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Rule of Law in China: Chinese Law and Business

Is China Trapped in Transition?

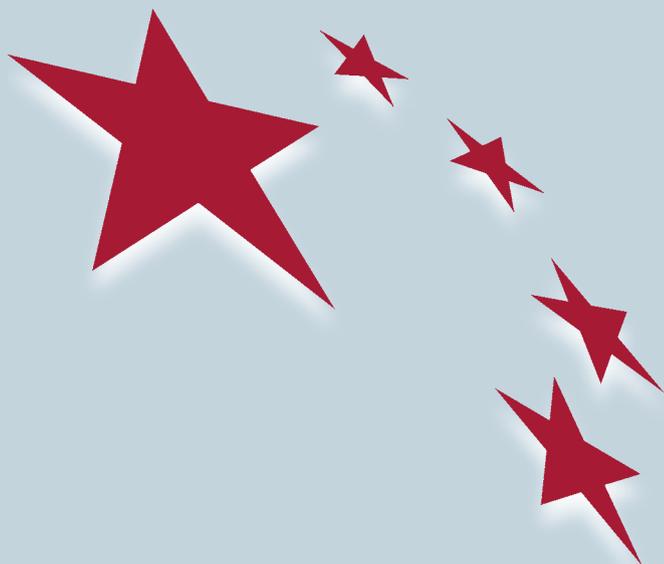
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Executive Summary

- This special report examines the thesis that China's transition is stalled. **Minxin Pei**, one of its main proponents, opens the discussion by summarizing his arguments in *China's Trapped Transition: The Limits of Developmental Autocracy* (Harvard University Press, 2006). The subsequent briefs examine Pei's thesis that China is caught in 'partial reform equilibrium' by considering political, economic, governance, legal, banking, and foreign investment reforms.
- **Joseph Fewsmith** argues China's political system will resist democratization, and that this will distort patterns of growth and governance. Nevertheless, China's political system is more capable of confronting established interests and of adapting to changing circumstances than the trapped transition thesis would maintain.
- **Barry Naughton** takes issue with claims about economic stagnation. He argues that China's economic system is more capable and resilient than ever before.
- **Dali Yang**, while acknowledging the governance challenges, argues that there has been progress in social development and economic change. Major efforts to construct a modern regulatory state have paid dividends in increased transparency, efficiency, and fairness of the state.
- **Randall Peerenboom** argues that it is too early to conclude that China is trapped in transition. By following the East Asian model, China has made remarkable progress, outperforming the average country in its lower-middle income class on indicators measuring rule of law, good governance, and human development.
- **Jacques deLisle** similarly concludes that the jury is still out on legal reforms. There are formidable obstacles to the full realization of the rule of law in China, but a number of factors suggest that reforms will continue.
- **Michael Dowdle** raises several methodological issues which challenge fundamental assumptions in Pei's argument. The standard frameworks used are based on developed countries that have successfully made the transition. Judged by those standards, developing countries will fail. But then, he points out, by the same measure, the US would have failed at a similar stage of development.
- **Victor Shih** notes that the banking system has improved significantly. However, the well-being of the financial sector remains intimately linked with the communist party-state. Thus, the key indicators for the future of China are political.
- **Lester Ross** finds that although the rate and proportion of increase of foreign direct investment have declined, market access and new forms of foreign investment continue to expand. Reaction against foreign investment has been largely sector-specific rather than systemic.
- In response, **Minxin Pei** focuses on the meaning and logic of the partial reform equilibrium in a decentralized and predatory authoritarian state. He considers the standards and benchmarks for assessing whether China is in fact trapped in transition, and the crucial issue of whether its gradualist approach has been successful.

Is China Trapped in Transition?

Introduction

These policy briefs are the result of a workshop held in Oxford in March 2007, sponsored by the Oxford Foundation for Law, Justice and Society, which set out to examine whether China is trapped in transition, as has been claimed by Minxin Pei, among others.

