

**Rule of Law in China: Chinese Law and Business**

# Traps, Gaps, and Law: Prospects and Challenges for China's Reforms

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## Executive Summary

- It is unwarranted or too early to conclude that China's transition is 'trapped', legally and politically. Judging the level of China's political and legal reform and development, and whether it is adequate to the challenges it faces, is problematic. Cross-national metrics for rule of law, good governance, economic inequality, and democracy tell us little about whether China's level of legal development is consistent with continued growth and political stability.
- China is a flawed unit of analysis. Because much of Minxin Pei's argument is about China as a whole, he risks implying a relatively uniformly 'trapped' transition and understating the crucial diversity in law and legality in China.
- The notion of a 'trapped transition' also risks implying, unpersuasively, that the success of China's ongoing transition can be discerned from how closely China follows a single, relatively linear path towards a particular endpoint that will resemble modern Western states with developed market economies, liberal-democratic politics, and full-fledged rule of law.
- Among the most significant challenges for China's legal reforms are several 'gaps': a gap in implementation between the law on the books and the law in practice; a regional gap between the developed coastal cities and the hinterland, posing challenges of maintaining legal and institutional coherence and integration; a gap between formal laws based on 'foreign models' and 'Chinese realities'; and a gap between an 'instrumentalist' and a more 'rule of law'-like or 'institutionalized' notion of law.
- This last gap is perhaps most fundamental. It separates the once adequate but narrowly instrumentalist conception of law and legal institutions from a more encompassing conception of the rule of law that accepts, in principle and practice, the autonomy and authority of the law and legal institutions even where they bring unwanted consequences for the economy, politics, or the powerful.
- If China fails to close or manage these gaps well, it could face a 'trapped transition', but one with legal aspects that are more complex than Pei's account suggests.

## Traps, Gaps, and Law: Prospects and Challenges for China's Reforms

### *Is China in a 'trapped transition'? How would we know?*

Minxin Pei presents a provocative account of ways in which political, legal, and economic reforms have encountered difficulty in China. He argues that the once stunningly successful strategy of reform is falling into a paralysis of partial reform, inherent in its gradualist approach. Weak laws and legal institutions are a major part of the problem, whether as cause or symptom. The result imperils China's long-running economic miracle and, in turn, the Chinese Communist Party regime's political viability.

Pei rejects some common arguments: that China has undertaken impressive economic reform while ignoring political and legal reform; that this gap will close as law and politics catch up with economics; or that this gap will bring crisis as the 'contradictions' between a dynamic economy and sclerotic polity become unsustainable; or that this gap can endure because China has found an alchemy of resilient authoritarian politics and internationally open, market-based economics.

Much turns on whether Pei's, or others', scenarios are right. At stake are the prosperity, stability, and prospects for democracy and the rule of law in China, and beyond. Several considerations suggest that it is unwarranted or, at least, premature, to conclude that China's transition is 'trapped'.

### *Assessing the levels of legal and political reform and their adequacy*

Judging the levels of China's political and legal development, and whether they are adequate to the challenges China faces, is problematic. Pei's pessimistic answer marshals an impressive range of data, but is, in the end, qualitative. Other qualitative assessments, which also find support in relevant data, reach very different conclusions.<sup>1</sup>

Broad cross-national metrics tell us something about China's level of rule of law, democracy, or governmental capacity, but they still may say little about whether that level is consistent with continued growth, political stability, and an 'untrapped' transition.

Two examples illustrate the limitations of global comparisons. A literature in the political sciences assesses 'strong' and 'weak' states. But this analysis maps poorly onto degrees of governance. The US, for example, is cast plausibly as having a weak state, but one that provides a high degree of governance. A literature in political economy associates a high level of inequality with political instability. But states that have similarly worrisome Gini Coefficients vary widely in political stability and capacity.

