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**To cite this article:** Ding Chen, Simon Deakin, Mathias Siems & Boya Wang (2017): Law, trust and institutional change in China: evidence from qualitative fieldwork, Journal of Corporate Law Studies, DOI: [10.1080/14735970.2016.1270252](https://doi.org/10.1080/14735970.2016.1270252)

**To link to this article:** <http://dx.doi.org/10.1080/14735970.2016.1270252>



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Published online: 11 Jan 2017.



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# Law, trust and institutional change in China: evidence from qualitative fieldwork

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## ABSTRACT

China's rapid growth in the absence of autonomous legal institutions of the kind found in the west appears to pose a problem for theories which stress the importance of law for economic development. In this article we draw on interviews with lawyers, entrepreneurs and financial market actors to illustrate the complexity of attitudes to contract, corporate and financial law and economic growth in contemporary China. In the case of product markets, we find that business relations are increasingly characterised by a mix of trust-based transacting and legal formality. Financial markets are less like their western counterparts, thanks to the preponderant role of government in asset allocation, and a lack of transparency in market pricing. Overall, China's experience does not suggest that law is irrelevant or unrelated to growth, but that legal and economic institutions coevolve in the transition from central planning to a market economy.

**ARTICLE HISTORY** Received 24 October 2016; Accepted 29 November 2016

## 1. Introduction

What has been the contribution of the legal system in general, and of contract, corporate and financial law in particular, to economic growth and development in China? The Chinese experience of rapid growth in recent decades appears to contradict the claim that 'law matters' for economic development.<sup>1</sup> It seems to be the case that China incompletely recognises the security of contract and property rights which new institutional economics identifies as

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<sup>1</sup>R La Porta, F Lopez-de-Silanes and A Shleifer 'The Economic Consequences of Legal Origins' (2008) 46 *Journal of Economic Literature* 285.

having been essential to the rise of market economies in the global north.<sup>2</sup> Official discourse in China identifies a version of the rule of law ‘with Chinese characteristics’, which is explicitly distinct from the prevailing notion of the rule of law in the west.<sup>3</sup> For many commentators, it is precisely the absence of western notions of legality in China which is responsible for driving Chinese growth, by enabling business and government alike to act with a degree of flexibility which is not found in more developed industrial economies.<sup>4</sup>

There are, in principle, many pathways to industrialisation,<sup>5</sup> and there is no a priori reason to believe that China’s route has to be the same as that of any other country. Yet, claims for Chinese exceptionalism too often rely on broad brush references to ‘culture’ and ‘values’ which remain elusive to systematic analysis. There is therefore a danger of embedding a narrative of China’s development beyond the rule of law which, as some commentators (if a minority) have recognised, fails to capture the changes which have occurred in legal institutions and in attitudes to the legal system contemporaneously with the rise of a market economy since the 1980s.<sup>6</sup>

In this article we explore the hypothesis that ‘law matters’, or conversely, that it does not matter at all except in so far as it is absent, for China’s economic development. To set the scene, section 2 seeks to clarify the nature of the theoretical claims at stake. We discuss a conception of the rule of law as a ‘deep stable state’ of a societal game,<sup>7</sup> in which it becomes the first best response

<sup>2</sup>D North and R Thomas, *The Rise of the Western World: A New Economic History* (Cambridge University Press 1973); D North, *Institutions, Institutional Change, and Economic Performance* (Cambridge University Press 1990).

<sup>3</sup>For the most recent discussion, following the plenary meeting of the Communist Party from October 2014 with ‘rule of law’ as central theme, see J Garrick and Y Bennett (eds), *China’s Socialist Rule of Law Reforms Under Xi Jinping* (Routledge 2016). Others refer to it as a ‘rule by law’, see e.g. R Peerenboom, *China’s Long March Toward Rule of Law* (Cambridge University Press 2002) 8.

<sup>4</sup>C Jones, ‘Capitalism, Globalization and Rule of Law: An Alternative Trajectory of Legal Change in China’ (1994) 3 *Social & Legal Studies* 195; F Upham, ‘Speculations on Legal Informality: Comment on “Winn’s relational practices and the marginalization of law”’ (1994) 28 *Law & Society Review* 233; F Upham, ‘Myth-making in the Rule-of-Law Orthodoxy’ in T Carothers (ed), *Promoting the Rule of Law Abroad: In Search of Knowledge* (Carnegie Endowment for International Peace 2006); F Allen, J Qian and M Qian, ‘Law, Finance and Economic Growth in China’ (2005) 77 *Journal of Financial Economics* 57; R Gilson and C Milhaupt, ‘Economically Benevolent Dictators: Lessons for Developing Democracies’ (2011) 59 *American Journal of Comparative Law* 227.

<sup>5</sup>A Gerschenkron, *Economic Backwardness in Historical Perspective: A Book of Essays* (Belknap Press of Harvard University Press 1962).

<sup>6</sup>K Pistor and PA Wellons, *The Role of Law and Legal Institutions in Asian Economic Development, 1960–1995* (Oxford University Press 1999); R Peerenboom, *China’s Long March Toward Rule of Law* (Cambridge University Press 2002); R Peerenboom, ‘The Political Economy of Rule of Law in Middle-income Countries: A Comparison of Eastern Europe and China’ (2010) 28 *UCLA Pacific Basin Law Journal* 64; C Guarnieri, ‘Judicial Independence in Authoritarian Regimes: Lessons from Continental Europe’ in R Peerenboom (ed), *Judicial Independence in China* (Cambridge University Press 2010); BL Liebman, ‘Legal Reform: China’s Law-Stability Paradox’ (2014) 143 *Daedalus* 96.

<sup>7</sup>M Aoki, ‘Strategies and Public Propositions in Games of Institutional Change: Comparative Historical Cases’ (2017) *Journal of Comparative Economics* (forthcoming).

of actors to align their behaviour with publicly articulated legal norms.<sup>8</sup> We compare the equilibrium properties of the 'rule of law', so conceived, with alternative modes of coordination, including the mix of interpersonal trust and clan-based relational contracting which is associated, in the Chinese context, with the practice of *guanxi*. We also discuss complementarities between *guanxi* and authoritarian political control as modes of coordination.

In section 3 we discuss methodological considerations and in section 4 we present our empirical evidence of the role of contract, corporate and financial law in China. It draws on interviews and focus groups with entrepreneurs, managers, lawyers and bankers in Beijing and the Pearl River Delta, carried out between November 2013 and December 2015. The interview data provide evidence that attitudes to trust and law are changing as the market economy develops and deepens, and that a transition from *guanxi*-based transacting to a more formal, legally-driven approach to contracts is taking place, although unevenly across industrial sectors and regions. We also observe differences in attitudes to law in product and financial markets, respectively.

