Reforming Asian Socialism

The Growth of Market Institutions

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CHAPTER 3

The Creation of a Legal Structure for Market Institutions in China

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Introduction

It is often supposed, by both advocates and critics, that the hallmark of a true free-market economy is the absence of governmental regulation: the less regulation, the freer the market. If this were so, then the task of reforming socialist economies would be fairly straightforward: once the political decision to move to a market economy had been made, one would simply dismantle the stultifying apparatus of state planning. Whatever was left afterward would be a market economy. To be sure, there would still be political decisions to be made about economic reform, but these would be largely tactical in nature: do gradualist measures, for example, ease the pain of transition or simply prolong it?

Unfortunately, "the market" is not a self-defining institution. At most, it connotes some kind of decentralized system of voluntary exchange subject to constraints. Yet even such a simple definition begs the most important questions: what counts as voluntary, for example, and what can be exchanged? The market cannot function without some institution capable of making and enforcing rules that answer such questions. If this institution is the state, then the delineation of the rules of the market is, in its own way, just as much "state intervention" as the delineation of the rules of planning. The rules of the market are much more than mere ground rules for fair exchanges: in defining what shall count as a protected entitlement and what can be traded, they can have an enormous influence upon the distribution of wealth and power in society. The decision to expand the role of the market in a society's economy, therefore, is only the first of many strategic political decisions that must be made along the way to any particular institutionalization of the market.

The picture is further complicated by the fact that a desire by policymakers to have a market system in general, or even some particular institutionalization of the market, does not automatically call forth the legal institutions necessary for the market to operate. It would be very surprising if the

legal system created within a planned or largely planned economy happened to be suited to the needs of a market economy. The system that protected "state property," for example, cannot be counted on to protect private property just because the scope of permissible individual ownership has been broadened. A legal system is not only a set of definitions of rights, but also a set of procedures for doing things with those rights. Indeed, the treatment of what I have provisionally labelled rights may lead us to the conclusion that they should not have been called rights at all in the first place.

In short, the transition from traditional socialism by no means entails a retreat of the state from the economic sphere. The creation and maintenance of any particular set of market institutions requires that those institutions be defined and protected.

Market institutions can be thought of as having two legal facets. First, the law defines the institutions and rules of the market. The law defines what kind of natural persons can form contracts, and what type of organization can be considered equivalent to a natural person for contracting purposes; it defines what counts as property subject to purchase and sale and what kind of act will establish a binding contract. Obviously, different systems could have very different answers to these questions and still justifiably be called "market" systems. We can call these institutions and rules the substantive legal facet of market institutions.

Second, the law supplies—indeed, one could, following Holmes,[1] say the law *is*—the set of procedures for making these institutions a reality. This may be called the procedural legal facet of market institutions. These two facets are separable only conceptually. In practice, the contours of a substantive right depend crucially on the extent to which it can be realized. There is no difference between saying that you have no right to do X and saying that you have a right to do X but that no real-world consequences will follow from the existence of that right. If the substantive content of rights, and in particular rights appropriate to the functioning of market institutions, matters, then it is crucial to understand the procedural context within which those rights exist.

This chapter will examine the extent to which China has the kind of legal system (or any set of institutions, whether or not they are called legal) suited to the task of defining and enforcing rights appropriate to a market economy. It will show that in many respects, the reform of China's legal institutions lags far behind the reform of its economic system. The final section addresses the question of whether this lag really matters.

1. "The prophecies of what the courts will do in fact, and nothing more pretentious, are what I mean by the law." Oliver Wendell Holmes, *The Path of the Law,* 10 HARV. L. REV. 457, 461 (1897).

The "Traditional" (Post-1949) Legal System

Scholars and others have often questioned whether modern China has ever had anything that can justifiably be called a "legal system."[2] Obviously it all depends on what one means by "legal system." It is certainly true that in many important respects, the legal system of post-1949 China[3] was vastly different from the set of institutions known as "legal" in the industrialized West. That system was, not surprisingly, part and parcel of the economic system with which it coexisted, and the point of that system was state control over economic activity.

The legal system reflected this both in its substantive rules and in its procedures. Let us take as a case study a contract for the delivery of raw materials from coal mine to steel mill. The traditional (i.e., post-1949) Chinese legal system dealt with this phenomenon very differently from the way that a legal system designed for a market economy would.

The traditional model of the planned economy views the state as essentially one giant vertically integrated productive firm: "China, Inc."[4] The various ministries are divisions within the firm and enterprises are factories. The role of contracts prior to economic reform was essentially one of fleshing out the details of the plan.[5] Whether at the central or the regional level, state plans simply could not cover all the details of the production and allocation of all industrial products. Moreover, contracts were the form in which the planned transfer of products from one enterprise to another became specific, concrete

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2. See, e.g., THOMAS B. STEVENS, ORDER AND DISCIPLINE IN CHINA: THE SHANGHAI MIXED COURT 1911–27 (University of Washington Press, 1992). When I reveal my academic specialty (Chinese law) to taxi drivers and other casual acquaintances in China, the response is almost always a snort of derision and disbelief—"There *is* no law in China"—followed by an anecdote in support of the proposition.