A more finely tuned comparative analysis might provide more insight, but problems remain. On a prominent rule of law measure, China ranks above average when compared to countries of a similar income level. China is behind the culturally similar but economically more developed East Asian countries. Compared to the post-socialist states, China ranks above the former Soviet Union but trails Eastern Europe. China also lags behind its most common contemporary comparator, India. Countries with levels of income or inequality similar to China's have disparate rankings on the rule of law.<sup>2</sup>

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1. Examples or descriptions of these views include Bruce Gilley, *China's Democratic Future* (Columbia University Press, 2004); Merle Goldman and Roderick MacFarquhar, 'Dynamic Economy, Declining Party-State', in *The Paradox of China's Post-Mao Reforms* (Harvard University Press, 1999); Gordon Chang, *The Coming Collapse of China* (Random House, 2001); Andrew J. Nathan, 'Authoritarian Resilience', *Journal of Democracy* 14:1 (January 2003); James Mann, *The China Fantasy* (Viking, 2007).

2. World Bank, *World Governance Indicators 1996–2005*; Daniel Kaufmann, Aart Kraay and Massimo Mastruzzi, *Governance Matters V: Governance Indicators for 1996–2005*.

More qualitative comparative assessments do not bring much resolution either. Within the East Asian model, that until recently appeared to offer a paradigm for development without democracy and that has appealed to China's reform-era leaders, there has been such diversity among legal systems as to strain the model's coherence. Japan from the Meiji Restoration through the Occupation Constitution, Taiwan under martial law, Korea under military dictatorship, Singapore under a single party-dominant regime, and Hong Kong under British rule differed profoundly in ordinary measures of the rule of law such as government under law; autonomy of the judiciary and legal profession; courts that resolve economic disputes and handle civil liberties fairly; and publicly known, relatively stable, and consistently applied laws.

The diversity within the East Asian legal experience and the complex correlation between democracy and the rule of law show that legal and political reform cannot be lumped together. For democracy, China has rankings far below its near-median rank on rule of law.<sup>3</sup> Indeed, a key strategy of the Chinese leadership has been to use law as a substitute for democratic politics and as a means for performing functions that democracy often serves: checking misbehaviour by officials that threatens economic growth, holding wayward or abusive officials accountable, and permitting public input into governance. In sum, it is not clear that China's level of legality is low, or insufficient to sustain transition. Economic inequality, lack of democracy and cross-national 'rule of law' comparisons tell us little about the adequacy of China's law, legal institutions, and political order.

### ***China as a unit of analysis***

'China' is a problematic unit of analysis. Legality and governance are strikingly uneven across the country.

Shanghai is a world away from Chongqing, and several worlds away from a rural county in Henan or Guangxi. Pei recognizes this. But much of his evidence and argument concern China as a whole. By inferring a general and relatively uniform 'trapped' transition, he risks underemphasizing the intranational differences that pose some of the greatest challenges to China. The problems facing China, including those implied by the legal and political shortcomings Pei discusses, vary more in character and severity than Pei's aggregate assessment suggests.

### ***Trapped locution?***

The notion of a 'trapped transition' risks implying that there is a single path, and that China faces a crisis to the extent that it strays from that path. In practice, however, progressive change may come in fits and starts, or with sharp, if temporary, reversals. Moreover, transition from the dysfunctional system of the late Mao years, or any other starting point, may not ineluctably dictate transition to a particular end state. It may be misguided to follow current global conventional wisdom and assess China's transition in terms of its approximation of, or pace in moving towards, an outcome that resembles contemporary states with developed market economies, liberal-democratic politics, and full-fledged rule of law.

Even if the endpoint of a successful transition is, predictably, a country that is rich, stable, market-oriented, democratic, and governed by law, knowing the endpoint does not tell us how countries that lack these attributes acquire them, or how to evaluate a transition while it is in progress. The weakness of 'transitology monoculture' is evident from the comparative histories of today's developed states, the countries associated with the East Asian model, and the fragments of the former Soviet bloc.