Section 5 concludes that, in the current rapidly changing environment, some aspects of the conventional picture of Chinese economic development may need to be rethought. Above all, closer attention should be paid to identifying in which respects China's trajectory is distinct from that of other countries undergoing industrialisation, and those aspects of its experience which may not be so very different after all.

## 2. Conceptual framework: the coevolution of institutions and markets

### 2.1. Formal and informal institutions

New institutional economics identifies a number of roles for institutions in underpinning processes of market exchange, from securing property rights to enforcing contractual agreements.<sup>9</sup> Departing from the general equilibrium foundations of neoclassical economics, institutional theories maintain that the perfectly competitive market is an anomalous case, which is rarely if ever found in practice, and, to the extent that it is, depends on formal and informal rules for its operation.<sup>10</sup> Particular sub-branches of the institutional literature place greater or lesser emphasis on the role of formal rules and sanctions in creating the conditions for contract performance. The presence of informal institutions, which can generate a basis for interpersonal or inter-organisational trust in business contacting, is generally recognised to be important.

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<sup>8</sup>D Chen and S Deakin, 'On Heaven's Lath: Rule of Law, State, and Economic Development' (2015) 8 *Law and Development Review* 123.

<sup>9</sup>North, *Institutions* (n 2).

<sup>10</sup>RH Coase, *The Firm, the Market and the Law* (University of Chicago Press 1988).

According to Douglass North, too little is known about the evolution of informal institutions or of their mode of operation,<sup>11</sup> but very much the same point can be made about more formal institutions. While neoclassical economics has provided elegant and tractable models of how a perfect market works (or would work, if it ever existed) to create a society-wide equilibrium, economics, in common with the social sciences more widely, has not yet come up with a good account of how market economies are formed in the first place.<sup>12</sup>

Attempts to fill this gap have recently been made using concepts of social evolution drawn from game theory and complexity theory. A market economy is understood to be the result of an evolutionary process which stabilises the practices which underpin the impersonal exchange of goods and services.<sup>13</sup> Stabilisation, in this sense, can be thought of as involving the coordination of actors' strategies in environments of varying degrees of uncertainty. Conventions, understood as shared information<sup>14</sup> and norms, understood as directives or signals based on shared conceptions of legitimate or appropriate behaviour,<sup>15</sup> enable actors to align their strategies in a way which overcomes the risk of defection or non-cooperation, thereby enhancing gains from trade and creating a social surplus which reinforces those same norms and conventions.

In this approach, institutions are seen as complex systems of conventions and norms of varying degrees of formality.<sup>16</sup> They retain and embed information on strategies which have been more or less successful in the past, and thereby store knowledge which actors can access through interpretation and observation.<sup>17</sup> As individual agents are capable of updating their strategies in the light of changes to the material or social setting in which they find themselves, so the institutions of a market economy are able to adapt to shifts in patterns of trade and in the technological bases of production and exchange. This process of adaptation is, to a certain degree, contingent and path-dependent, resulting in lags in adjustment, and, in some contexts, persistently sub-optimal outcomes,<sup>18</sup> but is functional up to a point, enabling institutions and market relations to achieve a degree of 'fit' or complementarity over time. Thus institutions and markets *coevolve*.<sup>19</sup>

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<sup>11</sup>North, *Institutions* (n 2).

<sup>12</sup>D North, *Understanding the Process of Economic Change* (Princeton University Press 2005).

<sup>13</sup>M Aoki, *Toward a Comparative Institutional Analysis* (MIT Press 2001); M Aoki, *Corporations in Evolving Diversity* (Oxford University Press 2010).

<sup>14</sup>D Lewis, *Convention: A Philosophical Study* (Harvard University Press 1969).

<sup>15</sup>H Gintis, *The Bounds of Reason: Game Theory and the Unification of the Social Sciences* (Princeton University Press 2009).

<sup>16</sup>North, *Institutions* (n 2); Aoki, *Analysis* (n 13).

<sup>17</sup>P Young, 'The Economics of Convention' (1996) 10 *Journal of Economic Perspectives* 105.

<sup>18</sup>MJ Roe, 'Path Dependence, Political Options, and Governance Systems' in KJ Hopt and E Wymeersch (eds), *Comparative Corporate Governance: Essays and Materials* (de Gruyter 1997).

<sup>19</sup>S Deakin, 'Legal Evolution: Integrating Economic and Systemic Approaches' (2011) 7 *Review of Law and Economics* 659.

A coevolutionary framework may help us better to understand some long-standing problems in the law and development and law and economics literatures. One of these is the role of law in contract enforcement. Empirical studies of the operation of contract law stress the role of informal, or non-state, institutions in generating contractual cooperation. Thus Stewart Macaulay's study<sup>20</sup> emphasised what he called the role of 'noncontractual' elements of business relations, by which he meant repeat trading, reputation and interpersonal trust, in engendering contractual cooperation. By contrast, more formal institutions of contract law, such as written agreements and court-based sanctions, seemed to play a marginal role at best in shaping the strategies and behaviour of managers Macaulay interviewed. Since Macaulay's sample consisted of business transactions in a mature industrial economy with a highly developed system of contract law and a well-functioning court system, one reading of his research is that contract law does not matter anywhere: if it is marginal in the US context, it is likely to be even more irrelevant to the practice of contracting in developing economies which lack a similarly articulated legal infrastructure.

Informal institutions, understood as those which do not rely on the state to enforce contracts, may be expected to work well in contexts where trading takes place among a small number of actors, who know each other and deal on a repeated basis. In a world of small-numbers bargaining, there are strong incentives not to cheat as this risks exclusion from the group. Personal knowledge about the capabilities and trustworthiness of trading parties can save on the search, monitoring and verification costs associated with impersonal exchange. In Macaulay's study, many of the managers had built up personal relationships with each other over a long course of dealing, and these personal ties helped to consolidate the reputations of the wider organisations of which they were a part, so helping to build inter-organisational trust.

The downside of this type of interpersonal trust is that it is difficult to realise economies of scale and the deep division of labour associated with large-numbers bargaining. Small-scale exchange minimises transaction costs at the expense of high production costs. A variety of informal mechanisms evolved at various points to assist the transition to impersonal trade in the west, by facilitating information flows and enabling parties to signal their trustworthiness.<sup>21</sup> Avner Greif's study of the Maghribi traders<sup>22</sup> showed how a social network based on shared religion, social ties and language helped to build long-distance trade in the Jewish Maghribi community of the late Middle Ages. Many of the trust-building practices of the

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<sup>20</sup>S Macaulay, 'Non-contractual Relations in Business: A Preliminary Study' (1963) 28 *American Sociological Review* 1.

<sup>21</sup>North and Thomas (n 2); North, *Institutions* (n 2).

