

## **Promoting U.S.-China Business Relations**

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Donald Clarke, George Washington University Law School

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Thank you. That's a hard act to follow. I'm not sure I have quite the same ringing conclusion to come to. I'm pleased, I guess, to see that what I have to say is going to dovetail somewhat with what John was talking about. Indeed I think it's going to find many points in common with what John was saying. Maybe that suggests we're on to something or that we both have our heads buried in the same sand pile.

What I want to do today is to talk about certain features of the Chinese legal system that are of importance when you think about the future of China's emerging private sector. Again John highlighted the importance to his definition of the rule of law of the idea of a private party, that is, non-state controlled parties, and their ability to effectively put the machinery of the state into action in the service of their own goals. That's what would be called the vindication of a right. I'm going to suggest that the current system of China in many ways does not really meet the needs of the private sector primarily because China's legal system is both historically and under socialism overwhelmingly statist in orientation. For that

reason it serves private needs to a certain extent but only kind of incidentally. I think that the historical orientation explains many features of China legal system that are not found or found to a much lesser degree even in other socialist legal systems. Of course there are not very many socialist legal systems left.

First of all I want to put the legal system in a bit of social context because it's important to remember that other institutions may be of far greater importance to the development of the private sector, particularly economic development, than the legal system. There's a well-known hypothesis of institutional economics associated these days most prominently with Professor North, that robust rights of property and contract are necessary, a requisite to economic development. I do think though that the Chinese case suggests that some important qualifications to this theory are necessary because clearly informal and non-state institutions can go a long way toward providing the kind of security and predictability that investment requires, and even, I would suggest, in societies that think of themselves as having well functioning legal systems such as the U.S. it's really not clear to what extent these institutions are a necessary cause of economic development. I think we should bear in mind that it may be that these institutions are just kind of functioning decoratively alongside of other less visual institution that are making the real contribution. But at this point I don't want to go beyond simply stating these kind of familiar caveats and for the rest of the talk I want to elaborate on the statist nature of the legal system in China and the sometimes unexpected implications this has for the private sector. When I say statist legal system, I mean a legal system

designed -- to the extent that human institutions are the product of conscious design -- to serve the needs of the state. Even though it might well, as I mentioned, incidentally serve the needs of individual members of society, it does this somewhat as an incidental byproduct of serving of state needs.

Now of course it is not surprising to find the legal system that developed to serve the needs of a socialist economic order also has a statist orientation but I think the statism of China's legal system goes well beyond that of legal systems of the U.S.S.R. and socialist Eastern Europe. The legal systems of those countries trace their origins I think ultimately to Roman law, which was quintessentially concerned with disputes among individuals. Then they had to adapt the individualistic concepts of Roman law to the acts of state organizations and other collective bodies and that wasn't a simple task. But the legal system inherited by the Communist Party of China, on the other hand, was one that had always been driven by the needs of the state. If you look at the two great legal texts of the Qing Dynasty, the Da Qing Lü Li, which is the Statutes and Sub-statutes of the Great Qing, and the Da Qing Hui Dian, the Institutes of the Great Qing, these are both rules and procedures that are compiled for the guidance of officials, not for subjects to use in cite. Indeed, as everyone who has read even a couple of pages of Chinese legal history knows, it was unlawful in fact to offer advice to those wishing to bring complaints before the local magistrate. There's a well-known case, again among people who study these things, of a man who charged no fee at all for preparing a

litigation complaint and was nevertheless subject to punishment, so there wasn't even the notion of a kind of unauthorized practice of law.

While I think we can think of socialism in the economies of the former Soviet Union and Eastern Europe and the statism that came with it as a kind of a historically brief detour in the development of the fundamentally individualist legal systems of those states, on the other hand socialism in China served to reinforce the statist tradition of the Chinese legal system, and of course China has not undergone the same political transformation that we have seen in the post-socialist states of the former Soviet Union and Eastern Europe. So as a consequence the legal environment within which the private sector operates remained profoundly different.

One of these differences I think is what I would characterize as a kind of continuous nature of rights and not a binary nature. What I mean by that is in Western legal systems we think of rights as existing or not. One has a right or one does not or one should have a right or one should not, and this is how we carry on arguments about these things. Now in formal terms the Chinese legal is no different, but I think in practice one frequently encounters rights being treated as if they were continuous. In other words, they are treated as if they gave the holder a certain claim -- sometimes stronger, sometimes weaker -- against other competing interests that might or might not be characterized as rights, and whether the right holder wins will depend on the strength of the competing interest at any given moment. Now conflicts between rights are not unusual in any legal system and

legal decision makers of course have to make the choice. What I do think makes the Chinese system different is that instead of certain interests being elevated into the form of a right, one finds instead that rights or things that are characterized as rights are instead treated as just another kind of interest and weighed accordingly.