The briefs address several major themes. What are the appropriate standards, indicators, or benchmarks for determining whether a country is trapped in transition? How does China compare with other countries at a similar level of development? Has China's gradualist approach to reforms been successful, or has it delayed the day of reckoning? Or worse still, has it locked China in a trap, where entrenched vested interests are able to block further reforms? Why do so many countries, after an initial period of rapid growth and reform, experience the 'middle-income blues'? What lessons can be learned from Europe, America, or the East Asian countries that have successfully overcome them? What should China do to ensure that the reforms do not stall, given its particular circumstances? What would be the consequences for China and the world if China were in fact trapped in transition?

Summary of the propositions

Minxin Pei

Minxin Pei opens the discussion by presenting four perspectives on reforms. First, liberal evolution, where economic reforms result in stronger institutions, the rule of law and liberal democracy. Second, authoritarian resilience, where the Chinese Communist Party (CCP) retains power for some time, by adopting reforms and co-opting important factions. Third, imminent collapse, which pundits

have repeatedly, and incorrectly, predicted for much of the last twenty-five years. Fourth, authoritarian stagnation, the perspective favoured by Pei.¹

Pei believes that while the CCP is resilient in its ability to suppress anti-regime forces, it is incapable of restraining the predatory behaviour of the lower-level elites who, he claims, enjoy 'unprecedented discretionary power and near-total unaccountability'. China is therefore trapped in a partial reform equilibrium because there is now need for deeper, particularly political, reforms. Yet, the elites benefit from the status quo and oppose more radical reforms that would undermine their power and privileges.

In support of his thesis, Pei notes that much progress on political reform occurred in the 1980s and 1990s. The political climate has since become considerably cooler for NGOs and others advocating deeper political reforms. Economic growth has slowed, while state control and intervention in the economy remain high, even increasing in some areas. Corruption remains rampant.

The consequences of China's trapped transition are dire. Maintaining the status quo will lead to an accumulation of social strains and governance deficits such as rising inequality, pervasive

1. There are other alternatives, including authoritarian resilience with ongoing reforms, leading eventually to a communitarian or other nonliberal variant of democracy. Peerenboom argues that economic reforms will continue to provide the material basis, and lead to broad-based demands, for reforms in other areas, as they have in other successful East Asian states. In that sense, the experience of East Asian countries is broadly consistent with modernization theory. However, the experiences of East Asian countries also suggest that the current ruling party will be able to adapt and remain in power for some time. Moreover, while China is likely to democratize, it will probably not become a liberal democracy. See Peerenboom, *China Modernizes: Threat to the West or Model for the Rest?* (Oxford University Press, 2007).

corruption, deterioration in social services, and environmental decay. While Pei does not predict imminent collapse, he does suggest there will be increased political instability. The current situation is unstable and unsustainable. He also suggests that foreign governments will become increasingly impatient with the slow pace of political reforms, and engage in strategic hedging in their relations with China.

Political reforms

Joseph Fewsmith is sympathetic to Pei's argument on stagnant political reforms. He finds support for Pei's thesis that economic growth has provided the state with the resources to repress societal challenges and distribute patronage, thus delaying political reforms and creating governance deficits that have distorted China's socio-economic growth and undermined social justice. He notes that the Leninist features of China's political system largely remain: controls of the media, personnel selection, and the police.

However, he cannot reconcile Pei's dark depiction of a rapacious predatory state spiraling out of control with China's robust economic growth. Pei's thesis cannot explain the many changes adopted in recent years to respond to precisely the same governance deficits that Pei identifies. Fewsmith attributes these changes to the greater resources available to the central government as a result of reforms to the fiscal system, and to policy changes introduced by the Hu–Wen administration. Whereas the Jiang administration emphasized aggregate economic growth, Hu and Wen have placed more emphasis on sustainable, 'people-oriented' development, and on reducing environmental degradation and social inequality as part of an effort to establish a 'harmonious society'.