Pei appreciates that the paths of transition, especially in law and politics, depend on many factors, including elites' choices. He limits the risk of the endpoint fallacy by keeping his concept of a trapped transition functionalist, focusing on the

3. Ibid.; Economist Intelligence Unit, *Democracy Index 2006*; Jacques delLisle, 'Chasing the God of Wealth while Evading the Goddess of Democracy' in *Development and Democracy* (Sunder Ramaswamy and Jeffrey Casson, eds., University Press of New England, 2003).

regime's ability to deliver law and governance adequate to maintain growth and stability. Nonetheless, this rhetoric brings risks as well as power. To invoke the ubiquitous discourse of 'transition' is to take on the baggage that comes with the terminology. This includes risks of implying excessive linearity and homogeneity in the process, judging current circumstances in comparison to an idealized post-transition endpoint, and setting a misleadingly high bar for what a 'non-trapped transition' requires. To some extent, this problem is inescapable. Our reference points inevitably are past transitions and present paragons that may not exhaust the range of possible successes and failures. The loaded rhetoric of 'transition', however, is not the best means of avoiding error in the analysis.

This does not establish that we should assume a rosier view than that which Pei advances. It does, however, cast doubt on his claim that China's transition is trapped, and on our knowledge of its being so. It also suggests that the challenges facing legal or legal-political reform in China likely differ from those Pei emphasizes.

### ***'Gaps' and prospects for China's legal-political reforms***

#### ***The implementation gap***

The most commonly noted problem for legal development and the rule of law in China is the gap between the law in principle and the law in practice. The law on the books in China is too often not effectively translated into law in reality.

In some respects, this predicament has worsened as China's legislation and regulations have improved. Chinese reality has moved impressively toward a more sophisticated, market-based, and property rights-recognizing economy, and more tentatively toward institutionalizing, monitoring, and limiting the exercise of governmental authority. Changes in the formal legal rules have moved in the same directions much more rapidly, contributing to the implementation gap. The Contract Law of 1999, for example, is more friendly to market principles,

protective of party autonomy, and familiar to contract lawyers from market economies than the Economic Contract Law of 1981 or the revised version of 1993 were. The Company Law of 2005 more closely resembles analogous laws in developed capitalist systems than did its 1993 predecessor and the 1980s laws and regulations governing enterprises. Administrative litigation, procedure, reconsideration, licensing, and compensation laws and rules adopted since the late 1980s replaced the near-vacuum that preceded them. The revised versions of the Criminal Law and the Criminal Procedure Law during the mid-1990s removed provisions that raised the most obvious concerns about residual Maoism and disdain for due process values.

These and other laws that regulate key substantive areas are sometimes under-enforced, whether due to overly ambitious content of specific laws or a more general lack of will or means. The implementation gap affects, although unevenly, a full range of legal areas, including contract, company, administrative, and criminal laws, as well as laws governing intellectual property, village elections, property expropriation, employment rights, and many other subjects. Enforcement of court judgments is also a problem. The reasons for this are many, including rational decisions by parties to settle, judgment-proof defendants, limited enforcement resources, poor training of judges and other officials, resistance from officials or defendants, local protectionism, ideological opposition to the laws' content, conflicting or unclear legal and policy mandates, and corruption, including in the courts.

The implementation gap also extends to the legal rules for making legal rules. The chasm has closed somewhat between the institutions and procedures prescribed in the constitution and laws and the informal mechanisms that play large roles in shaping laws and exercising governmental power. The National People's Congress, for example, has assumed a greater role in fashioning legislation. Effects include delaying and prompting the revision of major laws, including, recently, bankruptcy and property laws. Ministries and their peers in the state

hierarchy became and remain key actors in making laws that are relevant to their portfolios. Courts play a larger and more conventionally judicial role than they previously did. Such developments are significant, but still leave the increasingly regularized system oblique to formal ideals.

Three other gaps also contribute to the challenges facing efforts to strengthen law and legality.