<sup>22</sup>A Greif, 'Contract Enforceability and Economic Institutions in Early Trade: The Maghribi Traders Coalition' (1993) 83 *American Economic Review* 525.

Maghribis can be understood as incentive-compatible in the sense identified by efficiency-wage and principal-agent models. These contractual and social devices enabled trade to take place between different Maghribi groups, between which there were relatively few direct links, and were also extended to non-Maghribi traders.

The seminal studies of Macaulay and Greif describe environments in which social cooperation emerges on the basis of the iterative behaviour of agents. Informal mechanisms such as reputation, kinship, social ties and religious affiliation are used to build trust, in isolation, it seems, from formal institutions of contract enforcement. It is possible, in this perspective, to see law as actively harmful to the building of trust, since courts are removed from the context in which trading relations develop, and may insist on enforcing formal agreements at the expense of the parties' tacit understandings of their mutual commitments.<sup>23</sup> Yet the claim of law's irrelevance can be taken too far: otherwise, it is difficult to explain the rise of modern contract law coterminously with the market economy, which is widely identified as one of the defining features of institutional development in the global north.<sup>24</sup>

It could be that the law is simply expressing or reflecting a deeper economic reality, but to see law in such purely 'epiphenomenal' terms may be to underplay the incentive properties of formal legal institutions.<sup>25</sup> Although only a tiny percentage of contractual disputes reach the stage of litigation, the possibility of a legal sanction in a contractual 'endgame' of the kind created by a transactional dispute or the bankruptcy of one of the parties can be expected to influence the 'state of play' in earlier phases of a bargaining relationship. In principle, contract law can play the role of a 'correlating device' which alters the parties' ex ante incentives and helps overcome collective action problems in situations akin to the prisoner's dilemma or stag-hunt game.<sup>26</sup> The law may stay in the background for the most part, while still exerting an influence on the contractual environment by selecting in, as well as out, particular strategies. An equilibrium in which contractual cooperation becomes the 'first best strategy' of actors without recourse to litigation could in principle be just as stable (and perhaps more so) as one in which agents make regular recourse to the courts to enforce their agreements. From this point of view it is not necessarily surprising that Macaulay's interviewees reported that they were relatively indifferent to formal agreements and only litigated as a matter of last resort. Nor can Greif's study of the Maghribi traders' coalition, in isolation from a consideration of the

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<sup>23</sup>PS Ring and AH Van de Ven, 'Developmental Processes of Cooperative Interorganizational Relationships' (1994) 19 *Academy of Management Review* 90.

<sup>24</sup>N Ferguson, *Civilization: The West and the Rest* (Penguin Press 2011); R Cooter and H-B Schaefer, *Solomon's Knot: How Law Can End the Poverty of Nations* (Princeton University Press 2011).

<sup>25</sup>S Deakin, D Gindis, G Hodgson, K Huang and K Pistor, 'Legal Institutionalism: Capitalism and the Constitutive Role of Law' (2017) *Journal of Comparative Economics* (forthcoming).

<sup>26</sup>Deakin (n 19).

wider institutional context, justify a view that the quality of the legal system is irrelevant to contract enforcement.

Empirical research has also qualified the claim that law does not matter for contract enforcement. There is evidence to suggest that the relative indifference displayed towards contract law by business firms reported by Macaulay and other studies of common law systems<sup>27</sup> is specific to certain industries and sectors, and possibly to certain legal cultures. In Germany, for example, it seems that contract formality is not viewed in such negative terms, and that both formal agreements and the standard-form contracts drawn up by trade associations play a role in generating trust.<sup>28</sup> Nor is it clear that indifference to the law is optimal in aggregate welfare terms: in the more legally conscious German business environment, firms were found to be less likely than they were in the UK to pursue debts through litigation, suggesting that there are deadweight costs associated with reliance on informal contracting.<sup>29</sup>

A second issue illuminated by thinking of institutions in evolutionary terms is that of corruption. Societies in which corruption is widespread are those in which field experiments and surveys report a high degree of 'antisocial punishment'.<sup>30</sup> This is the inverse of 'altruistic punishment', or the tendency of actors to withdraw cooperation from those who free ride or otherwise depart from norms of social solidarity, even where to do so incurs a private cost for the 'cooperators'. An example of this would be refusing to give, or to accept, a bribe. In the case of antisocial punishment, those who *do not bribe or take bribes* are the ones who are punished or shunned.<sup>31</sup> The empirical evidence suggests that there is a high degree of correlation between the incidence of altruistic (or conversely, the absence of antisocial) punishment in a society, and the strength of its public institutions, in particular the level of democracy it has achieved.<sup>32</sup>

These studies imply that the rule of law, like contractual cooperation, is an emergent phenomenon, which depends on the presence of interlocking institutions and practices: a state capable of exercising authority in a way regarded

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<sup>27</sup>Macaulay (n 20); H Beale and A Dugdale, 'Contracts between Businessmen: Planning and the Use of Contractual Remedies' (1975) 2 *British Journal of Law and Society* 45.

<sup>28</sup>S Deakin, C Lane and F Wilkinson (1998) 'Performance Standards in Supplier Relations: Relational Contracts, Organisational Processes and the Institutional Environment', University of Cambridge CBR Working Paper Series, No 100.

<sup>29</sup>A Arrighetti, R Bachmann and S Deakin, 'Contract Law, Social Norms and Inter-firm Cooperation' (1997) 21 *Cambridge Journal of Economics* 171.

<sup>30</sup>Gintis (n 15).

<sup>31</sup>M Cinyabuguma, T Page and L Putterman (2004) 'On Perverse and Second-order Punishment in Public Goods Experiments with Decentralized Sanctioning' Brown University Department of Economics Working Paper 2004-12; L Denant-Boéumont, D Masclet and C Noussair, 'Punishment, Counterpunishment and Sanction Enforcement in a Social Dilemma Experiment' (2007) 33 *Economic Theory* 145; N Niki-forakis, 'Punishment and Counterpunishment in Public Goods Games: Can We Really Govern Ourselves?' (2008) 92 *Journal of Public Economics* 91.