Fewsmith identifies several inhibiting factors, including elite attitudes that emphasize administrative reforms rather than democratization: the lack of grass-roots demand for democracy from a citizenry that is largely satisfied with the steady improvement in their standard of living and trusting

of the government, and urban resistance to extending the vote to the rural masses. He concludes that China's system will resist democratization for a substantial period of time, which does not mean however that democratization will not occur, or that China is trapped in transition. Rather, the transition may be proceeding slowly.

Economic reforms

While mostly agreeing with Pei's discussion about the limits of political reform, Barry Naughton finds that Pei's analysis of the economic situation inverts the reality. Whereas policymakers were indecisive through the mid-1990s, unable to push through reforms in the face of opposition from powerful entrenched interests, the government has since tackled many difficult problems, including downsizing state-owned enterprises, forcing the military to sell off its interests in commercial enterprises, abolishing allocations of foreign exchange and the dual-tier foreign exchange system, and, most importantly, regaining central control over the fiscal system through tax reforms. Moreover, the government has taken aggressive action to address grain procurement, the banking system, and telecommunications, in each case, adopting policies that limit monopoly power and enhance competition.

Further, China has engaged in a systematic process of building government capabilities, strengthening institutions, and investing in human capital. The government has also begun to restructure the state-owned sector to improve accountability and deliver dividends to the government, to increase central government oversight of local land transactions and transparency, and to rebuild rural education and health systems.

These developments bode well for the future. However, current policies are still far from optimal. Existing problems, if unresolved, could imperil future growth. There is a need for stronger institutions, including a better property rights regime, and a system of accountability that ties economic decisions more closely to the individual decision-makers

responsible. Many of these issues will be decided on political grounds. Nevertheless, at this point China is progressing economically.

Good governance

Dali Yang notes that perspectives on reform are likely to depend on how the role and transformation of the Chinese state is viewed. In particular, the 'developmental school' sees strong state involvement as a positive influence on the economy, whereas the 'distorted-market school' considers a large role for the state as an obstacle to further market-oriented reforms. Pei's argument, which relies heavily on the claim that the elite have a vested interest in maintaining the status quo, is consistent with the distorted-market perspective.

Yang observes that contrary to the image of being inept, corrupt, and out of touch, the government has overcome several major crises, including Tiananmen Square in 1989, the fall of communism in the former Soviet Union and Eastern Europe, the Asian financial crisis in the late 1990s, and SARS in 2003.

Simultaneously, it has responded to many governance deficits and pursued a wide range of reforms to rationalize governance, limit rent-seeking, increase efficiency and fairness, and improve the investment environment for foreign and domestic companies.

Such reforms include the streamlining of government; an overhaul of the administrative approval and licensing systems; the divestiture of businesses operated by the armed forces, government entities and Party organs; the establishment and strengthening of regulatory agencies; budget and financial management reforms; and the introduction of competitive mechanisms for government procurements and land allocation. Whereas Pei and others suggest that corruption is worsening, Yang argues that efforts to curtail corruption have paid off, and that China fares better than per capita GDP predictions would imply.

While acknowledging the problems, Yang however questions Pei's assumption that the cause is an authoritarian and predatory state. Many such

problems are found in democratic developing countries as well. He concludes by reminding us that many developing countries would gladly catch the same 'pathologies of transition' that have produced double-digit growth rates, significant reductions in poverty, and dramatic improvements in human development.

Legal reforms: rule of law and development

Noting that indicators of the rule of law and good governance correlate highly with wealth, Randy Peerenboom suggests that China's performance is best judged relative to other countries in its lower-middle income class. By that measure, China is doing reasonably well. It performs better than the average country in its class on the rule of law, and reasonably well on most other core indicators of good governance. Moreover, the perception that China's legal system, as a whole, deteriorated between 1998 and 2004 is incorrect, as demonstrated by a wide range of reforms that have altered virtually all aspects of the legal-political system.