3. As well as pre–1949 China, but the point will not be argued here.

4. A brief description of the Chinese planning system can be found in Donald C. Clarke, *What's Law Got to Do with It? Legal Institutions and Economic Reform in China,* 10 U.C.L.A. PAC. BASIN L.J. 1, 5–6 (1991); for a fuller account, see Barry Naughton, *China's Experience with Guidance Planning,* 14 J. COMP. ECON. 743 (1990); and Barry Naughton, *Industrial Planning and Prospects in China,* in Eugene Lawson, ed. U.S.-CHINA TRADE: PROBLEMS AND PROSPECTS 179 (Praeger, 1988) [hereinafter B. Naughton, *Industrial Planning*].

5. "Various enterprises and business units give concreteness to the state plan and ensure its completion through signing economic contracts. Whether or not the state plan is actually feasible can be reflected through the implementation of contracts. Therefore, without contracts the plan will come to nothing; the fulfillment of contracts is precisely the implementation of the plan." *Jingji guanxi zhong de zhongyao zhunze* (An Important Standard in Economic Relationships), Renmin ribao (People's Daily), Dec. 17, 1981, at 1, quoted in PITMAN B. POTTER, POLICY, LAW AND PRIVATE ECONOMIC RIGHTS IN CHINA: THE DOCTRINE AND PRACTICE OF LAW ON ECONOMIC CONTRACTS 146 (Ph.D. diss., Univ. of Washington, 1986).

obligations.[6] Clearly, the contracts that fleshed out the details of the plan could not be entirely, or even mostly, free in the sense that the parties could simply decline to contract if the terms did not suit them. The means must be as mandatory as the ends. On the other hand, it is important to remember that plan targets themselves were formulated in a back-and-forth process that tried to take enterprise capabilities into account.[7] Consequently, it would be a mistake to draw too sharp a distinction between plans and contracts in the prereform system. Contracts were the continuation of the plan by other means.[8]

Because contracts were so closely tied to the plan, the state had no interest in enforcing them unless they worked to fulfill the goals of the plan. As long as contracts specified the details that the plan could not, the state would support their enforcement. As soon as the plan changed, however, and the transaction called for in the contract was no longer necessary or desirable from the standpoint of the plan, the state would not only permit, but would even require the contract to be changed to meet the new circumstances.[9] In addition, enterprises had little reason to be very worried about "damage"[10] caused by breached contracts. The state would make up for such damage by increasing subsidies or reducing relevant targets.[11]

A contract between a coal mine and a steel mill is thus entered into at the behest of their administrative superiors. It becomes legally valid not because

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6. See RICHARD PFEFFER, UNDERSTANDING BUSINESS CONTRACTS IN CHINA, 1949–1963 20 (Harvard Univ. Press, 1973).

7. See generally Thomas P. Lyons, *Planning and Interprovincial Co-ordination in Maoist China*, 1990 CHINA Q. 37; B. Naughton, *Industrial Planning*, *supra* n. 4.

8. For a study of Chinese contract law and practice that emphasizes the voluntary aspects of contracting in China and disagrees with some of the characterizations made here, see Roderick Macneil, *Contract in China: Law, Practice, and Dispute Resolution*, 38 STAN. L. REV. 303 (1986).

9. See R. PFEFFER, *supra* n. 6, at 53.

10. I put the word "damage" in quotation marks for two reasons. First, the term must be understood in a new way because of the great significance of operational targets assigned to Chinese state-owned enterprises. To a Chinese enterprise manager, damage could mean reduced revenues and lost profits, but it could also mean increased difficulty in meeting any target set by superiors. Suppose a contract breach means the enterprise is unable to fulfill its output target. If the enterprise is a monopolist, reduced output might actually increase profits. Thus, no loss would be cognizable under Western contract law. In a Chinese state-owned enterprise, however, employees could suffer real losses in the form of reduced bonuses for failure to meet the output target.

Second, damages are not really damages at all as far as the enterprise is concerned if adjustments are somehow made to eliminate their effect on the enterprise.

11. See P. POTTER, *supra* n. 5, at 52. A case where the breach was handled as described is noted in R. PFEFFER, *supra* n. 6, at 54–55. The disinclination to enforce contractual rights is one consequence of the soft budget constraint analyzed in JANOS KORNAI, ECONOMICS OF SHORTAGE 75 (North-Holland Pub. Co., 1980).

it is the expression of the will of the parties, but because it has been authorized (and subsequently approved) by higher levels.

Second, the contract, like statutory law in general in such a system, does not grant "rights" as such. If a law says that X "shall" be done, you do not necessarily have a right to some kind of redress if X is not done and you are thereby damaged. If one is looking for rights, Chinese laws appear very poorly drafted indeed. "Should" is liberally used alongside of "must"; laws frequently state that X "should normally" or "should in principle" be done, but give no hint of when exceptions can be made.

The intention of the drafters becomes clear, however, if one considers the law as a crystallization of state policy directed to administrators. Most economic contracts must be approved by these administrators; they are the ones who must "obey" the law. Where the law says that contracts "should in general" contain a certain provision, is a contract without that provision invalid? Have its signers violated the law? The question is impossible to answer. The relevant question, for the state, is whether, when one looks at *all* of the contracts approved by the relevant authority, the rule of "in general" or "in principle" has been satisfied. What the law aims to establish is a kind of statistical regularity, not any particular individual's right to something.

Thus, if a steel mill believes that a delivery from a coal mine is not up to standard, the matter will not be resolved by reference to issues of rights or fault. The steel mill will first complain to government administrators, and the dispute, if not resolved earlier, will eventually rise to the first administrator with authority over both enterprises.[12] That official's primary concern is to take the action that will best fulfill the goals of the plan. If the coal is indeed of poor quality, which party is in the best position to do something about it? Can the steel mill's targets still be met with inferior coal? Fault comes into the picture only, if at all, when it is time to assess the performance of enterprise managers for the purpose of bonuses or promotions. (Indeed, because we are assuming that both enterprises are in the same industrial "system" (*xitong*), a promotion may take a manager from one enterprise to the other.)