<sup>32</sup>B Hermann, C Thöni and S Gächter, 'Antisocial Punishment across Societies' (2008) 319 *Science* 1362.



as legitimate by its citizens is the precondition, but also the result, of a social norm which regards bribery as transgressive. In the same way, societies in which corruption is the social norm are likely to generate, and be generated by, authoritarian and coercive states, which, lacking legitimacy, are required to operate through force.<sup>33</sup> The issue to consider is the process by which it becomes the ‘first best response’ of public officials to refuse bribes when they are offered, and for citizens not to offer them. As shown by numerous studies conducted by international organisations since rule of law studies became the vogue in the mid-1990s, it is not possible to make this shift by simply legislating for it. A legal norm cannot in itself bring about the practice of the rule of law. The process needs to be understood, instead, in evolutionary terms, as the emergence of a ‘deep stable state’ of societal cooperation, which develops incrementally, is not preordained, but may become self-sustaining once it reaches a certain point.<sup>34</sup> The hypothesis that the rule of law coevolves with impersonal exchange of the kind associated with a market economy is one which would merit further research using a variety of contemporary and historical sources.<sup>35</sup>

The rise of formal institutions is conventionally associated with economic development in the global north.<sup>36</sup> Most likely it is part, but only part, of a complex trajectory. The emergence of formal institutions does not rule out a continuing role for informal institutions in contract enforcement. Reputation-based mechanisms, along with interpersonal trust based on repeated trading among close-knit groups, continue to play a role in market exchange.<sup>37</sup> The persistence of informal institutions can be attributed to their transaction-cost reducing functions.<sup>38</sup> However, informal institutions more often operate in conjunction with formal ones, than in contradiction to them. It is the interlocking of the formal rules of the legal system with the social foundations of cooperation in exchange which should be the focus of attention.<sup>39</sup>

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<sup>33</sup>For the Chinese context see Yuhua Wang, *Tying the Autocrat's Hands: The Rise of the Rule of Law in China* (Cambridge University Press 2014). Specifically for judicial corruption: L Li, ‘The “Production” of Corruption in China’s Courts: Judicial Politics and Decision Making in a One-party State’ (2012) 37 *Law and Social Inquiry* 848. Specifically for company law: R Tomasic, ‘Company Law Implementation in the PRC: The Rule of Law in the Shadow of the State’ (2015) 15 *Journal of Corporate Law Studies* 285.

<sup>34</sup>Aoki, ‘Strategies’ (n 7), *Analysis* (n 13).

<sup>35</sup>Chen and Deakin (n 8).

<sup>36</sup>Ferguson (n 24); Cooter and Schaefer (n 24).

<sup>37</sup>R Ellickson, *Order without Law; How Neighbors Settle Disputes* (Harvard University Press 1991); L Bernstein, ‘Opting Out of the Legal System: External Contractual Relations in the Diamond Industry’ (1992) 21 *Journal of Legal Studies* 115; L Bernstein, ‘Merchant Law in a Merchant Court: Rethinking the Code’s Search for Immanent Business Norms’ (1996) 144 *University of Pennsylvania Law Review* 1765; L Bernstein, ‘Private Commercial Law in the Cotton Industry: Creating Cooperation through Rules, Norms, and Institutions’ (2001) 99 *Michigan Law Review* 1724.

<sup>38</sup>Bernstein, ‘Opting Out’ (n 37); A Dixit, *Lawlessness and Economics: Alternative Modes of Governance* (Princeton University Press 2004).

<sup>39</sup>Arrighetti and others (n 29).

## 2.2. Law and finance

Since the mid-1990s, a large body of quantitative research has highlighted the potential significance of law for financial development<sup>40</sup> and thereby, according to the majority view, also for economic growth.<sup>41</sup> Many of these studies make the claim that legal protection of investor rights is a prerequisite for the growth of capital markets, while protection for secured creditors is essential for the growth of credit markets.<sup>42</sup>

There are various methodological problems with these studies. Many researchers, including two of the authors of the present article, have challenged the quantitative methods used to measure the degree of legal protection provided by the law for shareholders and creditors.<sup>43</sup> Historical research on the development of capital markets in the US and the UK has also challenged the 'law matters' claim. In both countries, capital markets and product markets alike experienced a transition from personal exchange based on interpersonal trust to impersonal transacting. There was also a shift from informal institutions to formal ones, which was accompanied by the shift from regional capital markets to integrated national ones. Legal rules providing investor protection emerged only at a later stage, after the rise of a broadly based investor class. According to this historical evidence, it was the rise of the capital market which prompted legal reforms, contrary to the direction of causation assumed by the law matters hypothesis.<sup>44</sup>

But if the findings of La Porta and others<sup>45</sup> do not very well explain the financial development of early industrialisers such as the US and UK, the role of formal institutions protecting investors might be more relevant to newly-established capital markets in today's emerging countries. Unlike the situation in the US and the UK where stock markets evolved without direct state assistance from small regional markets into larger national exchanges, newly established stock markets in many middle-income countries are

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<sup>40</sup>R La Porta, F Lopez-de-Silanes, A Shleifer and R Vishny, 'Law and Finance' (1998) 106 *Journal of Political Economy* 1113.

<sup>41</sup>RG King and R Levine, 'Finance and Growth: Schumpeter Might Be Right' (1993) 108 *Quarterly Journal of Economics* 717.

<sup>42</sup>La Porta and others (n 1); S Djankov, O Hart, C McLiesh and A Shleifer, 'Debt Enforcement around the World' (2008) 116 *Journal of Political Economy* 1105; S Djankov, C McLiesh and A Shleifer, 'Private Credit in 129 Countries' (2007) 84 *Journal of Financial Economics* 299; S Djankov, R La Porta, F Lopez-de-Silanes and A Shleifer, 'The Law and Economics of Self-dealing' (2008) 88 *Journal of Financial Economics* 430.

<sup>43</sup>See M Siems and S Deakin, 'Comparative Law and Finance: Past, Present and Future Research' (2010) 166 *Journal of Institutional and Theoretical Economics* 120.

<sup>44</sup>JC Coffee, 'Convergence and Its Critics: What Are the Preconditions to the Separation of Ownership and Control?' in JA McCahery and others (eds), *Corporate Governance Regimes: Convergence and Diversity* (Oxford University Press 2002); BR Cheffins, *Corporate Ownership and Control: British Business Transformed* (Oxford University Press 2008); C Mayer, 'Trust in Financial Markets' (2008) 14 *European Financial Management* 617; J Franks, C Mayer and S Rossi, 'Ownership: Evolution and Regulation' (2009) 22 *Review of Financial Studies* 4009.

<sup>45</sup>La Porta and others (n 1), (n 40).

consciously designed and imposed by the state. They often have a national role from the outset, in contrast to the localised stock exchanges of nineteenth-century Britain and America. Thus impersonal exchange dominates the market from the outset. Nor can it be said, in these cases, that capital market practices preceded legal and institutional reforms. Given the lack of informal substitutes for state-designed institutions, it is possible that legal protection of investors may indeed be a prerequisite to the development of stock markets in middle-income countries.