### *Developed China and the hinterland*

Legal 'gaps' are among the intranational disparities that make China the wrong unit for analyzing whether China's transition is 'trapped'. Some evidence indicates that reliance on *guanxi* and other substitutes for markets has waned, and that use of contracts and formal legal standards has grown, more in places like Shanghai than in less developed and cosmopolitan regions. The distribution of lawyers in China shows similar regional differences. Law firms with well-educated attorneys are concentrated in Shanghai, Beijing, and the other major coastal cities. Clients, both foreign and domestic, consider it worthwhile to pay high fees for their services in drafting agreements, researching regulations, seeking opinions and approvals from state agencies, and asserting legal rights in dispute resolution procedures.

The quality, as well as the quantity, of judicial talent is unevenly distributed. For example, nearly 90 per cent of the judges in Shanghai have full college degrees, and roughly a third of judges on the high and intermediate courts have graduate law degrees. Their counterparts in the poorer inland areas do not have these credentials. In low-level courts, outside the top cities, many judges lack legal education, and receive only modest on-the-job training. These interregional disparities in educational and professional levels are broadly paralleled among officials serving in law-related posts in other branches of the Party and state apparatus.

Notwithstanding the corruption scandals that have shaken Shanghai, Beijing, Xiamen, and elsewhere over the last quarter of a century, it is widely acknowledged that the debilitating effect, if not

the dollar value, of corruption is worse in the hinterland than on the gold coast. Several factors give credibility to this conclusion. In the more fully marketized economy, the opportunities for rent-seeking through gatekeeping are reduced. In the more developed urban centres, officials face greater risk of scrutiny and demands for law-conforming behaviour from anti-corruption investigators, administrative law suits, emergent media, and foreign investors, who may lobby their governments. The vast, diversified economies of the major coastal cities produce fewer of the entanglements between officials and dominant enterprises that fuel local protectionism and what Pei terms the predatory state.

Another indicator of the regional gap in legality and governance is the limited impact of policies designed to draw foreign investment to inland China.

Despite the inducements such policies offer and the lower cost levels in targeted regions, outcomes have been disappointing. Some of the difficulty stems from poor infrastructure, low-quality inputs, thin local markets, and remoteness from richer markets. Weak laws and institutions also receive much of the blame, however. The 'second tier' cities that have emerged as foreign investment destinations are ones in which the institutional infrastructure and commitment to law are seen as relatively strong.

Even the laws on the books vary significantly from place to place. Sophisticated, market-supportive, and international-style laws are more common in China's developed coastal jurisdictions. This legal diversity is potentially a mixed blessing, allowing adaptation to local circumstances but threatening the coherence of the wider legal order. The lack of effective methods for managing this variety is a clearer cause for concern. Lawmaking power remains national in principle. Delegation to local organs is limited, discretionary, and often ambiguous. Local laws' inconsistency with higher national ones can be addressed by legislative review, but this rarely occurs. There are no regular and reliable mechanisms to resolve the status or meaning of existing regulations or local laws when new laws, especially national statutes, are adopted to address the same subjects.

Compounding these difficulties is rampant de facto decentralization, as Pei notes. As frustrated central authorities and outside observers lament, local protectionism is a chronic economic and political problem. In addition, local officials often are disconcertingly unresponsive to central directives on a wide range of issues that include implementing tax laws, regulating business enterprises, providing compensation for expropriated property, enforcing intellectual property laws, quashing corruption, and enforcing other criminal laws. These phenomena produce some of the most troubling intranational variations in laws' efficacy and impact.

### *Foreign models and Chinese realities*

Overly ambitious adoption of foreign models sometimes leads to ineffective laws. Such attempted borrowing has become an increasingly important cause of the implementation gap. It also sometimes produces laws that are inferior to more modest and indigenous alternatives as means to desired ends. These difficulties can weaken respect for law generally. That would be a serious problem in China, where respect for law is still fragile.