Legal Institutions in a Market Economy

Let us now consider what has to be different in an economy attempting to move away from planning and toward a market. To understand that, however, we need to specify some reasons why a society might want to make the move.

12. This example is taken from, and more fully detailed in, John A. Spanogle and Tibor M. Baranski, Jr., *Chinese Commercial Dispute Resolution Methods: The State Commercial and Industrial Arbitration Bureau,* 35 AM. J. COMP. L. 761, 764–65 (1987), who label it "administered resolution."

As an economic reform strategy, the move to market allocation usually represents a recognition that planners simply cannot process the infinite number of facts about an economy that must be assimilated before a working plan can be formulated.[13] Decentralized decision making made by myriad actors, each responding to price signals, is viewed as superior. As a political reform strategy, market allocation may be favored over bureaucratic allocation because it reduces the dependence of citizens upon state officials for their daily needs. The following discussion will consider only the implications of the economic justification.

If the state seeks to establish market institutions as an economic reform measure, the key question is whether prevailing legal institutions make it possible for market institutions to function the way they must if there is to be any difference from the old system.

Perhaps the single most important feature of law and rights in a market economy is *general applicability.* The point of economic reform is to get rid of state micromanagement of enterprises according to a plan. Given this goal, regulation by enterprise-specific directives must yield to regulation by rules of general applicability. This is because the difference between laws of general application and enterprise-specific directives is that the latter need to be guided and coordinated; they need to have some rationale behind them to make sure that they have the desired effect; in short, they have to be part of a plan. But the plan is what we were trying to get rid of. Allocative decisions are to be made instead by decentralized actors responding to price signals. High-priced inputs, for example, are supposed to go to those enterprises that, because they produce a valuable product, can afford them, not to those that can persuade their supervisory government organ to supply them. The task for law in market-directed economic reform is to play a similar role: to function as an aspect of the environment in which enterprises operate. If all economic law is enterprise-specific and the product of bargaining between the enterprise and superior levels of administration, there can be no hope of making its content rational and internally consistent without something like a plan. If law is to be used in support of market institutions, it must apply indifferently to large numbers of economic actors. Otherwise the system will revert to the kind of ad hoc bargaining whose inadequacies led to the drive for reform in the first place.[14]

The key question, then, is whether there is any institution in China ready and able to undertake the task of uniform application of a set of rules defining

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13. Vaclav Havel's philosophical expression of this view is quoted in the introduction to this volume: "The essence of life is infinitely and mysteriously multiform, and therefore it cannot be contained or planned for, in its fullness and variability, by any central intelligence." VACLAV HAVEL, SUMMER MEDITATIONS 62 (Knopf, 1992).

14. I make this argument more fully in Donald C. Clarke, *The Law, the State and Economic Reform,* in Gordon White, ed., THE CHINESE STATE IN THE ERA OF ECONOMIC REFORM 190 (M.E. Sharpe, 1991).

and protecting market institutions. For a number of reasons, the courts in China are the most likely candidate for this task—more likely, that is, than any other institution. They are, however, hampered in several ways that cast doubt on their ability to accomplish it.

Courts are the most likely candidate to undertake the uniform and general enforcement of rules because individual courts, not just the system as a whole, have the putative authority to issue orders cutting across bureaucratic and territorial boundaries. That is, a judge sitting in a Hunan county and appointed by the county People's Congress could, under proper circumstances, legitimately order a state-owned, city-run handicrafts factory in Harbin to pay a sum of money to a collectively owned, township-run sandalwood supplier in Guangxi.

No other institution in China, including the Communist Party, has this kind of formal authority. As noted earlier, the traditional way to solve disputes in China has been to find the common superior with jurisdiction over both parties. This principle applies not only to dispute resolution, but also sometimes to the most basic kinds of communications or cooperative relationships. If two units in different systems (*xitong*) would gain from some mutually beneficial arrangement, they can't just do it. They must go through proper channels. Enforcement of rules by any institution other than courts is inevitably going to run into the problems of particularism and bargaining that economic reform was intended to move away from.

There is another reason that courts have the potential to be more effective than the traditional bureaucracies in helping the government implement uniform and consistent policies. A pervasive problem in any authority system is ensuring that commands from the top are carried out at the lower levels of the system that interact directly with the object of regulation. There is a progressive loss of control as the organization becomes larger and the distance increases between policy makers at the top and policy implementers and enforcers at the bottom. The difficulties encountered by Chinese policy makers at the center in seeing their directives implemented are well known.

The key advantage of court-enforced policy (i.e., "law") over bureaucratically implemented policy is that, if the system works properly, it minimizes the number of layers between policy making and policy implementation. Parties come before the court with a specific dispute that the court has the power and the authority to resolve. The court resolves this dispute by direct reference to the original text of the policy issued by the relevant policy maker.[15] There is, in principle, no reason why this text cannot have been directly formulated and

15. I am speaking, of course, of the type of legal question that is so clear-cut that it never makes it into court in real life. I should not be understood as saying that where the issue is debatable, the court resolves it through a process of formal deduction from premises set forth in the texts.

approved by the central authorities. When a court resolves a dispute, therefore, there is only one intermediate layer between the central policy makers and the regulated parties. Thus, court enforcement of rules has the potential to provide a much greater degree of uniformity and consistency than enforcement by other bureaucracies—provided the courts can actually command obedience and have a system for ensuring consistent enforcement.