Account should also be taken of differences between product markets and capital markets. Except as in the case of certain former socialist countries, it is very rare to see the product market being entirely monopolised, even by the state. Private actors can generally find some way to get around rules designed to suppress market-based exchange. Thus one feature of centrally planned economies in the middle decades of the twentieth century was the coexistence, with the state-owned sector, of a sizable informal economy, which provided flexibility lacking in the formal sector, and came to be tolerated or even encouraged as a result. Thus, while in socialist systems the conventional function of contracts was to control, not to enable, individual behaviour and the economy,<sup>46</sup> market-based exchange did develop outside the formal sector, thereby compensating for the lack of a legal underpinning to contract enforcement in product markets. The de facto coexistence of the formal and informal sectors under the socialist system meant that there was an experience of private exchange (albeit semi-official) which could be drawn on.

Any such continuity is lacking in the case of newly established capital markets. The supply of financial products is often still monopolised by state-owned enterprises and leaves little option for private actors, who must take or leave what is on offer. The mandatory nature of securities laws and the modern electronic transaction systems in many emerging markets further reduces the room for private contracting, particularly for retail investors. Where legal rules are ineffective or are sub-optimally designed, the inability of private parties to contract around the legal framework poses a problem for the development of the capital market.<sup>47</sup>

In this type of environment there is no guarantee that rules will be made and implemented in a manner that adequately protects the interests of investors. In states with a minimal or still emergent rule of law, where constitutional rules curbing the power of the executive branch are lacking and the legislature and judiciary are subject to executive control, the legal system is almost certain to be captured by elite groups and to serve their interests.<sup>48</sup>

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<sup>46</sup>M Zhang, *Chinese Contract Law* (Brill 2006) 47–50 for China.

<sup>47</sup>D Chen, *Corporate Governance, Enforcement and Financial Development: The Chinese Experience* (Edward Elgar 2013).

<sup>48</sup>M Shirley, *Institutions and Development* (Edward Elgar 2010).

Rules protecting investors are unlikely to emerge or, if they are formally adopted, to be incompletely observed and enforced.<sup>49</sup> Information asymmetries make capital markets particularly prone to types of abuse such as ‘tunneling’ which are designed to transfer wealth from public investors to governmental elites.<sup>50</sup> Thus the law and finance literature creates a paradox: systems most in need of investor protection are the least likely to adopt them.

### 2.3. *The Chinese case*

China provides an opportunity to test these arguments.<sup>51</sup> Since 1978, China has managed to maintain an economic growth rate which averages out at 8–9% per annum over the past three decades. Its legal system had to be rebuilt practically from scratch after the Cultural Revolution. The professionalism of judges has been increasing and there is evidence that judicial independence has also been enhanced, with a bifurcation between high-profile political cases, which are still subject to executive interventions, and the large majority of routine cases, in which judges are unlikely to come under political pressure.<sup>52</sup> At the same time, there is evidence of regional differences, with judicial professionalism most in evidence in Shanghai and the cities of the Pearl River Delta, along with other centres of commercial activity.<sup>53</sup> In addition, individual judges remain subject to hierarchical controls which limit the progress made towards merit-based recruitment and promotion systems.<sup>54</sup>

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<sup>49</sup>K Pistor and C Xu, ‘Incomplete Law: A Conceptual and Analytical Framework and its Application to the Evolution of Financial Market Regulation’ (2003) 35 *Journal of International Law and Politics* 931.

<sup>50</sup>D Chen, ‘Developing a Stock Market without Institutions: The China Puzzle’ (2013) 13 *Journal of Corporate Law Studies* 151.

<sup>51</sup>See e.g. RH Coase and N Wang, *How China Became Capitalist* (Palgrave Macmillan 2012); L Yueh, *China’s Growth: The Making of an Economic Superpower* (Oxford University Press 2013); D Kennedy and J Stiglitz (eds), *Law and Economics with Chinese Characteristics: Institutions for Promoting Development in the Twenty-First Century* (Oxford University Press 2014); G Xu, *Does Law Matter for Economic Growth? A Re-examination of the ‘Legal Origin’ Hypothesis* (Intersentia 2014); G Yu, *The Roles of Law and Politics in China’s Development* (Springer 2014); G Yu (ed), *Rethinking Law and Development: The Chinese Experience* (Routledge 2014); J deLisle, ‘Law and the Economy in China’ in GC Chow and DH Perkins (eds), *Routledge Handbook of the Chinese Economy* (Routledge 2014) 255; JJ Kroncke, *The Futility of Law and Development: China and the Dangers of Exporting American Law* (Oxford University Press 2016); C Xu ‘The Fundamental Institutions of China’s Reforms and Development’ (2011) 49 *Journal of Economic Literature* 1076.

<sup>52</sup>Weixia Gu, ‘Courts in China: Judiciary in the Economic and Societal Transitions’ in Jiunn-rong Yeh and Wen-Chen Chang (eds), *Asian Courts in Context* (Cambridge University Press 2014); F Yulin and R Peerenboom, ‘A New Analytical Framework for Understanding and Promoting Judicial Independence’ in R Peerenboom (ed), *Judicial Independence in China* (Cambridge University Press 2010); Guarnieri (n 6).

<sup>53</sup>M Pei, G Zhang, F Pei and L Chen, ‘A Survey of Commercial Litigation in Shanghai Courts’ in Peerenboom (n 52) 221; K Henderson, ‘Half-way Home and a Long Way To Go: China’s Rule of Law Evolution and the Global Road to Judicial Independence, Impartiality and Integrity’ in Peerenboom (n 52) 23.

<sup>54</sup>Guarnieri (n 6).

The limited effectiveness of the Chinese legal system in the aftermath of the Cultural Revolution was, however, compensated for by the continuing influence of the Confucian tradition which stresses the importance of interpersonal relationships and social networks as the basis for commercial and wider societal coordination (*guanxi*).<sup>55</sup> As in the early stages of the industrial revolution in the west, it was the informal institution of *guanxi* which underpinned exchange. The rapid expansion of product markets and China's emergence as 'the World's factory' would not otherwise have been possible. What is much disputed is whether China's reliance on *guanxi* represents a relationship-based path to economic growth which departs from the law-based path of western industrial development. It could be a characteristic of a given stage of industrialisation, which will diminish over time. Another possibility is that, as we have argued above, formal and informal institutions will continue to coexist as they have done in the economies of the global north, albeit in ways which reflect China's developmental path.

