

Rule of Law in China: Chinese Law and Business

Regulating Enterprise: The Regulatory Impact on Doing Business

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in collaboration with

The Centre for Socio-Legal Studies,
University of Oxford

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Executive Summary

This special report examines the regulatory impact of doing business in China from a variety of angles and across a variety of subject areas.

- Adopting a neo-institutional approach, **Andrew Mertha** of Washington University demonstrates how organizational politics, institutional structure, administrative hierarchies, overlapping jurisdictions, competing agency interests, and tensions between the central government and local governments have impacted on intellectual property developments.
- **Lou Jianbo** of Peking University argues that real estate reforms, while leading to considerable improvement in urban housing, have been driven by competing policy objectives that at times have undermined efforts to provide adequate housing to all urban residents.
- **Terry Halliday** of the American Bar Association claims that attempts to balance market efficiency and social stability have undermined insolvency laws in the past, and will increase legal uncertainty in the implementation of the recently passed Enterprise Bankruptcy Law.
- **Mark Williams** of Hong Kong Polytechnic University contends that the passage of an Anti-Monopoly Law may impede the transition to a more robust market economy by providing the authorities with the means to protect domestic firms from foreign competition.
- **Peng Xiaohua** of the Asian Development Bank argues that effective implementation of the Anti-Monopoly Law will require a political framework, not provided for in the current draft law, for resolving policy issues and addressing bureaucratic rivalry.
- **James Zimmerman** of Squire, Sanders & Dempsey suggests that the government's efforts to promote unions and to pass a labour contract law are driven by political concerns to shore up Party discipline, and may have a negative impact on foreign investment in China.
- **Randy Peerenboom** notes that the Supreme People's Court often acts like a legislative body in issuing various forms of interpretations and opinions, and yet has not kept pace with the general reform trend to increase transparency and public participation in the law-making and rule-making processes.
- **Yuka Kobayashi** of Oxford University finds that while China, as a new member of the World Trade Organization (WTO), is still learning the ropes, accession to the WTO has provided an impetus for legal reforms and the establishment of a 'commercial rule of law'.

Introduction

These policy briefs are the result of conferences held in Hong Kong and Beijing in the summer of 2006 on the regulation of business in China, which were sponsored by the Foundation for Law, Justice and Society, an independent think tank affiliated with the Centre for Socio-Legal Studies of Oxford University. The participants addressed a wide range of subjects, including recently issued and yet to be promulgated draft laws and regulations in the areas of bankruptcy, anti-monopoly, real estate and labour; as well as developments in mergers and acquisitions, telecommunications, corporate social responsibility, dispute resolution, intellectual property, banking and financial governance, and the impact of China's accession to the World Trade Organization (WTO) on legal and economic reforms.

The eight policy briefs included here address several major themes and topics, including the methodology of reform and the suitability of different approaches to regulation; the impact of political, social and economic factors on legal reforms and vice versa; the influence of bureaucratic rivalries on implementation; the increasing diversity of economic actors and the rise of interest groups with clearly defined and oftentimes competing agendas; and the impact of economic globalization on the domestic regulatory system and the pushback from domestic actors, including foreign businesses, when it comes to international policies and practices that are not in their interests.

The first brief by **Andrew Mertha** takes up the contentious issue of intellectual property (IP) rights. China has been much criticized for failing to implement rules for the protection of IP rights. Whether China is significantly different in that regard from other lower-middle income countries is debatable.¹ However, the size of the China market,

the amount of money at stake, the ever-increasing trade deficits with the United States and Europe, and China's rising superpower status have led to intense pressure on China to strengthen implementation.

Yet implementation of IP rules depends on a variety of factors, as Mertha shows. In his discussion of policymaking and implementation in the IP area, he provides a more general framework for understanding regulation and implementation from a neo-institutional perspective. Regardless of the area of law, certain general principles apply in China, and for that matter, elsewhere.

Firstly, administrative rank is an important factor in understanding relations between bureaucracies and regional governments. This is true in all countries, but especially true in China. At the same time, the complexity of the organizational structure, combined with other factors that affect the relative power of various government entities, may present challenges to foreign investors seeking to determine the ultimate decision-maker.

Secondly, as is also true elsewhere, one must follow the money to determine the incentives and disincentives of the enforcement agency. Agencies are likely to compete over functions that generate revenues, while shifting responsibility to other agencies for other functions.

Thirdly, implementation is affected by shifting trends in decentralization and recentralization.

Fourthly, the scope for action of subordinate authorities depends on their relationship to superior or host units in the administrative hierarchy, and the resources and personnel available to them.