Limitations of Courts as Guarantors of Market Institutions

The remarkable breadth of the formal authority of courts merely underscores its purely formal character. China's courts suffer from severe limitations as guarantors of the generally applicable system of rights necessary to a complex market order because they are often unable or unwilling to enforce legal standards. First, judges may simply lack the education necessary to do the job competently. China now has some fifty "political-legal institutes" and university law departments that annually produce about 5,000 bachelor of law graduates.[16] Because very little legal education took place between the mid-1960s and the late 1970s, there is a great shortage of persons qualified to serve as judges. Recent graduates, in their early twenties, are simply too young. Many judges are demobilized army officers with little education; there is as yet no career judicial bureaucracy with clear, or even vague, standards of competency. Until the 1995 promulgation of the Law on Judicial Officers, there were *no* objective qualifications that all judges had to have. As of 1993, one third (33.3 percent) of judicial personnel lacked postsecondary education.[17]

Judicial ignorance of the law is particularly devastating in a system such as China's because it is so difficult to remedy. Chinese judicial procedure is basically inquisitorial, leaving a great deal of initiative to the judge instead of to the parties and their lawyers. Just finding the applicable law can be an impossible task. Laws and regulations are promulgated by a bewildering variety of governmental and quasi-governmental bodies, and no comprehensive and up-to-date indexes are available. There is no regular system of case reporting that allows judges to see how other courts have handled similar problems.[18] Quite often there will simply be no statutory rule directly on

16. See *Legal Eagles,* China Daily, Mar. 4, 1993, at 3.

17. See Ren Jianxin, Supreme People's Court Work Report, March 22, 1993, in BRITISH BROADCASTING CORPORATION, SUMMARY OF WORLD BROADCASTS, PART 3: THE FAR EAST [SWB/FE], April 12, 1993, at C1 (report delivered by president of Supreme People's Court to first session of Eighth National People's Congress).

18. The Supreme People's Court does publish the *Supreme People's Court Gazette,* a periodical containing directives, interpretations, and cases (generally lower court decisions thought to be particularly instructive). In addition, judges no doubt have access to case reports that are not publicly available.

point, or there may exist contradictory rules. In these cases, there is simply no way of guessing how an untrained and ill-educated judge will choose to decide the issue and no sense of what sorts of arguments should or should not count.

Furthermore, even if judges have enough education to do the job, they may be corrupt or partial and unwilling to render a correct judgment. Official corruption is a serious problem in China—indeed, it was one of the grievances that sent the people of Beijing and other cities into the streets in the spring of 1989—and Chinese press reports make it clear that it extends to the judiciary. It is difficult, however, to quantify it in a rigorous enough way to provide meaningful comparative perspective. The number of news stories on the topic is a function of the government's wish to publicize the problem, not necessarily of its size. Without reliable data, it is possible only to note the existence of this obstacle to law implementation, not to specify its degree.

In addition, even if judges are able and willing to render a correct judgment, their decision may be overridden by higher authorities within the court. Courts at all levels have as part of their structure an Adjudication Committee headed by the president of the court. It is the highest decision-making body within the court as an institution. It is official policy that "judicial independence" means not that the particular judge or judges hearing the case should be independent from outside pressures (i.e., senior judges in the same court), but at most that the court *as an institution* should be free from outside pressures. The Adjudication Committee has the power, among other things, to override the decision of the judges who actually heard the case and conducted the trial and to order them to enter a different decision. Reports in the legal press show that in many courts it is routine for the Adjudication Committee to decide cases (often before the hearing), with the result that "those who try the case do not decide it, and those who decide the case do not try it" (*shenzhe bu pan, panzhe bu shen*).

Also, the court as a whole is subject to many outside pressures and is particularly vulnerable to local government direction. Judges can be threatened with various unpleasant consequences if they do not decide as the threatener wishes. I shall look here at only one kind of vulnerability with a specific institutional basis, that is, the power of the local party and government to dictate to courts how they shall decide cases.

The local party tends to judicial matters through its Political-Legal Committee (*zheng-fa weiyuanhui*).[19] This committee has traditionally been in

19. According to the Notice of the Central Committee of the Chinese Communist Party on the Establishment of Political-Legal Committees (*Zhonggong zhongyang guanyu chengli zheng-fa weiyuanhui de tongzhi)* (Central Committee Doc. No. 5, 1980), the Political-Legal Committee, inter alia, "guides (*zhidao*) the work of the various political-legal departments" (this would include courts) and "properly disposes of important and difficult cases." This document, not to my knowledge publicly available, is cited in *Zhonggong zhongyang guanyu jiaqiang zheng-fa*

charge of the police, the procuracy, the courts, other aspects of judici administration, and civil affairs. The Political-Legal Committee is ofte headed by the leader of the local police or of the local party and governmen

It has long been the practice in China for local party secretaries or part committees to review and approve the disposition of cases by courts. This wa the concrete manifestation of the principle of party leadership. The offici theory now is that Party leadership is to be exercised at the level of legislatio or general policy making, not in the adjudication of specific cases. But it ha proved difficult to break old habits.

