

The rule of law in China

China's rapid growth seems to have been achieved without formal contract and property rights. But as China moves to a market economy, the rule of law will become increasingly important for continued growth. By **Ding Chen, Simon Deakin, Mathias Siems and Boya Wang**

IT IS NOT easy to draw lessons for the world economy from the recent turbulence in China's stock markets. The Shanghai and Shenzhen stock exchanges are small in relation to the overall size of the Chinese economy, and equity financing has played a limited role, so far, in supporting the growth of Chinese firms. There are longer-term trends in the Chinese economy and business practice which we need to consider when trying to understand China's growth path. One of these is the role of institutions which underpin markets and commerce, including the legal system.

At first sight, China's rapid growth over the past three decades has been achieved without contract and property rights of the kind which have underpinned the growth of the economies of the global north since the beginnings of industrialisation. But that does not mean that contract and property rights have played no role in China's growth. Although the Chinese constitution only recently acknowledged a right to property, Chinese law had already recognised individual interests in real estate and personal property.

In its pursuit of a law-based society, China does not claim to follow the 'rule of law' in the western

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sense. The legal system is formally subordinate to the party-state and to the objectives it pursues. These objectives have changed over time and can now be summed up in the goal of instituting a 'socialist market economy'.

Can a market economy be created by central planning? Some critics of the Chinese model have argued that Chinese capitalism, like capitalism elsewhere, has developed 'from below', and that the over-strong party-state is now getting in the way of further growth.

Others take a different view, arguing that the absence of a western-style legal system need not be a problem for China. Middle-income countries will grow more quickly if an activist state substitutes for the legal system in providing a stable framework for private enterprise.

A further factor in China's growth is the practice of interpersonal trust or 'Guanxi'. Many think formal legal enforcement of contracts and property rights is unnecessary where social

networks and reputation provide a basis for commercial dealing.

There is an element of truth in each of these positions, but they are in danger of mischaracterising the role of the Chinese state. They also downplay the dark side of Guanxi, which is often indistinguishable from corruption.

The emergence of legal systems was important to the rise of the West, but it is a mistake to associate the rule of law with a small state or one that simply 'gets out of the way' of business. At the core of the rule of law is the practice of applying legal norms in an objective and neutral way, without regard to differences in the status or wealth of those to whom legal rules are addressed.

A central idea in the evolution of the rule of law in liberal societies is that of the public-private divide. This cuts both ways. The state acknowledges a private sphere which is beyond the reach of government. The other aspect of the rule of law is that the public sphere is protected from the market. We should recall that Magna Carta proscribed not just the denial or delay of justice, but also its sale ('to no one will we... sell justice').

The 'rule of law state' (as it is described in the civil law or continental European legal tradition) is not synonymous with weak government. On the contrary, by limiting its own powers, the state ensures that where it does act, it can do so more effectively.

One of the lessons of history is that market economies cannot function without an effective state. Government was needed to provide the institutional infrastructure of exchange in the market economies of the West. ►





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- State capacity is partly a function of the resources available to government, but also of the legitimacy of government action. Behavioural studies show that lack of general respect for legal rules is correlated not just with the level of economic development of a society, but also with the presence of democracy.

This is the weakness inherent in the model of 'authoritarian capitalism' which some scholars have used to explain China's growth. Authoritarian states sometimes appear strong, but in certain crucial respects are weaker than democracies because their governments often lack legitimacy. The state can intervene extensively in the private sphere, but has also limited defences against takeover by vested interests. States of this kind, once captured by private interests, tend to rely on force and corruption to achieve their goals. Corruption may facilitate one kind of co-ordination between economic agents who know each other well and trade with each other on a regular basis, but it creates deadweight costs for private enterprise.

Reliance on interpersonal trust to substitute for law also has its limits. The dark side of Chinese Guanxi is the exclusion of outsiders from access to business networks. Markets based on impersonal trade, or exchange between relative strangers, generate scale and scope effects not available where trade depends on personal ties. Impersonal trade requires a legal system which can guarantee the neutral enforcement of contract and property rights.

For the past two years, as part of research funded by the ESRC's Rising Powers Programme, we have been carrying out fieldwork in China, as well as collecting and analysing statistical data on the role of the law in contract enforcement.

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Three findings stand out. The first is that Guanxi is playing a reduced role in governing economic relationships. Contract formality is becoming more important as the economy matures. This is particularly the case in sectors characterised by the influx of capital from Hong Kong and overseas sources. It is also a feature of fast growing sectors such as software and biotechnology. More traditional sectors such as construction, and those with a still preponderant role for state-owned enterprises, continue to place greater stress on Guanxi.

The second finding is that there is pent-up demand for the rule of law. Entrepreneurs and managers increasingly expect the courts to enforce contractual agreements in an objective way, without regard to personal contacts or network ties. Many of the businesses we spoke to said that they nevertheless had more confidence in the courts of their own city or district than those based in other regions of cities in which they have invested.



Traditional sectors such as construction continue to place greater stress on interpersonal trust.

The third finding is that businessmen and women in China associate the rise of the market with the decline of traditional forms of trust. There is a belief that as markets deepen, prices will become more transparent. This belief is stronger in the case of product markets than in the case of the financial markets, although some investors think financial markets will become more transparent over time.

Our econometric evidence points in the same direction. Using data which tracks differences in the institutional framework of different Chinese provinces, we found that the listed companies based in regions with more effective court systems and a better record of protection of contract and property rights were better able to weather the financial shock of 2008.

China is undergoing a transition to a market economy which has momentous significance for the wider global economy. There are many myths associated with this transition, not least concerning the role of institutions in China's growth. Our research suggests that China's legal system is developing as part of the shift towards capitalism, and is playing a significant role in fostering confidence in impersonal, market-based exchange. This is not to say that China's developmental path will be identical to that of the West. The idea of the 'rule of law with Chinese characteristics' continues to shape official discourse in China. How the legal system evolves in coming years may tell us a good deal about the long-term prospects for the Chinese model. ■



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