Recent laws on economic matters illustrate the pattern. The 1999 Contract Law accords a large role to 'reasonableness', adopts 'anticipatory breach', and narrows formerly broad state interest exceptions. The revised Company Law and Securities Law of 2005 add or expand notions of fiduciary duties for directors and officers, derivative suits, appraisal and other shareholder rights, liability for securities misrepresentation, and obligations to guarantee accuracy of disclosures. These laws show influence from, or convergence toward, developed capitalist, especially Anglo-American models. The principal motivation for such changes has been the hope that such laws would do for China what they appeared to do in their countries of origin: strengthen markets, promote economic efficiency and the mobilization and allocation of foreign and domestic capital, and redress problems of corporate governance.

Such legal transplants are dauntingly difficult, however. As many commentators have noted, the

practical meaning of these borrowed legal terms remains unsettled. Legal contexts and institutions, such as judicial precedents, autonomous and experienced courts, expert and professional enforcement agencies, specialized bars, and scholarly commentary, which have given the terms meaning in US or UK law, do not yet exist in China.

Those institutions and other complementary actors, such as institutional investors, strong financial and business media, and experienced managers and independent directors, are not available to give the provisions clear content and make them effective in the Chinese context.

China's World Trade Organization (WTO) accession demanded extensive revisions of many laws to meet international standards or replicate foreign models. This too has not gone smoothly. Other WTO members have complained vociferously about China's implementation of these obligations and have filed for formal dispute resolution. These controversies also have fueled doubts about China's broader commitment to the rule of, or even by, law.

Laws addressing political issues have suffered from similar, indeed larger, implementation gaps. Influences from abroad have been weaker in these areas, but China's lawmakers still have borrowed significantly from external models, partly in response to foreign criticisms and expectations. Examples include expanding constitutional articles and legislation that promise rights and democracy, revising criminal law provisions that raised human rights concerns, adding a human rights provision to the constitution, signing major UN human rights conventions, and amending the constitution to give greater status to private property.

Legal borrowings and the difficulties they create interact with the gap between coastal and hinterland legal development. The most developed areas have tended to be the early adopters and testing points of laws, especially economic ones, derived from abroad. Also, large and dynamic enterprises in the most developed areas are more connected to the international economy through investment and trade.

Those links provide another less formal, but powerful channel for the regionally uneven influence of foreign legal models.

The gaps between foreign-influenced formal law and intranationally varied law in practice are likely to remain a significant challenge even though they are partly the products of alterable political choices. Although there are obvious costs to choosing some legal changes that follow international norms, scaling back borrowing is still difficult in the face of beliefs about such reforms' positive economic effects, pressure and advice from abroad, and the inertia from earlier legal reforms that have looked to outside models.

### *Instrumentalism and institutionalization*

Perhaps the most fundamental but elusive gap is between a relatively narrow instrumentalism, consistent with the first waves of legal reform, and the very different attitudes toward law and legal institutions that are consistent with a full-fledged rule of law.

From the Third Plenum of the Eleventh Central Committee's sixteen-character slogan ordering greater attention to and respect for law, through the Jiang Zemin-era call for 'ruling the country by law and building a socialist rule of law state', to Hu Jintao's prescriptions for a state that is based on law and safeguards citizens' rights and interests, the regime has emphasized law. Beyond such rhetoric, the regime has relied on law and courts to articulate and advance major policies and restrain excesses of the state and private actors. Law has been seen as a vital means to promote market-oriented growth, to limit actions by Party and state functionaries and others that threaten economic progress or political order, and to provide channels for public articulation of grievances and preferences that might otherwise breed unrest or pressure for democracy.

Much of this legal reform is consistent with a Leninist vision, in which laws and legal institutions are merely means to substantive ends of economic development and authoritarian rule, and are justified to the extent that they advance those ends.

Whether the regime can advance beyond this to the 'rule of law' depends partly on one's definition. In many accounts of the rule of law, key elements include judicial and constitutional review, an autonomous judiciary, legal accountability of public officials, and effective mechanisms to keep government and political institutions within the bounds of legally defined powers. Meeting that standard requires accepting the autonomy and authority of laws and legal institutions, in spite of any unwanted consequences for the economy, politics, or the powerful. Foundations for a model that is more open to these principles have been emerging among reformist intellectuals, including lawyers; among inhabitants of state institutions, including the courts; and from China's increasingly complex, developed, and internationally open economy and society. If Pei is correct about the regime's resistance to basic reform and its inability to adjust course, pressures from such key constituencies and markets are even more essential for change, as well as potentially threatening to the regime.