In relation to the capital market, China established its two principal stock exchanges, the Shanghai Stock Exchange (SHSE) and the Shenzhen Stock Exchange (SZSE), in 1990 and 1991 respectively. By the end of 2008, in terms of market capitalisation, China already ranked second in Asia, next only to Japan, and fourth in the world. However, stock market capitalisation does not necessarily indicate a productive role for the capital market, as most of the equity capital raised on the Shanghai and Shenzhen exchanges flowed into SOEs rather than private business firms. During this period the Chinese government promoted the growth of equity finance to help SOEs overcome financial difficulties after the recession of the mid-1990s, when large parts of the financial sector were technically bankrupt because of widespread non-performing loans. To this day, the stock market continues to be dominated by companies which are directly or indirectly owned by the state. Where private companies are listed in one or other of the domestic markets it is often because they are better connected rather than superior in efficiency terms. Thus it is far from clear that Chinese stock markets are adequately servicing the macroeconomy.<sup>56</sup>

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<sup>55</sup>S Li, 'China's (Painful) Transition from Relation-based to Rule-based Governance: When and How, Not If and Why' (2013) 21 *Corporate Governance: An International Review* 567; T Zhou and M Siems, 'Contentious Modes of Understanding Chinese Commercial Law' (2015) 6 *George Mason Journal of International Commercial Law* 177.

<sup>56</sup>C Walter and F Howie, *Privatizing China: The Stock Markets and Their Role in Corporate Reform* (John Wiley 2003); S Green, *The Development of China's Stock Markets, 1984–2002: Equity Politics and Market Institutions* (Routledge 2004); J Wu, *Understanding and Interpreting Chinese Economic Reform* (Thomson 2005); H Ren, 'How to Improve the Capital Structure of China's Listed Companies [Ruhe Youhua Woguo Shangshi Gongsi Ziben Jiegou]' (2004) 2 *Shanghai Jinrong Xueyuan Xuebao* 60; Chen, *Corporate Governance* (n 47).

### 3. Methodological approach: the case for qualitative, interview-based fieldwork for understanding institutional change

Our fieldwork research aimed to obtain information on how the transition to market economy in China was playing out at the level of contractual relations between firms and in the financing of firms. More specifically, we were interested in finding out from lawyers, entrepreneurs and others about the relative importance now attached to contract formality, on the one hand, and *guanxi* or interpersonal trust, on the other. We also wanted to obtain these actors' perceptions of judicial transparency or, conversely, corruption. In the context of law and finance, we were interested in how far finance was becoming formalised, and on the likely effects of the gradual liberalisation of the system for the registration of IPOs on the two main stock exchanges.

Altogether we spoke to 81 individuals, 28 in individual interviews and the rest in a total of nine focus groups (see [Appendix 1](#)). Twenty respondents were interviewed more than once, with the final set of interviews in December 2015 providing us with the opportunity to get feedback on initial findings.

The majority of the interviewees were practising lawyers; others were entrepreneurs, bankers and legal scholars who also had practical experience of the workings of courts and financial markets. The interviews were conducted on a non-attributable basis. Given the sensitive nature of the material, and in order to ensure that respondents gave as full an account as possible of their experiences, the interviews were, with a very small number of exceptions, not recorded, but verbatim notes were taken during the meetings and typed up afterwards. The questions were based on a semi-structured questionnaire which was distributed to the interviewees in advance to the interviews (see [Appendix 2](#)). Some of the questions were factual ones. We also asked questions about the interviewees' perceptions of the operation of legal institutions and financial mechanisms and their interpretation of changes in the legal and financial environment over time.

Qualitative research of the kind we conducted clearly has its limits. Such research is based on a numerically limited sample of responses which cannot be shown to be representative of the wider population of relevant actors. In addition, it is non-replicable, in the sense that other researchers will not be able to reproduce the conditions under which the research was conducted, and hence difficult to validate. On the other hand, research of this kind may be the only means by which we can direct evidence of an institutional transition of the kind China has been experiencing, while it is going on. Data on such issues as the quality of court-based enforcement in China are regularly collected, making quantitative analysis possible,<sup>57</sup> but always

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<sup>57</sup>See e.g. Wang (n 33). For other interview-based research on China see R Stern and S Li, 'The Outpost Office: How International Law Firms Approach the China Market' (2016) 41 *Law & Social Inquiry* 184;

with something of a lag, and there are limits as well to this approach, which depends on the use of indicators to measure features of institutions which are inherently hard to capture in quantitative terms. Thus there is a trade-off involved in the use of different methods:<sup>58</sup> quantitative approaches provide a representative but often imperfect picture, which prioritises breadth over depth, and entails unavoidable measurement problems, as well as lags; qualitative research, while not representative in the same sense, offers direct evidence on the perceptions of actors in the midstream of a process of societal change, provides narrative and contextual information which is lacking from quantitative approaches, and should, if undertaken successively, result in 'thick' empirical descriptions of particular trends and events of the kind which statistical analysis, with its focus on average effects, is liable to miss. Qualitative research is ideal for identifying 'anomalies, multi-stranded relationships, or unanticipated patterns, that suggest the limits of general patterns and call simplistic relationships into question'.<sup>59</sup>

It is for these reasons that some of the principal studies in the field we are considering, such as those of Macaulay and Bernstein,<sup>60</sup> relied on qualitative approaches of the kind we adopted. Nor should it be thought that qualitative fieldwork of this kind is a straightforward process, or simpler to conduct than desk-based quantitative research. 'Keen observational skills, thorough record keeping, and a high degree of self-awareness and ethical management of social relations' are required in addition to 'appropriate language skills and sufficient understanding of the local context to gain access, recognise informal institutions, and accurately interpret culturally coded observations'.<sup>61</sup> It is perhaps these considerations, as much as any perceived shortcomings of qualitative research methods, which explain why interview-based fieldwork is not used more often in institutional analysis.

## 4. Empirical findings: institutional change and market development in contemporary China

### 4.1. Changing attitudes to law and the legal system

Many of the interviewees mentioned that there had been a steady increase in the volume of legislation in recent decades, in particular on commercial issues. However, a widespread view was that these new laws did not

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X Jia and R Tomasic, *Corporate Governance and Resource Security in China: The Transformation of China's Global Resources Companies* (Routledge 2010).

<sup>58</sup>J Buchanan, D Chai and S Deakin, 'Empirical Analysis of Legal Institutions and Institutional Change: Multiple-methods Approaches and their Application to Corporate Governance Research' (2014) 10 *Journal of Institutional Economics* 1.

<sup>59</sup>A Poteete, M Jansenn and E Ostrom, *Working Together: Collective Action, the Commons, and Multiple Methods in Practice* (Princeton University Press 2010) 35.

<sup>60</sup>Macaulay (n 20) and Bernstein (n 37).

<sup>61</sup>Poteete and others (n 59) 16.

necessarily provide legal certainty. In particular, problems of interpretation of the Chinese Company Law were noted; many of its provisions were seen as having been drafted in an excessively general fashion.<sup>62</sup> It was therefore seen to be crucial to supplement legislation by taking into account the judicial interpretation provided by the Supreme People's Court (SPC), in particular its 500-page annotated commentary on the Company Law, as well as the rules promulgated by the securities commission (the CSRC) for companies issuing securities to the public. Even so, some of the interviewees were sceptical about the functioning of company law: a common view, responding to a question about the adequacy of shareholder protection, was that 'on paper the law is fine; in practice not but things are progressing' (lawyer and entrepreneur, Beijing, November 2014).