Judges may find themselves out of a job if they do not do as they are tol by the Political-Legal Committee or other local power holder. The form power of appointment and dismissal of court personnel is lodged in the loca People's Congresses. In practice, however, they act as rubber stamps for th local party organizational department. The real power is in the hands of th local party leadership. "This personnel power exercised by a small group c leaders hangs like the sword of Damocles over those who would do thing according to law."[20] "If the court insists on handling things according to la and disposes of certain cases in ways not satisfactory to these leaders, some c them will use their power to arbitrarily reassign the court's leadership."[21]

Finally, any judgment needs to be enforced, yet the courts are short o autonomous enforcement powers. It is frequently difficult to get court judg ments enforced against any determined defendant, to say nothing of a wel connected and politically powerful defendant. Indeed, the president of th Supreme People's Court in 1988 described the failure to enforce court deci sions as "the most outstanding problem in the administration of justice in th economic sphere."[22]

Why is it so difficult to execute judgments? First, there are few penaltie for refusing to obey a court order. Chinese courts have no contempt powe

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gongzuo de tongzhi (Chinese Communist Party Central Committee Notice on Strengthenin Political-Legal Work), Jan. 13, 1982, reprinted in ZHONGGONG NIANBAO 1983–84 (Yearbook c Chinese Communism 1983–84) 8-3, 8-6 (Taipei 1984) [hereinafter 1982 Political-Legal Notice

20. Zhao Zhenjiang, Zhou Wangsheng, Zhang Qi, Qi Haibin, and Wang Chenguang, *Lu falü shixiao* (On the Effectiveness of Laws), 2 ZHONG-WAI FAXUE (Chinese and Foreign Lega Studies), 1, 5 (1989).

21. Shi Youyong, *Shenpan zhong difang baohu zhuyi de chengyin ji duice* (Local Protec tionism in Adjudication: Causes and Countermeasures), 6 FAXUE (Jurisprudence) 15 (1989).

22. See Zheng Tianxiang, *Zuigao renmin fayuan gongzuo baogao* (Supreme People' Court Work Report), 4 ZHONGHUA RENMIN GONGHEGUO QUANGUO RENMIN DAIBIAO DAHU CHANGWU WEIYUANHUI GONGBAO (Gazette of the Standing Committee of the National People' Congress of the People's Republic of China) [NPCSC GAZETTE] 24, 29 (1988) (report delivere to 1st Session of 7th National People's Congress, April 1, 1988). Complaints about problems i implementing judgments are a regular feature of the annual Supreme People's Court work reports

and it is not a crime to refuse to obey a court order. Article 157 of the Criminal Law makes it a crime to refuse to carry out a judgment if the refusal is by means of threats or violence. This covers the person who interferes with the actions of others carrying out a judgment, but does not cover the person who is ordered to do something and simply does not do it.

Article 77 of the 1982 Civil Procedure Law empowered the court to fine or detain those who "have a duty to assist in execution" of civil judgments and refuse to do so, but this probably did not refer to the actual object of the judgment, who is usually called "the executee" (*bei zhixing ren*). Evidently this lacuna was noted, for the 1991 revision provides in Article 102 that parties themselves (as well as others) may be fined or detained if they refuse to carry out a legally effective court judgment or ruling.[23] It remains to be seen, however, how well this provision will be enforced.

Second, courts often lack sufficient bureaucratic clout to enforce their judgments against administrative units. Any clout they have comes from the bureaucratic rank of individual judges. Although courts and governments at any given level are supposed to be equal, court presidents generally have a lower bureaucratic rank than the chief executive of the government at the same level.[24] This means, for example, that the latter has access to some documents from the center that the former cannot see. It is simply alien to the way China functions that a lower-level official from one bureaucracy should be able to give orders to a higher-level official from another.[25] A low-status judge does not have the prerogative to disobey, much less to command, a higher-status official. As one county party secretary is reported to have said, "Tell me what matters more: official rank or the law? I can definitely tell you, rank matters more. Law is made by man; without man, how could there be law? Without man, how could law matter at all? That's why I say that rank matters more."[26]

Third, the cooperation of local authorities is needed. Judicial independence is not of much use if it results in nothing more than the issuance of a

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23. Refusal to carry out judgments is one of a list of acts in Article 102 that are said to subject the actor to criminal liability *if* they violate the Criminal Law. Aside from the fact that it is hardly necessarily to put into the Civil Procedure Law the truism that acts in violation of the Criminal Law will subject the actor to criminal liability, we have already seen that the mere refusal to carry out a court order does not appear to violate the Criminal Law.

24. See Fang Chengzhi, *Renmin fayuan zai guojia jigou zhong de diwei* (The Position of the People's Courts in the Structure of the State), 4 FAXUE ZAZHI (Jurisprudence Magazine) 15(1985); Tao-tai Hsia, The Concept of Judicial Independence 9 and n.23 (unpublished paper 1986).

25. See generally K. LIEBERTHAL AND M. OKSENBERG, POLICY MAKING IN CHINA: LEADERS, STRUCTURES, AND PROCESSES ch. 4 (Princeton Univ. Press, 1988) (discussing characteristics of the structure of state power).

26. See Fang Chengzhi, *supra* n. 24, at 16.

piece of paper. The enforcement of local court judgments may be supported by local authorities, if only because a judgment they opposed would likely not be issued in the first place. Nevertheless, courts are reluctant to move with force and authority against the truly recalcitrant defendant. In one case, an old man and his wife transferred their house to another and then wanted it back so they could give it to their son. To accomplish their purpose, they simply reoccupied the original house. The new owner took them to court and won both on first trial and on appeal. The defendants, however, refused to move out on the grounds that they were old. Fearing they would commit suicide, the court eventually ruled that they could stay until they died, at which time the court's judgment would take effect. The writer reporting this case criticizes the court, but displays the identical attitude when he says that where execution would "genuinely cause difficulty," one should consider an "appropriate postponement."[27]

The greater enforcement problem occurs with the execution of judgments from courts outside the jurisdiction of the local government. The enforcement of such judgments is essentially a voluntary matter for the local authorities.