There are troublesome signs in recent developments. Lawyers in the rights protection movement and defense counsel who represent those being prosecuted for criticizing regime behaviour have faced increased harassment and sanctions. Some official sources and senior leaders have called for limiting the power and autonomy of China's legal system, given its vulnerability to exploitation by foreign and domestic forces that allegedly try to undermine China's socialist order. Regime responses have been tepid or ambivalent when faced with scattered judicial efforts to make constitutional provisions directly operative, to strike down local laws for inconsistency with higher laws, and to entertain class action-like suits over securities fraud or property rights. Proposals to centralize court finances and lines of authority, so as to undermine local protectionism, have gained little traction.

Such disquieting episodes, however, should not overshadow the ongoing and recently reaffirmed elite commitment to legal development.

That commitment has survived and perhaps grown even while it has imposed losses, and generated opponents, among formerly powerful institutions and sectors. For example, in economic law, some reforms have helped level the playing field between foreign and domestic enterprises and between state-owned and private firms. Others have exposed formerly sheltered state enterprises to painful competition in domestic and overseas markets for goods and capital. Such reforms and changes in public law challenged the political and economic power of, and therefore had to overcome resistance from, formidable Party and state organs that once directed the economy and controlled enterprises at national and provincial levels.

Finally, a 'merely' instrumental commitment to law may be enough to move meaningfully toward the rule of law. Principled commitments to the rule of law are rare even in polities that score well on 'rule of law' metrics. This still does not mean that China's task is easily accomplished. It is no small matter to move from a relatively narrow instrumentalist notion of law to a 'second order' instrumentalist conception of legality that accepts significant law-created losses, redistributive effects, and constraints on the state as bearable costs of achieving desired ends.

### ***Minding the gaps***

Given China's growing international importance and the significant threats these gaps pose to China's future, closing the gaps where possible, and coping with them where not, are matters of great and global concern. Part of the answer lies in material and technical resources: to build institutions more capable of implementing and drafting laws and policies; and to reduce economic, institutional, and legal disparities.

Coping with the inter-regional gaps may mean a move toward federalism, in a double-edged and delicately balanced sense: establishing a quasi-constitutional grant of lawmaking powers to sub-

national units; and enhancing the national government's authority to impose uniformity where it is needed, for example, to satisfy WTO commitments, rein in fiscal indiscipline, or ameliorate Party and state actions that foster popular unrest.

Addressing the gaps that stem from foreign legal borrowing may require cultivating currently weak complementary institutions. It may also entail rehabilitating the argument that laws must suit Chinese conditions. Recent trends suggest capacity and will for correction and, indeed, possible over-correction. Factors supporting those trends include China's rising economic power and the resources and leverage it creates, China's complaints about the asymmetry and pain of WTO commitments, and Beijing's moves to articulate a 'Chinese model' that can provide developing countries with an alternative to the Washington Consensus.

The gap between China's current legal order and an institutionalized rule of law may be more intractable and require a more fundamental alteration of views among powerful political actors. Although the obstacles are formidable, several factors are favourable to such change and should not be discounted: prestige of ideals about the rule of law; foreign influences favouring particular types of reform; support from influential domestic constituencies; the momentum of prior rounds of legal reforms; and emerging beliefs among elites that such changes need not imperil stability or the Party's monopoly of power, or that, despite their riskiness, they are needed if China is to escape a trapped transition.

If inadequately addressed, the gaps in law facing the Chinese regime today could become features of a trapped transition. But that conclusion is, at best, premature, and the potential traps are more complex than is implied by a simple notion of stalled or backsliding legal reform and stagnant or deteriorating legal institutions.



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