In substantive terms, the interviewees indicated that the main aims of the post-1980 commercial laws had been to build up a market economy, to increase China's competitiveness, and to accommodate business interests, while also considering foreign models and international standards including IOSCO and the Basel standards on bank liquidity and solvency. But some also argued in favour of stringent regulation: the separation between banks and securities firms, relatively high bank capital requirements, and state ownership of the biggest banks had, according to one respondent, made China less vulnerable to the global financial crisis of 2008 than western countries.

Another interviewee expressed the view that, over the previous decade, Chinese lawmakers had also aimed to address the shortcomings of the market economy reforms not through reforms to the commercial or financial system, but by addressing social issues through labour law reform and changes to the social insurance system. Some of the other interviewees were more sceptical of this view, suggesting that lawmakers showed a stronger interest in economic matters than in matters of distribution. As one interviewee put it, today in China 'Hayek is more important than Marx' (lawyer and academic, Beijing, October 2013). One explanation for the business orientation of the reform process is, we were told, the close links between economic and political elites.<sup>63</sup> One interviewee expressed the position this way:

Inequality is a problem. The view was once, we must make the cake grow before we can start dividing it up. Some still think that but others say, the cake is big enough now. (Entrepreneur, Guangzhou, September 2014)

To similar effect was this comment on social reforms:

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<sup>62</sup>For a similar assessment see C Hawes, AKL Lau and A Young, 'Lifting the Corporate Veil in China: Statutory Vagueness, Shareholder Ignorance and Case Precedents in a Civil Law System' (2015) 15 *Journal of Corporate Law Studies* 341.

<sup>63</sup>A similar finding of other studies, including Peerenboom, 'The Political Economy' (n 6).



Everyone has social insurance now. But it's basic, it doesn't provide an elegant life, you have to work hard, it is different from the European way, cradle to grave, there is no psychological guarantee. In China you have to decide where you want to be above the basic level provided by the state. We can't nurse too many lazy people, it is unfair to make hard working people pay for them. (Lawyer, Beijing, December 2015)

We also asked the interviewees about their views concerning the relationship between law and economic development. One of them put it as follows:

China's development is the result of reducing the power of the state and giving more scope to private power. But three decades on, we realise that there are many problems associated with rapid growth. So the government perceives a real need for legalisation of the economy. Economic development creates demands for laws. (Lawyer, Foshan, September 2014)

This statement illustrates a view to the effect that in the initial reform process, starting in the late 1970s, economic change had occurred in the absence of a strong legal framework. However, there was also a general feeling that things had moved on. For example, another interviewee expressed the view that 'law is essential' in a commercial society based on trade and communication (lawyer, Foshan, September 2014). Directly responding to the question of causation, respondents stated that today 'the law responds to the economy' (lawyer, Foshan, September 2014) and that 'law is becoming more important as the economy develops' (entrepreneur, Guangzhou, September 2014).

The relationship between law and the economy also became apparent in responses that referred to differences within China, in particular in the interviews we conducted in Guangdong province. Interviewees also mentioned how far Guangdong's experience was different from those of other parts of China, comparing the low reported number of registered lawyers in Hunan to those in the Pearl River Delta (2,000 and 20,000). Mention was also made of the tendency of people in Guangdong to try to 'find a lawyer' in contrast to the approach in less commercially developed cities and regions where there was still a strong Confucian tradition, which revealed itself in a preference for family and network-based dispute resolution.

So, overall, the perceived relationship between law and economic change was that law tended to lag behind developments in the economy and had to catch up, but that there was a need for more and better law and law enforcement. This suggests some shift of emphasis, which the view gaining hold that the development of the legal system is an essential part of the transition process in order to avoid the 'middle income trap'.<sup>64</sup>

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<sup>64</sup>For the latter problem (including the Chinese context) see also R Peerenboom and T Ginsburg (eds), *Law and Development in Middle-Income Countries: Avoiding the Middle-Income Trap* (Cambridge University Press 2014).

## 4.2. The product market: *guanxi* versus contract formality

The view that in China informal institutions, such as *guanxi*, replace formal ones is a well-known position expressed by numerous legal scholars, economists and sociologists.<sup>65</sup> In our interviews some responses also emphasised the importance of non-legal factors, for example, interviewees who told us that ‘personal contacts are still important in business’ (entrepreneur, Guangzhou, September 2014), that ‘you have to know your business partners’ (law firm partner, Foshan, September 2014), and that the ‘importance of personal trust goes back to Confucius and is deeply embedded’ (manager, Foshan, September 2014).

However, the interviews also suggest that a transition is going on, from relationship-based to rule-based transactions in certain product markets and regions. This transition is in part attributable to economic growth, as the following account describes:

Prior to the 1970s transactions were very simple, the economy was less developed, *guanxi* was more important then, but as the economy became more complex, since the 1980s, contracts began to be used, people learn the hard way, many good claims failed for lack of a contract. The use of formal contracts began in the more advanced economic regions, in particular Guangdong, and spread from there. But in Guangdong and Fujian *guanxi* is still important because of networks and informal financing is still relied on. At the same time people see the risk in relying on *guanxi*. They create self-protection mechanisms, such as insisting on joint liability of family members when a company takes out a loan, and using cash. (Academic, Beijing, December 2015)

A larger market creates demand for legal certainty and reduces the importance of personal relationships in transactions. It also creates risks for firms. In the case of an enterprise we interviewed whose business was organised around complex leasing transactions in a large industrial sector with hundreds of players, we were told:

in our industry, contracts are formal. It is the only guarantee we have. We have an in-house lawyer for contracts and transactions. We try to stress the role of law in what we do. (Entrepreneur, Beijing, December 2015)

In this vein, interviewees also mentioned the role of technology, making information more easily accessible and facilitating the interaction with new business partners where written contracts become a necessity. One factor going against the use of informal agreements, referred to by some interviewees, was the practice of the Chinese courts in not accepting oral evidence of transactions.