In the era of economic planning this view did not do any harm and was indeed maybe the only view possible. Who were the right holders? It wouldn't matter in the era of economic planning, government institutions, and state owned enterprises. Now in a dispute between state owned enterprises it makes sense for the state to impose a solution that maximizes the interests of everyone concerned and so the concept of a robust right really serves no purpose. Rights represent among other things a choice. It's a choice for the right holder that can be exercised or forgone or bargained away. When we think of it this way I think it's clear that this kind of right – this kind of autonomy -- makes no sense in a system of pervasive hierarchy. Why should an enterprise manager have the right to insist that screws of a certain quality be delivered if the system would work better by delivering slightly inferior screws at a much lower cost and then making just an appropriate downward adjustment in the manager's quality targets? Needless to say in an economy of private actors this view of rights could lead to a great deal of unpredictability and the danger of judicial arbitrariness and this kind of unpredictability could in turn discourage investment. As I have kind of hinted at before, I think that very often we'll find that predictability can be supplied by other

institutions and circumstances, but certainly I think this aspect of the legal system as opposed to other systems that are out there is going to persist for some time.

Perhaps again as a result of the Chinese legal tradition being reinforced by decades of socialism, Chinese courts also do not play anything like the role played by courts in industrial societies. This is not simply because they are weak, financially dependent on local governments and lacking in strong enforcement powers, although all of those things are true of course. It's because the Chinese political system in effect consigns the implementation of different types of rules to different bureaucracies, and courts are just one of many different bureaucracies. So courts have responsibility for enforcing rights under, let's say, the Inheritance Law, but at the same time their role in enforcing rights apparently granted under, for example, the Securities Law, is tightly constrained. Then in other cases, for example, when involving banks, rules giving the courts authority to tell banks what to do have to be signed off on in effect by the bank regulator, formerly the People's Bank of China and now the China Banking Regulatory Commission. So for example if a Chinese court proposes to seize the bank account of a judgment debtor, it has to do that pursuant to rules that have been signed off on by the People's Bank of China. Otherwise the bank will say, "Who are you? You can't tell us what to do." So courts don't have that same kind of overarching power.

Under traditional Chinese socialism there's a historical background here. Under traditional socialism the main object of the courts' jurisdiction was individual citizens. Disputes between state-owned enterprises simply were not handled by the

courts. They were handled by the time-honored method of disposition by a common administrative superior. You just keep on going up the administrative hierarchy until you find someone that has authority over both the disputants and that body resolves it. So it was not necessary to give courts powers to enforce judgments against large state-owned enterprises because courts would not be making these judgments. Courts needed only to be more powerful than ordinary citizens.

What happens when you get into the modern era, the era of economic reform? We find a lot of enterprises, particularly private enterprises, that really don't fit within the planning system anymore, they don't fit within the hierarchy. They don't have this kind of administrative superior that traditional state-owned enterprises have so there's no common superior that can impose this solution to their dispute. As a result courts are in theory the institution that is supposed to have this overarching power to impose a solution on two private enterprises without a common administrative superior, but their historical lack of power makes it difficult for them to do this.

Let me move now to the issue of how legal norms can get enforced. When I first started studying Chinese law it was relatively easy to know what was going on because there wasn't very much law out there. That's not the case now. Now as everybody knows China has been promulgating a flood of legislation from a vast variety of legislative and administrative bodies since the beginning of the reform era in 1979. It used to be possible to go buy books at bookstores for collections of

Chinese laws. It was a volume maybe about this big by the mid-80s, but it's simply not possible to do that any more.

What is the significance of all this legislation? I think it can be understood only if we understand how these norms are enforced, if at all. I just want to canvass very briefly three main channels. We can think about citizen-initiated actions through citizen organizations. We can think about state-initiated actions through state organizations. It's just the state monitoring what's going on and then exercising some sort of power. Then finally we can think of citizen-initiated actions through state organizations. I want to discuss these in reverse order.

Now I suppose the paradigm case of citizen-initiated action through a state organization is people going to court. It's private parties attempting to use the machinery of the courts to realize their goals, to exercise their rights. As I've suggested before, courts in the Chinese polity are relatively weak actors, and so they are less able, I think, than courts in many other societies to serve as vehicles for the implementation of legal norms in private litigation. The government is not eager to foster a kind of private attorney-general system in which the legal system deliberately rewards private parties for bringing lawsuits that further the goals of public policy. In this country we have, for example, treble damages for private parties with antitrust suits and that's a very deliberate attempt by the state to enlist the resources of private parties in policing antitrust violations and in bringing antitrust violators to book. There are very few areas in which Chinese law does this.

The Consumer Protection Law has a system like this. It attempts to set up a kind of a reward system and there is a man named Wang Hai who is famous in China for using this system to make money. Some people think this is a terrible thing. Other people think this is a great thing. But that's exceptional in the Chinese legal system. By and large the state wants to keep the initiative in its own hands. For example, early efforts by corporate shareholders to enforce certain norms of the Securities Law through litigation were thwarted by a series of Supreme People's Court rules issued from 2001 through 2003 that simply made up a requirement that's completely absent from the Securities Law, and what they said was that the actual plaintiff must first have been punished through court action, in a criminal conviction, or by some state administrative agency. So essentially the Supreme People's Court would say you may sue for, in this case, misleading disclosures, but you have to get a key to the courthouse first and that key can only come from previous government action. That was their way of trying to control private litigation.