China has made considerable progress by following the East Asian model, adapted slightly in the face of twenty-first century realities. Certainly, China is entering a crucial stage of the reform process. Many countries are able to show initial improvement in terms of economic growth, institutional development and good governance, given low starting points. However, once they reach the middle-income level, they become bogged down. Deeper reforms are required, which require bold and progressive leadership. While only time will tell if China will be as successful as Japan, Taiwan, South Korea, Singapore, and Hong Kong, the country's progress to date, and the positive experience of these other East Asian countries, provide some grounds for optimism.

Legal reforms: institutional change and fundamental norms

Jacques deLisle raises several methodological issues that caution against firm conclusions about China's transition. These include inherent limits in linking the existing level of development (economic, political,

governance, legal) with potential for further reforms. There are weak links between the type of regime, the rule of law, economic growth, and diversity, even within successful East Asian countries. The reliance on subjective surveys to generate rule of law, good governance and democracy indexes, and the wide diversity within China militate against generalizations about the political, economic, and legal system, especially when much of the evidence is anecdotal in nature. He also cautions against the teleological assumption that the endpoint of reforms must necessarily be the same version of liberal democracy and the rule of law as found in Europe and America.

deLisle highlights an implementation gap between the law on the books and its actual practice; the wide differences in the quality of the legal system in economically developed regions and their poorer counterparts; and the incongruities that arise in transplanting laws, institutions, and practices between the different contexts of developed Western countries and China. The biggest challenge will be 'moving from a narrowly instrumentalist conception of law and legal institutions to one that accepts, in principle and practice, their autonomy and authority even where they bring unwanted consequences for the economy, politics or the powerful'. deLisle concludes that while the obstacles are formidable, the forces for change are powerful.

Legal reforms: constitutionalism

Michael Dowdle cautions against the assumption that constitutional development is linear, and that China will or should necessarily end up with a constitutional system that replicates rich Western liberal democracies. Moreover, there is wide institutional variation within Western liberal democracies.

Although Dowdle acknowledges that China is facing serious obstacles to reform, he questions whether we can conclude that it is destined to fail, given that other countries faced similar problems at a similar stage of development, eventually managing to overcome them. The existence of problems tells us little, if anything, about the capacity for change.

Dowdle believes that there is ample evidence of capacity for constitutional development, including the development and heightened awareness of constitutional norms, an increased interdependency between the state and civil society that has created the space for the emergence of a constitutional discourse, the rise of 'constitutional litigation', and the increased professionalism and authority of the National People's Congress and courts. He also notes that the CCP is neither monolithic nor omnipotent, and that there are considerable internal and external pressures to improve the legal system and develop a constitutional order.

Banking and financial sector

Victor Shih concurs with Naughton that China has been successful in reducing non-performing loans, and in reforming the banking industry and financial sector more broadly. He partly attributes the improvements to high growth rates, which made re-capitalization possible, but also to regulatory improvements, including the creation of a Banking Regulatory Commission, which has helped to control the rise of new bad loans.

However, he notes that fundamental reforms of the financial sector are still required. He recommends deposit insurance and further strengthening of monitoring mechanisms. In addition, the government must allow the domestic private sector into the banking business.

Shih doubts, however, whether the government will have the political will to undertake fundamental reforms, given that senior leaders appear determined to maintain control over the banking sector and to limit foreign competition so that they can continue to use banks to pursue policy and political outcomes. These policy goals include propping up state-owned enterprises, stimulating growth through investment in large infrastructure projects, supporting rural development, and addressing environmental degradation and regional inequality.

Foreign investment

Lester Ross observes that although foreign direct investment (FDI) has been and continues to be subject to various limitations, the overall trend has been towards greater openness. In fact, China remains one of the most open developing countries, and one of the leading destinations for FDI, along with the US. Moreover, although the rate of increase of FDI has declined in recent years, other forms of foreign investment have increased: venture capital, private equity, and public market share purchase. The decline in the proportionate share of FDI to total investment in recent years is due mainly to the rapid increase of domestic investment, spurred, in part, by the success of foreign investment.