Fifthly, given the relatively weak state of institutional development in China and the constant change in institutional configurations, personal power matters. Strong individuals may wield power beyond what would be construed from perusing government organization charts.

1. The fairness of the intellectual property regime has come under increasing criticism given that the regime, foisted on developing countries as a condition for admission to the WTO, results in a huge transfer of wealth from poor countries to a handful of rich countries. See, e.g., Stiglitz, J. (2006) *Making Globalization Work: The Next Steps to Global Justice*. Oxford: Oxford University Press.

Mertha demonstrates how these factors have limited implementation of IP rights in China, while also creating opportunities for sophisticated players to obtain better protection of their IP rights.

Lou Jianbo takes up another area of great interest to foreign investors and domestic investors alike: real estate. The government has created a three-tier system to address the problem of urban housing. High-income and upper-middle-income families purchase at market prices commodity housing with transferable granted land-use rights. Middle-income and low-income families purchase, at cost, affordable housing with non-transferable allocated land-use rights. The lowest-income families are provided subsidized low-rent housing. While the three-tier system has resulted in improved living conditions for most urban residents, problems remain.

Complaints about housing at the high end have centred on speculation and controls on supply by developers that lead to excessively high prices. In the middle, poor supervision and ambiguous incentives have led to allocation problems. At the bottom, the lack of resources devoted to low-rent housing has resulted in a housing shortage for the least well off.

The response has been a barrage of regulations, many of which directly affect foreign investors and residents. Developers are required to provide smaller, more affordable units. New rules have sought to control the supply of land and make sure adequate compensation was paid to those from whom land was requisitioned for development projects. To cool speculation, interest rates have been raised repeatedly, and taxes imposed on the transfer of land and housing. Foreign investment real estate companies have also been subject to a number of restrictions, and foreigners resident in China for more than one year limited to the purchase of a single primary residence.

Lou concludes that the new rules will not adequately address the housing needs for all urban residents. In his view, the government has pursued a number of goals, some of which are in tension with each

other, including the desire to provide adequate housing, to cool the overheated real estate market, and to regain control over land takings and the revenue generated from the sale of land-use rights.

The pursuit of multiple and oftentimes incompatible goals has also undermined legal certainty in enterprise insolvency. As **Terry Halliday** points out, for the last twenty years the government has attempted a variety of approaches that sought to fulfill two potentially incompatible goals: restructuring or liquidating companies as viable economic enterprises, while at the same time maintaining them as safety nets for workers. A complex regulatory regime emerged consisting of piecemeal regulations imposing different rules on state-owned enterprises (SOEs) and private actors, with some economic actors left uncovered. The need to balance incompatible goals left administrators with considerable discretion. The result was legal and practical uncertainty.

The 2006 Enterprise Bankruptcy Law (EBL) addresses the problems by providing a unified framework for enterprise insolvency. On its face, many of the controversial debates seem to be resolved in favour of creditors and international best practices. The scope of the EBL was expanded beyond SOEs to cover other financial institutions and other corporate forms. Unlike in the 1986 EBL, as of 1 June 2007, workers' claims are assigned a lower ranking, behind secured creditors. The new EBL also provides for two forms of restructuring, one similar to the English concept of composition, and the other to the American concept of reorganization. Moreover, restructuring and liquidation procedures will be handled by private actors rather than state agencies.

However, as Halliday demonstrates, the tension between a socialist *market* economy and a *socialist* market economy remains, with the likely result being continued legal and practical uncertainty as administrators are left with considerable discretion in balancing market demands for efficient insolvency proceedings with concerns for equity, including the fate of laid-off state-owned employees, and the government's overriding concern for social stability.

Thus, he concludes, 'the political bargain that permitted the passage of this law appears to be a compromise in which the law can be allowed to work, so long as it does not threaten particularly sensitive national or local political interests.

Mark Williams and **Peng Xiaohua** discuss the draft Anti-Monopoly Law and the conditions for its successful implementation. Williams argues that an essential precondition for the successful implementation of a competition law is an ideological commitment to a market economy. He claims that such a commitment is lacking, pointing to continued government intervention in the market, numerous policies that favour SOEs and the existence of administrative monopolies in key sectors.

Despite various reforms that have led to greater market access in some industries, the breaking up of monopolies in others, and SOE reforms, Williams argues that problems of competition continue in sectors where the state is still dominant, as well as from the abuse of administrative powers.

He concludes that the adoption of an Anti-Monopoly Law at this stage of development is inappropriate and may impede the development of a market economy, since the law may be, 'selectively or mendaciously employed as a trade weapon to protect domestic markets or domestic producers' by those in authority who see competition law, as part of an 'overarching industrial policy to promote "national champions" through mercantilist means'.