Local courts in China are considered in fact, although not in law, to be simply arms of local government. Courts are dependent on local government for their financing, and their personnel serve de jure at the pleasure of the local People's Congress and de facto at the pleasure of the local party organization. This sets the stage for the conflict of two principles. A court, wherever located, is by law empowered to issue a judgment binding on anyone, provided it has proper jurisdiction. In the Chinese political system, however—and by no means only the Chinese—the government of County A in Province X cannot tell the government of County B in Province Y what to do. Because of the identification of courts with local governments, their judgments are subject to the latter principle, not the former.

Local authorities often oppose the enforcement of outside judgments. Under economic reform, localities are more dependent than before on their own resources. Local enterprises form the revenue base for local governments. Thus, it is important to protect their financial health. The president of the Supreme People's Court complained about this phenomenon:

> Some localities—mainly party and government leaders at the basic level—demand that when the court passes judgment, it be favorable to the party from the locality. If it is not, they accuse the court of "embracing outsiders" (*gebozhou wang wai guai*). If a court from outside the locality rules against a local party in a suit, requiring that party to bear

27. Su Nan, *Fayuan de panjue zai mouxie difang nan yi zhixing* (Court Judgments Are Difficult to Implement in Certain Places), Fazhi ribao (Legal System Daily), Jan. 3, 1989, at 4

economic liability, to pay a debt, or to compensate for economic loss, certain leaders of the locality will obstruct the implementation of the court's judgment.[28]

The financial contract system, under which localities are obliged to turn over a fixed amount of revenues to the center each year,[29] has made it even less likely that local authorities will permit resources to flow out of the jurisdiction. Since local governments are usually the primary claimants on the enterprise's income, they bear the loss when their enterprise pays out to an outside party.

If it is common for local courts to rule against outsiders, it is easy to see why even the most upright local authorities would have good reason to be suspicious of the impartiality of an outside judgment against a local enterprise. They would naturally be reluctant to help enforce it. Sometimes outside court personnel will actually make a trip (at the winner's expense) to the loser's district to execute the judgment. But without the cooperation of local authorities, outside court personnel are simply strangers in a strange land. They have no connections, no authoritative letters of introduction, no influence, and no power.

It can be very difficult to obtain local court cooperation if the local authorities are dead set against it. Contracts across jurisdictions can be unenforceable. In one case, a local court refused to help enforce an outside judgment despite two specific orders from the Supreme People's Court to do so.[30]

In the face of this protectionism, local governments have begun to make treaties pledging to protect each other's enterprises as their own. Shanghai, for example, is reported to have signed agreements "on the protection of the legitimate rights and interests of enterprises" with nine provinces.[31] These treaties can play a useful role as long as the parties have an interest in

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28. Shi Youyong, *supra* n. 21, at 15 (citing a speech made by Supreme People's Court president Ren Jianxin in October 1988). Ren's predecessor made the same complaint in almost identical terms (and using the same colloquial expression) in April of 1986. See Zheng Tianxiang, *Zuigao renmin fayuan gongzuo baogao* (Supreme People's Court Work Report) (report delivered to 4th Session of 6th National People's Congress, April 8, 1986), reprinted in Zhongguo fazhi bao (Chinese Legal System News), April 23, 1986, at 2, 3.

29. See K. LIEBERTHAL AND M. OKSENBERG, *supra* n. 25, at 139.

30. See Chen Shibin, *Dawu xian fayuan jianchi difang baohu zhuyi, tuoyan san nian ju bu xiezhu zhixing waidi panjue* (Dawu County Court Persists in Local Protectionism; After Delaying Three Years, Still Refuses to Assist in the Execution of an Outside Judgment), Fazhi ribao (Legal System Daily), June 4, 1988, at 1.

31. See Yang Jisheng, *"East-West Dialogue" in China—the Strategy of Unbalanced Economic Development on the Mainland in Perspective*, 9 LIAOWANG (Outlook) (overseas edition) 5 (1989), in FOREIGN BROADCAST INFORMATION SERVICE, DAILY REPORT: CHINA [FBIS], Apr. 10, 1989, at 37, 39.

continued cooperation, and are more practical than the usual pious exhortations to local authorities.[32] They are, however, essentially unenforceable.

Rules, Rights, and Economic Development

The establishment and maintenance of market institutions in the reforming Chinese economy requires—or at least is substantially aided by—a particular kind of rule making and rule application. This rule making and application is characterized by generality and should be understood in opposition to the traditional system of ad hoc bargaining between individual enterprises and their superiors.

The problem with a system of general rules is that there is currently no system of institutions in China willing and able to enforce them. First, there is a chicken-and-egg problem. In the absence of complete economic reform, economic activity does not take place on a level playing field. Thus, applying general rules without taking individual differences into account is not only seen as unfair, but actually *is* so. Moreover, it may be counterproductive as well, if efficient enterprises that nevertheless lose money find themselves in trouble, for example, under the Enterprise Bankruptcy Law. However, the development of a market economy is obstructed to the extent that the principle of particularism reigns.