Ross notes that there have been a number of recent regulations that restrict foreign investment, including the introduction of rules restricting mergers and acquisitions, and prohibiting or limiting investment in key industries that affect national security or the national economy, such as defence, electric grid and power, oil and petrochemicals, telecommunications, coal, civil aviation, and shipping. However, these regulations have been accompanied by greater access in other areas. On balance, opportunities for foreign investors have expanded.

Ross disagrees with Pei's argument that foreign investment has contributed to a stalled transition in China. According to Pei, the government invited foreign investment because foreign investors were politically weak and less threatening to the ruling elite. Moreover, foreign investment has contributed to economic growth, thus providing the Party with the wherewithal to co-opt the populace and avoid fundamental reforms that would challenge entrenched interests.

Ross agrees that economic growth has enhanced state capacity. However, the result has been positive overall. Enhanced state capacity has led to a more professional, transparent, and efficient government. Moreover, foreign investment has led to significant positive social change, including a more politically aware citizenry, less swayed by party ideology.

Foreign investment has served as a model for the diffusion of norms, policies, and institutions throughout government and society. In short, it has been, and will continue to be, a positive force for social, economic, legal, and political change.

The complex reality of China today

Contemporary discussions about China tend to be overly polemical. One is either a dragon slayer, panda hugger, a China basher, or a Chinapologist. As this set of papers demonstrates, the reality is more complex. Attempting to come to grips with such a large developing country as China presents difficulties in dealing with the conflicting evidence. There is a lack of clear standards for assessing performance, and a dearth of successful models. The workshop participants found much value in Pei's analysis and considerable common ground, as well as areas of contention.

Progress since the 1970s reforms

First, there is general agreement that China has made significant progress in many areas since reforms began in the late 1970s. At the same time, there are still many problems, some of which will require more fundamental reforms than the ruling elite has been willing to countenance so far.

Second, there is general agreement that China's success to date is no guarantee of success in the future. However, while everyone agrees that China's reform project could fail, there are different views as to the likelihood of that happening, and what is required to ensure that reforms succeed.

Democratization

Identifying the problems is typically easier than coming up with feasible solutions: even if we were to agree with Pei's analysis, what would be the proposed remedy? Pei attributes many of the problems to the authoritarian nature of the ruling regime. However, as others point out, it is doubtful whether authoritarianism is the cause of many such problems, given that they are also found in developing democracies. Aware of the burgeoning literature on the shortcomings of third-wave

democracies, many of which perform considerably worse than China in terms of good governance, the rule of law, human rights, and other indicators of human well-being, Pei seems reluctant to propose democratization as the solution to China's ills. Indeed, a survey of the factors that usually contribute to the successful consolidation of democracy – a reasonably high level of wealth, strong institutions, elite commitment to democracy, cultural values that promote tolerance, civility and compromise, a robust and democratically oriented civil society – suggests Pei's prudence is justified.

International relations

Notwithstanding the foregoing, Pei advocates that foreign countries pursue a policy of critical engagement to promote political as well as economic change, not shying away from discussions of human rights and other controversial matters. It is true that foreign countries have in the past adopted more confrontational approaches towards China, including on human rights, with little success.

However, fuelled by decades of rapid economic growth, China has become more resistant to external pressure on a wide range of issues from revaluation of the RMB (the Chinese currency) through human rights to the pace of democratization. For instance, in response to the annual US State Department report, which China's State Council has denounced as 'an amateurish collection of distortions and rumours' driven by 'anti-China forces who don't want to see the existence of an increasingly wealthy and developed socialist state', China now issues its own critical report on the rights situation in the US. In response to pressures to democratize, China's State Council has issued a white paper on the subject of building political democracy that emphasizes that China must move at its own pace and build on and develop its own institutions to increase public participation and government accountability.