Peng, Principal Counsel at the Asian Development Bank, notes that in a developing country undergoing a transition to a market economy such as China, many competition issues are inextricably tied to other development and reform issues, including SOE restructuring, labour reforms, industrial policy, foreign investment, anti-dumping rules and intellectual property protection. Like Williams, he believes that, for the Anti-Monopoly Law to be effectively implemented, a policy framework must be created and institutionalized to harmonize the different areas and interests. This policy process would bring

together regulators from different sectors. Peng does not discuss the particular institutional configuration of this body, although he notes that it would require high-level support to be successful.

Yet one still wonders what type of body would have the authority to compel compliance from different ministries and industries seeking to further their own interests, as is all too common in China. As Williams points out, in the thirteen years since the central government began work on an Anti-Monopoly Law, all attempts to create a single high-level body capable of enforcing the law have been undermined by bureaucratic rivalry, with various sectors seeking exemption from the law. Indeed, the latest draft of the law is noticeably vague about what body would enforce the law and its administrative rank, attesting to the difficulty of achieving consensus on this issue. Recalling Mertha's general principles, the failure to specify a high-ranking body to enforce the law does not bode well for future implementation.

James Zimmerman discusses recent developments in labour unions and the draft labour contract law. He notes that the government has strongly encouraged the establishment of unions in foreign-invested enterprises. Although foreign-invested enterprises established by large multinational corporations generally have high labour standards, there have been many reports of labour violations in smaller foreign-invested companies. While the drive toward unionization may have been intended to strengthen protection for labour rights, and thus consistent with the government's broader policy of a 'harmonious society', Zimmerman places greater weight on the desire to strengthen Party discipline. He suggests that both foreign employers and local employees would object to the newly established unions using their powers to advance the Party line.

He also notes that the initial version of the labour contract law, which was largely the product of the All-China Federation of Trade Unions, would have greatly expanded the powers of unions. However, after a round of public comments from foreign investors and their representatives, including

the American Chamber of Commerce (AmCham) in China, as well as from domestic companies, union powers were curbed and a number of provisions in favour of employees scaled back.

This prompted the US Congress to rebuke the foreign business community in China for attempting to hinder the development of Chinese labour rights, a move which Zimmerman, currently the President of the American Chamber of Commerce (AmCham) in China and at the time the Chair of the AmCham Legal Committee, contends was ill-advised.

Randy Peerenboom points out that courts in China today often act like legislative bodies, making new law by issuing interpretations of laws that are binding on the courts. The general trend in China has been toward more transparency and greater public participation in the legislative law-making and administrative rule-making processes. In contrast, the judicial interpretation process is less transparent with significantly less room for public participation. The Supreme People's Court's Second Five-Year Agenda suggests, however, that positive reforms may be forthcoming.

Finally, **Yuka Kobayashi** notes that China's accession to the WTO has had a significant impact on legal and economic reforms. However, she rightly cautions that it is still very early in the process, and that China is still in the learning phase. She also rightly cautions that there are likely to be conflicts going forward given the high expectations of China's trading partners, the often vague and abstract language in WTO agreements and the nature of China's socio-legal system.

Regulation of business in China raises a number of issues, some of them universal, some of them specific to China, and some of them universal but with local nuances. As in all developing countries, many of the controversial social and policy issues are at bottom economic in nature, and attributable to insufficient resources. The lack of resources limits the ability of the government to provide adequate housing for low-income residences; the lack of a sound welfare system causes authorities to move cautiously in restructuring or liquidating insolvent

SOEs lest the ensuing massive lay-offs lead to social disturbances; and, as in other developing countries, the political economy weighs against strict adherence to IP rules, which results in a massive transfer of wealth from poor to rich countries.

More generally, there is a strong correlation between wealth and the rule of law and other good governance measures.² Accordingly, China's performance is perhaps best judged in relation to other countries in its income class. By that measure, China does reasonably well, outperforming the average lower-middle income country on rule of law, regulatory quality, government effectiveness and political stability, but lags behind in controlling corruption.³

Reforms since 1978 have undoubtedly resulted in major changes affecting virtually all aspects of the legal-political system. Although beyond the scope of this report, reforms have led to significant changes in Party-state relations, state-society relations, and to major governing institutions including the people's congresses, the judiciary, the procuracy, police, the legal profession and the administrative law regime.⁴

Nevertheless, institutions remain weak in comparison to those in developed countries, as is typical at this stage of development. As several of the contributors observed, bureaucratic rivalry has also undermined predictability, and in some cases hindered implementation of rules. In addition, central-local tensions have complicated enforcement, as local

2. Wealth is highly correlated with good governance indicators such as government effectiveness ($r = 0.77$), rule of law ($r = 0.82$), and control of corruption ($r = 0.76$). Wealth is also highly correlated with human rights and other indicators of human well-being, including civil and political rights ($r = 0.62$), social and economic rights ($r = 0.92$), women's rights as measured by the Gender Developmental Index ($r = 0.93$) and even physical integrity rights, though to a lesser degree ($r = -0.40$).