Second, making general rules stick implicates important questions of political power. It means drastically weakening the power of some institutions to grant exemptions and building institutions that can enforce the rules. Courts have seemed the natural candidate for the task because of their sweeping formal authority and their ability to keep to a minimum the amount of noise in policy transmission. They are not, however, capable of carrying it out as currently structured.

Power in China flows within bureaucratic systems, not across them. Rules that purport to operate horizontally, across bureaucracies, are essentially alien to the system and are difficult to enforce. Without the creation of an enforcement institution that transcends the traditional system of state power, any law promoting fundamental economic reform that purports to be generally applicable is unlikely to be effective.

While the legal system has undergone significant reforms in the last decade, in many crucial areas it remains as before and thus unable to perform the task of enforcing the rules of economic reform. First, there is no evidence to suggest that courts have more real power now than they did a decade ago.

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32. See, for example, the "solution" proposed by one writer: "The best way of solving the problem [of court judgments not being implemented] is for the relevant units and personnel to truly do things according to law" (Su Nan, *supra* n. 27, at 4).

The observance of court judgments for many institutions remains essentially voluntary. Yet establishing a system where courts have real power involves grasping some very thorny political nettles. Second, courts remain essentially the creatures of the level of government that appointed their personnel. They cannot be used to overcome the obstacles to reform posed by local protectionism and particularism when they are part of the very structure causing the problem.

The prominence of local and regional centers of political power on the list of obstacles to economic reform in China may shed light on the question of the proper role of the state in the establishment of economically efficient social institutions. Recent writing in law and economics has attacked the "legal-centralist" view, attributed to scholars from Hobbes to Calabresi, that the state is the exclusive creator of property rights.[33] Instead, these writers say, property rights may arise "anarchically out of social custom" and "from the workings of non-hierarchical social forces."[34]

It may be, of course, that the debate will turn out to be about what the participants mean by "rights." Just how compulsory must the corresponding duty be before we will find that a "right" exists? Ellickson's study of norms established spontaneously in the whaling industry hardly disproves the legal-centralist thesis when the writer concedes that the system broke down as economic pressures led some whalers simply to defect.[35] The assurance of enforcement, the confidence that others *cannot* defect at will, is the whole point of having a right, and the key to the arguments of Douglass C. North and others that well-defined rights are necessary for sustained economic development to occur.[36]

If we adopt a strong definition of "rights," however, the Chinese case suggests that the spontaneous-rights thesis, while not necessarily wrong, has limits in a complex economy. Efficient economic organization doesn't just happen: there are powerful political forces opposed to it that can be overcome only by more powerful political forces. State intervention is just as necessary

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33. See Robert C. Ellickson, *A Hypothesis of Wealth-Maximizing Norms: Evidence from the Whaling Industry,* 5 J. L. ECON. & ORG'N 83 (1989); R. Zerbe, The Development of Institutions and the Joint Production of Fairness and Efficiency in the California Gold Fields (Right Makes Might) (May 8, 1990) (unpublished manuscript).

34. See R. Ellickson, *supra* n. 33, at 83.

35. See R. Ellickson, *supra* n. 33, at 95 n.39.

36. "[W]ithout institutional constraints, self-interested behavior will foreclose complex exchange [and the economic growth that it makes possible], because of the uncertainty that the other party will find it in his or her interest to live up to the agreement." DOUGLASS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE, AND ECONOMIC PERFORMANCE 33 (Cambridge Univ. Press, 1990). On the relationship between economic growth and property and contract rights generally, see *id.* and DOUGLASS C. NORTH AND ROBERT PAUL THOMAS, THE RISE OF THE WESTERN WORLD (Cambridge Univ. Press, 1973).

to a complex market economy as it is to a planned economy. Local governmental power made the Commerce Clause necessary in the U.S. Constitution; federal governmental power is needed to enforce it.

A second issue raised by the weakness of rights-enforcing institutions in China is the extent to which that observed weakness challenges the connection made by North and others between economic development and well-defined and enforceable rights of property and contract. The intuitive appeal of the hypothesis is undeniable: it seems beyond dispute that the unavailability or unenforceability of property rights is going to deter useful investment that would otherwise occur. Consider the predicament of the Chinese peasant interviewed below:

> When asked, Mr. Yang says that agricultural production and income could increase even further if the family made some irrigation improvements, terraced more of their land, and planted fruit trees. Mr. Yang, though, is unwilling to make such capital improvements to the land. The profits from such investments would only be realized after several years, and Mr. Yang considers his family's use rights to the land too uncertain. Although the local leaders told him they could use the land for at least fifteen years, the [Yang family's] land use contract has no such term. And Mr. Yang notes that his neighbors were required to give up a portion of their land, on which they had recently planted fruit trees, for a road. The neighbors received no compensation.[37]

One might interpret the much-vaunted consumption boom in the Chinese countryside as evidence of agricultural investments forgone for the reasons cited by Mr. Yang.

On the other hand, nobody who was in China fifteen years ago can doubt the reality of the tremendous economic growth and rise in prosperity that has occurred since that time. How can that undeniable fact be reconciled with the finding of this chapter that legal institutions remain essentially unreformed and ill-suited to the institutions of a market economy, that property and contract rights are not well defined and reliably enforced?

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37. Tim Hanstad, *The Effects of Rural Reforms on a Chinese Family,* RURAL DEVELOPMENT INSTITUTE REVIEW, Spring 1993, at 1, 2. In another work based on the same set of interviews, the researchers write:

> If land is taken, little legal assurance is afforded the farmer in obtaining compensation—either for the disturbance of his usership or for improvements he may have made in the land. It appears that only nominal compensation, if any, is given. . . . [T]he farmer will not keep the continuing benefit of long-term improvements. . . .

