 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.[30] And commentators have pointed out that various drafts, instead of focusing solely on competition issues, attempt to ensure "fair" prices (including prices that are not "too low") and to achieve other social objectives as well that would be better accomplished through separate legislation.[31]

While state policy makers naturally tend to think of lawmaking as a solution to problems, in fact many pro-competition objectives can be achieved without anti-monopoly regulation and an enforcement bureaucracy at all. As discussed above, trade liberalization measures such as reducing barriers to domestic entry and to imported goods and services, as well as enhancing the flow of

29 The case in question pitted the Guangzhou Huaqiao Real Estate Development Company against the journal *China Reform*. Excerpts from the text of the judgement 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. For further sources, see Liebman, "Innovation through intimidation," appendix B, case 185.

30 Kovacic, "Foundations for economic legal reform."

31 See American Bar Association (ABA) Sections of Antitrust Law and International Law and Practice, "Joint submission on the proposed anti-monopoly law of the People's Republic of China," 15 July 2003, available on http://www.abanet.org/intlaw/committees/business_regulation/antitrust/abaprcatfinalcombo.pdf; see also ABA Sections of Antitrust Law, Intellectual Property Law and International Law, "Joint submission on the proposed anti-monopoly law of the People's Republic of China," 15 May 2005, available on http://www.abanet.org/intlaw/committees/business_regulation/antitrust/chinacommentsantimonopoly.pdf.

information, will generally be far more effective than legal regulation through prohibitions and penalties.

Bankruptcy law was until quite 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 apply to actual bankruptcies, which were governed far more by state policy than by legal rules. In August 2006, a substantially revised Enterprise Bankruptcy Law was finally adopted by the NPC's Standing Committee, to come into effect on 1 January 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.[32] 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.

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 and there is a public-good element to securities regulation. For this and other reasons, China's Securities Law can be considered a useful framework. Without discussing it in detail, the main point 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.[33] 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 – such as 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.

32 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 Donald C. Clarke, "State council notice nullifies statutory rights of creditors," *East Asian Executive Reports*, Vol. 19, No. 1 (15 April 1997), pp. 9–15.

33 Sebastian Heilmann, "The Chinese stock market: pitfalls of a policy-driven market," *China Analysis*, No. 15 (2002), available on http://www.chinapolitik.de/studien/china_analysis/no_15.pdf.

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.[34] 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, 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 discussed above, 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, however, do add to the menu of business vehicles and thus constitute progress from this perspective.

Conclusion

The introduction to this article identified the models of state-driven and market-driven development. 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 market-driven development has not been attempted at all. In both models, the goal is to serve the needs of the market economy. In state-driven development, that is the whole point of seeking foreign advice on lawmaking. But as Alford points out, while multilateral financial institutions and economists are sceptical of the ability of Western politicians to get it right when they regulate economic activity, they seem oddly to have more faith in the ability of Chinese politicians, who after all have much less direct experience of a market economy and the workings of civil society, to put their prescriptions into effect.[35]

China has so far followed 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 legal institutions established really mattered for China's development has not been demonstrated. The key challenge ahead 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

34 Henry Hansmann and Reinier Kraakman, "The essential role of organizational law," *Yale Law Journal*, Vol. 110, No. 3 (2000), pp. 387–440.

35 William Alford, "The more law, the more …? Measuring legal reform in the People's Republic of China," in Nicholas C. Hope, Dennis Tao Yang and Mu Yang Li (eds.), *How Far Across the River? Chinese Policy Reform at the Millennium* (Stanford: Stanford University Press, 2003), pp. 122–49.

institutions almost by definition cannot be created by the state; they should be enabled and permitted, but not forced into existence.

What concrete steps might China take? First, institutions that collect and disseminate information contribute to flexibility and adaptability in other institutions, since one 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 does as well, and it is important in policymaking to recognize both sets of costs. 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. The purpose of China's legal system is to serve China's needs. Legal reforms in continental Europe or the United States are not discussed in terms of whether or not they conform with the civil law or the common law model, and there is no reason for Chinese policy makers 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. The result is that inappropriate and inefficient rules are not weeded out. But because they are widely recognized as inappropriate, actors within the legal system tend simply to ignore them. 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.

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.[36] 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 that Liebman plausibly attributes to the public's lack of confidence in courts and not to an increase in social harmony.[37]

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 China (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

36 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.

37 Benjamin Liebman, "China's courts: restricted reform," in this volume.

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 rule. 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.

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 experts and enacting comprehensive statutes – are much less than they were. Many laws and institutions are now in place; what the state must now 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."[38] Ideally, the outcome will reflect local conditions in China; international best practices may be a reference but should not be a target.

38 Rubin, "Growing a legal system," p. 2.