Contextual and evidence-based assessments

There is consensus about the need for proper benchmarks to make sense of the claim that China's transition is stalled. Unfortunately, there is considerable disagreement over what the proper benchmarks should comprise. Pei suggests standards that in effect represent the end-result of the transition process: sustainable 'green' growth, social justice, universal access to education and health care, judicial independence, adequate central funding of the judiciary, and the separation of the Party and the state.

However, Dowdle and others caution against using the standards of developed countries to assess a lower-middle income country such as China. DeLisle points out the dangers of uncritically attempting to transplant institutions and practices from the rich liberal democracies to China. What works in one context may not work in another. China has been successful, to a large extent, because it has adopted a pragmatic approach to reforms, seeking to build on existing institutions and resources. Economic reforms have succeeded in large part because of the internal consistency of policy and the ability to mobilize resources. Institutions must be of adequate quality to support the resource mobilization effort, but they do not necessarily have to approach the standards of developed country economies.

Comparative contexts, US and Asian models

There is also a general consensus that China's performance must be understood in a comparative context. However, as Pei and others have noted, there are numerous problems with the current indicators. Moreover, knowing that China currently outperforms the average country in its income class does not necessarily project that China will continue to outperform other countries in the future.

Nor is it clear that lessons can be drawn from comparison with the US. Despite many similarities, there are significant differences between the US in

the late 1800s and early 1900s, and China today. The global environment has also changed dramatically. The experiences of successful East Asian countries are arguably more relevant, given that their development has been more recent, and that there are greater cultural, political, legal, and economic similarities. However, there is some disagreement over the merits of the East Asian model, even as to whether such a model exists, given significant differences among the successful East Asian states.

Theories of development, the merits of gradualism

There is general agreement regarding the need to avoid the teleological assumption that all states develop in the same way and are converging to the same endpoint. The literature on development is replete with the failed attempts to export specific institutions and practices to developing countries. However, as Pei notes, the general direction of transition is clear: to a form of a market economy, combined with the rule of law, and a democratic constitutional order that protects human rights.

However, how to reach this general goal remains unclear. Further study of middle-income countries, both successful and unsuccessful, is required, to determine and address the problems they face. Additionally, there needs to be a deeper understanding of the relationship between economic, legal, and political reforms, including democratization, and their proper sequencing. One of the major areas of disagreement among the participants at the workshop was over the benefits of gradualism, and whether it is sustainable. Everyone acknowledged that there are costs as well as benefits, but these can be weighed differently.

Pei sees the drawbacks of gradualism as outweighing the benefits. Shih agrees that the Party elite has a vested interest in the survival of the regime, and

thus is not willing to give up control over key parts of the economy. However, he disagrees that gradualism will ultimately become untenable because of rent dissipation by insiders, pointing to banking sector reforms as evidence. Yang argues that the government has made progress in curtailing corruption and reducing opportunities for rent-seeking. Moreover, the experiences of other East Asian countries, which suffered a degree of corruption and rent-seeking at a similar stage of development, suggest that a gradualist approach need not fall prey to paralyzing predatory state behaviour.

It is a truism that a gradualist approach takes time. In the interim, the public will suffer from corruption and other social injustices. However, as Dowdle observes, 'we cannot dismiss gradualism simply because it is too gradual for our tastes. The real world often does not operate in accordance with our moral sensitivities'.

Socialism, development, and democracy

Finally, there are different views over the extent to which socialism and a single party state are obstacles to further reforms and development. On the one hand, Pei and others observe that no Leninist state has ever made a successful gradual transition to democracy. Conversely, however, there has never been a Leninist state like China, which has undertaken such wide-ranging reforms in the direction of a market economy, the rule of law, and a nascent constitutional order.

In summary, while most of the participants do not see China as trapped in transition thus far, they all recognize the serious problems, and concede that China's transition could yet become stalled, as Pei has suggested.



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