ROY L. PROSTERMAN AND TIM HANSTAD, LAND REFORM IN CHINA: A FIELDWORK-BASED APPRAISAL 37 (Rural Development Institute, 1993).

It is possible, of course, that this chapter is simply wrong: perhaps, despite surface appearances, legal institutions in China provide far more predictability and stability than they appear to.

Second, perhaps both the North hypothesis and the findings of this chapter are right. China's current growth could then be explained as taking place *in spite of* the absence of appropriate legal institutions. The tremendous advance over the prereform period is explained not as a function of how hospitable the current institutional structure is to economic development, but instead as a function of how unimaginably inhospitable and restrictive the prereform system was. The thunderclap of growth we have witnessed over the past several years is, in this view, nothing more than the air of entrepreneurship rushing in to fill a vacuum. It is, essentially, a one-time-only advance that will stall out when further gains from exchange can be obtained only from a division of labor and institutional complexity not supported by China's legal institutional structure.

Finally, the North hypothesis may simply be wrong: perhaps stable and predictable rights of property and contract are only a small part of the explanation of why economic growth occurs. It may be that while these rights matter at the margin, reasonably effective institutional substitutes are available and other factors are much more important contributors to economic development. Macauley, for example, demonstrated the discontinuity between contract law and the contracting practices of businesses in the United States; what mattered more to the parties than the law was that they were in a relationship that was beneficial to both.[38] According to this theory, I keep my promise to you not because of the threat of legal sanctions, but because I want to do business again, either with you or with those who would hear about any promises I broke.

This theory, of course, has its limits. If the promise of further business is the only glue that holds contractual relations together, then an entire class of necessary and useful contracts—those between parties who have no need or desire for anything more than a one-shot deal—will be unenforceable and thus discouraged. There are, however, reasons for thinking that in China this class of contract is relatively rare, and that therefore this problem is relatively unimportant, at least for the moment.

First of all, China's population is not very mobile. Although mobility has increased tremendously in the economic reform era, changing one's residence is still difficult. Therefore, a party who prepays on a contract has less reason

38. See Stewart Macauley, *Non-Contractual Relations in Business: A Preliminary Study,* 28 AM. SOC. REV. 55 (1963). On the theory of relational contracting, see Ian Macneil, *Contracts: Adjustment of Long-Term Economic Relations under Classical, Neo-Classical, and Relational Contract Law,* 72 NW. U.L. REV. 854 (1978).

(although not of course *no* reason) to fear that the other party will simply disappear with the money.

Second, only a small percentage of economic activity measured by value is conducted by individual entrepreneurs, with most of the rest conducted by units of government at various levels.[39] These are much more likely to be known quantities to a prospective business partner. Altogether, then, it may be that relational contracting can carry economic development in China a long way even in the absence of a well-functioning formal system.

A further question raised by the North hypothesis is whether we might expect to see not economic development as a response to institutional innovation, but rather institutional innovation as a response to economic development. Can demand create supply? Under this conjecture, the growth and increasing complexity of economic activity in China will eventually tend to generate the institutions needed to keep it going. The difficulty here is supplying a mechanism whereby demand elicits supply. Many societies in history would have been much better off with a well-developed legal system, but they didn't all get one.

The most plausible scenario may be one founded on the increasing power of regional governments coupled with an increased mobility of capital. While the central government has not so far shown much capacity for creating a set of institutions that can effectively enforce property rights, it may be more possible for the provinces (and perhaps governments at even lower levels) to do so. Why should they want to? The answer here lies in competition for resources. The region that provides the most hospitable environment for economic activity will reap the rewards of increased employment and tax revenues.[40] This may be one of the reasons behind the judicial cooperation agreements signed by Shanghai with several other cities in the late 1980s[41] and more recently by courts of several cities along the Yangtse.[42] The key to this

39. See figure 1 in Barry Naughton, *Distinctive Features of Economic Reform in China and Vietnam,* chapter 12 in this volume. A small percentage of output is attributable to joint ventures and wholly foreign-owned enterprises.

40. One should also note that in the absence of strong, *enforceable* central policies on environmental protection, such competition is likely to lead to severe pollution that "will make Eastern Europe look like a nature park." Ann McIlroy, *An Economic Boom Is Fuelled by Environment-Destroying Material,* Vancouver Sun, May 1, 1993, at B2 (quoting Western diplomat in Beijing).

41. See n. 31 *supra.*

42. *Xiang-E liushisi-jia fayuan lianshou gongpo yidi zhixing nan guan jian xiao* (Sixty-Four Courts in Hunan and Hubei Join Hands, Achieve Results in Overcoming the Problem of Executing Judgments in Other Regions), Fazhi ribao (Legal System Daily), July 24, 1991, at 1 (reporting mutual execution agreement among courts of several cities along the Yangtse); Peng Changlin, *Jianli jingji shenpan sifa xiezhu zhidu, xieshou gongke anjian yidi zhixing nanti* (Establish a System for Judicial Cooperation in Economic Adjudication; Join Hands to Conquer the Problem of Executing Judgments in a Different Locality), *Jingji fazhi* (Economic Legal System), No. 7, 1992, at 30–32 (enthusiastically praising same agreement).

scenario is that provinces must be independent enough to be able to offer meaningful differences in economic environment, but not independent enough to obstruct the free movement of capital.

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