3. Kaufmann D., Kraay, A. and Mastruzzi, M. (2006) 'Governance Matters V: Governance Indicators for 1996-2005'. World Bank paper.

4. See Peerenboom, R. (2002) *China's Long March toward Rule of Law*. Cambridge: Cambridge University Press; Peerenboom, R. (2007) *China Modernizes: Threat to the West or Model for the Rest*. Oxford: Oxford University Press.

officials, promoted primarily on the basis of their ability to ensure economic growth and social stability, pursue rapid growth in any way possible, even if that means circumventing or simply violating national laws, regulations and policies. As in other countries, the simultaneous pursuit of conflicting policy goals has also undermined implementation, as government officials are then free to pursue the goals that further their interests.

In terms of economic policy, the general trend has been for greater openness, despite a variety of restrictions on foreign investment. Indeed, China has been one of the most open developing economies in the world. Its average tariff rate of 10% is much lower than that of Argentina (32%), Brazil (31%), India (50%) and Indonesia (37%). Its ratio of imports to gross domestic product (GDP) is almost 35%, compared to 9% for Japan. China has also been more open, and relied more heavily on foreign direct investment, than South Korea, Japan or Taiwan. In 2003, the ratio of the stock of foreign investment to GDP was 35% in China, compared to 8% in Korea, 5% in India and 2% in Japan.

Whether the trend for openness will continue remains to be seen. Foreign businesses must now also compete in the policymaking arena with increasingly assertive domestic interest groups pushing their own agendas, including representatives of labour, professional services such as lawyers, and large national industries. As in other countries, there is also a notable trend toward a rising nationalism seeking to resist globalization. This nationalist sentiment is fuelled by the perception that other countries are engaging in unfair trade practices and protectionism. Advocates of this view point to the invocation of surge mechanisms and the reliance on anti-dumping cases to protect US and European industries from imports of Chinese textiles and other products; the US government's rejection on national security grounds of the sale of Unocal to a Chinese

company; as well as the general failure of the Doha Development Round of WTO negotiations to address the imbalances in the international trade regime that have resulted in widening income gaps between rich and poor countries.

Some commentators claim there are already ample signs of a retrenchment, including new restrictions on automobile manufacturers to encourage local brands and stimulate domestic product development; restrictions on foreign banks' expansion of retail branches; limits on large-scale retail outlets; recent telecom rules that make it difficult for foreign companies to control International Communist Party companies established in China through an offshore vehicle; the limitations on foreign-invested real estate companies and the push to establish unions in foreign-invested enterprises discussed above; and the championing of national companies and the potential misuse of an Anti-Monopoly Law as a mercantilist tool to prevent market access by foreign competitors as discussed by Williams.

On the other hand, China has by and large lived up to its WTO commitments to increase market access in key industries such as banking, insurance and financial services. It has taken steps to reduce the red tape to establish a business in China, simplified the approval process and made it easier to establish wholly foreign-owned enterprises in many industries. It has also passed an insolvency law, which at least on its face is remarkably creditor friendly, and represents a defeat for labour.

In short, as throughout the entire reform period, the government continues to adopt a gradualist approach driven by pragmatic experimentalism rather than neo-liberalism or any other clearly defined economic ideology. With an average annual growth rate of ten per cent since 1978, and China consistently among the top three destinations for foreign investment, the results, at least thus far, have been impressive.



The Foundation

The mission of the Foundation is to study, reflect on and promote an understanding of the role law plays in society. This is achieved by identifying and analysing issues of contemporary interest and importance. In doing so, it draws on the work of scholars and researchers, and aims to make its work easily accessible to practitioners and professionals, whether in government, business or the law.

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The main objective of the programme is to study the ways in which Chinese law and legal institutions encounter and interact with the social environment, including economic and political factors, at local, regional, national, and international levels.

The Foundation's perspective in pursuing this objective is that of entrepreneurs considering investment in China, the lawyers advising them, executives of an international institution or non-governmental authority, or senior public officials of another country. The combination of this objective and our particular perspective constitutes a unique approach to the study of the role of law and its relationship to other aspects of society in China.

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