Let me turn now to other government agencies. Courts aren't the only state actors that might respond to citizen prodding, but it's important to keep in mind that the kind of prodding that is available is only that of disorganized individual citizen discontent, and not organized pressure or from pressure groups, because the Chinese government remains very suspicious of any organizations that are not under the control of the state. So much so that in 2003, for example, the Minister of Civil Affairs issued a list of proscribed organizations that included unauthorized

fishing clubs and associations for the study of antique furniture and paper cutting. That's the degree to which the central government concerns itself about these things.

We can also think about state action through state organizations. That's the type of action that the state is most comfortable with. The government agencies decide on their own to implement state norms. There're a number of problems, not insuperable problems, but certainly problems we should keep in mind to monitoring the implementation of state laws in that way. One is that government agencies in charge of policing certain norms have a vested interest in their violation, so local branches of China's Environmental Protection Bureau, for example, live by the fines they impose. It's a kind of eat-what-you-kill method of budgeting. They have an interest on one hand in finding violations where none exist, and at the same time they have no interest in closing down genuinely frequent violators since that would cut off the source of income. What we see is a kind of continuing bargaining process between these environmental protection bureaus and the entities they regulate, in which they are allowed to continue polluting provided they keep paying a kind of a fine to the Environmental Protection Bureau.

Second, the rulemaking powers of government are often very unclear. This of course is not necessarily a fatal defect. We will never get complete clarity in any legal system. I think what's somewhat special about the Chinese legal system is that it doesn't supply an effective way of clarifying these powers through testing either in a court system or in some other kind of administrative system. For

example, the Chinese Securities Regulatory Commission, the equivalent of China's SEC, has very limited powers over matters not involving securities but it's taken it upon itself to issue a number of regulations pertaining to internal corporate governance.

At the time, for reasons that I don't completely understand -- and I receive contradictory answers about it when I ask Chinese scholars about this -- it doesn't always wish to openly assert its power to make these regulations, and so it attempts to have the companies under its jurisdiction internalize the norms in question by writing them into their articles of incorporation. In other words, instead of telling companies that certain kinds of transactions must be approved by a majority of independent directors on the board, it will issue a regulation purporting to require companies to amend their articles in the association so that such a rule is written into their articles of association, and the implicit threat is that companies that don't go along may find their next application for share issuance rejected.

Now in theory a company could bring an administrative lawsuit. Let's suppose you are a company that doesn't go along with this arguably excessive assertion of authority by the CSIC. You then apply to issue stock, over which they do unquestionably have power. They reject your application because you didn't go along with what you believe is an unlawful assertion of power. You can bring an administrative lawsuit against the CSIC for rejecting your filing on what ought to count as legally irrelevant grounds but to the best of my knowledge no company has ever done so. The reasons for this are quite complex but the simple point is simply

that the regulatory power of agencies remains in a kind of uncertain twilight and subject to considerable bargaining between agencies and regulated bodies.

Now in the days when the state sector was dominant, agencies such as the CSRC would function as one branch of the state and try to perform the mission with respect to another branch. Bargaining and power balancing was simply a natural and normal part of this. In the new era of the emerging private sector, I think the old ways are no longer enough. The political bargaining between state and actors, state agencies, is not adequate. On the other hand, a good substitute has not yet emerged.

Finally citizen action through citizen organizations: As I suggested at the beginning, it's important not to overlook the potential role of civil society's institutions playing roles not played by the legal system. For example, in the United States, it's difficult even here for creditors to achieve low-cost and reliable enforcement of claims against debtors through court action. It's very, very difficult, so they rely on non-state institutions -- for example, credit reporting agencies -- to assess the creditworthiness of the borrower before lending the money and hopefully thus forestalling the need to go to court at all.

In China, however, the growth of non-state institutions in response to market demand is severely hindered by the state's suspicion, that I spoke of, of uncontrolled organizations, especially in the case of information. So a number of non-legal institutions that we take for granted that are, if not essential, at least highly conducive to this new functioning of the economy -- institutions like credit reporting

agencies and an independent and reliable financial press, private arbitration organizations – a number of these institutions are stunted or non-existent in China, not because there's no demand for them but because it's the intended result of a deliberate policy.

At this point -- and not just wrapping up here -- we can return to the caveat and the theme with which I began. The theme is that the Chinese legal system because of its heavily statist tradition from both the Imperial and Socialist eras is not well adapted to dealing with the needs of an individualistically oriented private economy, and the caveat is that the inadequate legal institutions don't necessarily matter a great deal to the private sector if there are adequate substitutes. Unfortunately it's the statist orientation of China's legal system that has also erected barriers in the way of creation of adequate substitutes. Thank you very much.