One view was that the growth in legal formality would not necessarily displace *guanxi*, because ‘even when the parties agree a formal contract, they

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<sup>65</sup>See section 2 above.

often don't use it' (lawyer, Foshan, September 2014). Another view was that the *guanxi* would continue to be important in filling in the gaps in contracts:

The relationship between trust and the legal system is one of complements. With the rise of the legal system *guanxi* may become less important but *guanxi* will continue to exist in the future and will still play a role. Because of cultural differences the legal system may never play the same role in China as it does in the West. But it is not necessary to describe one system as better or worse than another. (Lawyer, Jiangmen, December 2015)

But some interviewees explicitly associated *guanxi* with corruption and with holding back economic growth:

I strongly disagree with the argument that China has developed quickly because of an absence of law. *Guanxi* is dragging the economy down. The dark side of *guanxi* is non-enforcement of contracts. In some cases, especially where the government is involved, *guanxi* is connected to bribery of government officials. There is a very high social cost to this. Reliance on *guanxi* is a problem and without it China would have had faster growth. Oral and informal agreements are increasingly associated with internal transactions and family contracts. For large enterprises and SOEs, contracts are always written. (Lawyer, Jiangmen, December 2015)

As a consequence of this process, contracts have become more complex and formal over time, and lawyers are increasingly used for contract drafting. The current situation is well illustrated in the following statement about contracts from a software entrepreneur:

With very few exceptions they are all in writing. There is a big difference between past and present. In the past, contracts were short, maybe 2–3 pages. Now they are longer, and more detailed and complex, 20 or 30 pages. Clauses used to be simple, now they are long, detailed, and specific. There are terms on interpretation and confidentiality. In the past, there were no dispute resolution clauses, now you do see them. Knowledge of contract terms and of the role of contracts has increased as overseas firms have entered the Chinese market. They tend to insist on more detailed and formal contracts. There are some standard forms which are used. Big companies tend to use their own. These contracts are not very fair to SMEs. (Entrepreneur, Beijing, November 2014)

Standard form contracts are said to be increasingly used and come in different forms:

they are of three types: first, standard terms issued by government departments. For example, property contracts, construction contracts, labour contracts. These standard forms tend to be complete and detailed. Second, standard form contracts issued by large firms such as SOEs. These are usually simpler. They are basically imposed on the other party and serve the interests of the SOEs. Third, standard form contracts supplied by law firms and legal counsel who upload them on to the web. These are often simple, not much used by experts, but

they are used by people in more everyday transactions. (Lawyer, Beijing, November 2014)

One interviewee (lawyer, Jiangmen, December 2015) also commented that standard form contracts imposed by SOEs are often seen as unfair.

With respect to the normal duration of contracts, one of the interviewees (entrepreneur, Beijing, November 2014) mentioned that they had a long-term contract of more than five years with their main supplier. This contract provided details on prices, quality, quantity as well as a guarantee clause for the products provided and a dispute resolution clause. Conversely, most of the other interviewees indicated a preference for short-term contracts, though also with some variation. According to one of them 'it is mostly one job, one contract, but we keep in touch with customers through after-sale services' (entrepreneur, Foshan, September 2014), while according to another:

Long-term contracts are not very common, one year is normal, two years is possible. You can have a long term contract if you know the other party well. It's rare. You may have framework contracts with basic terms, duration of one year. (Lawyer, Foshan, September 2014)

The future development of contractual drafting is likely to be influenced by the growing influence of contracts with trading partners from other legal systems (other countries as well as Hong Kong). But this will not necessarily lead to full convergence of the practices of contractual drafting given that there is a good deal of variation even within the countries of the developed world. For example, the relatively short-term contracts found in China seem to be in line with its association with the civil law origins of its legal system as research has found that in Britain and the US contracts tend to be lengthier than in continental Europe due to the tendency toward literal interpretation of terms in common law courts and due to the role of default rules in civil law countries.<sup>66</sup>

### **4.3. Attitudes to the courts, enforcement, and judicial corruption**

According to one of our interviewees 'litigation is a last resort and you would only use it if the relationship was ending' (lawyer, Foshan, September 2014). Another entrepreneur explained that he had not used courts in order to enforce claims, adding that:

I have heard of others ending up in court. The results are never satisfactory. My approach is: keep out of the courts, it's not worth it. (Entrepreneur, Beijing, November 2014)

Such scepticism about the role of formal contracts and judicial enforcement is not at all unique to China. As we have seen, Macaulay reports similar

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<sup>66</sup>See M Siems, *Comparative Law* (Cambridge University Press 2014) 136.

statements of US entrepreneurs according to which 'disputes are frequently settled without reference to the contract or potential or actual legal sanctions' and that 'you can settle any dispute if you keep the lawyers ... out of it [because] they just do not understand the give-and-take needed in business'.<sup>67</sup> As we noted above, these comments do not necessarily imply the absence of equilibrium selection effects of the legal system. In the Chinese case, however, the likelihood of any such effect could be conditioned by the variable institutional quality of the court system.

On this point, our interviews suggest a mixed picture. Some interviewees indicated that the quality of court procedures and of judgments was improving, in particular in the economically more advanced regions, that the majority of cases were decided on an objective basis, and that judicial independence was respected in ordinary cases. Reference was also made to the strengthened qualification requirements for judicial appointments, the growing sophistication and length of judgments, and the recent requirement to publish courts' decisions online. A trend towards litigation is also confirmed by quantitative data. A former judge from Shenzhen indicated to us that between 1999 and 2008 the case load per judge rose from around 100 to more than 300 cases per year. Other research has also found that judicial enforcement is playing a more pronounced role than has been the case in the past.<sup>68</sup>

Interviewees also reported, however, concerns over judicial corruption. In this context, many respondents saw *guanxi* in a negative light. According to one of the interviewees, for example, '*guanxi* is a problem; both parties may go looking for it, they will try to influence the judge' (lawyer and entrepreneur, Beijing, November 2014). In particular, *guanxi* was seen as a problem where judges had close ties to one of the parties or their lawyers. Some references were also made to executive or political interference in judicial proceedings. At the same time, some interviewees suggested that judges seen as open to influence were taking a risk, for example:

The judge who relies on *guanxi* is now risking his career. There is a younger generation entering the judiciary. They have a belief in justice and they are against *guanxi* and simply obeying those in authority. (Lawyer, Guangzhou, December 2015)

Several respondents referred to the practice of judges favouring local parties in disputes. A number of entrepreneurs gave us instances of what they regarded as this 'local protectionism', for example:

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<sup>67</sup>Macaulay (n 20) and section 2 above.

<sup>68</sup>D Clarke, P Murrell and S Whiting, 'The Role of Law in China's Economic Development' in T Rawski and L Brandt (eds), *China's Great Economic Transformation* (Cambridge University Press 2008); Zhou and Siems (n 55).

There is a strong sense of local protection. In my home town where a case was tried I won easily. In another case in a different province the court kept refusing to hear the case without legal justification. Even when cases are appealed you feel that they protect the local party. (Entrepreneur, Beijing, December 2015)

In a similar vein was this comment from a lawyer:

Judicial protectionism does exist. There was a recent case in which an insolvent company had assets of over £100 million but the goods were sold at auction and suppliers got only £4 million. There was probably corruption. There is a feeling of a lack of judicial independence and of a loss of impartiality. (Lawyer, Jiangmen, December 2015)

Another view was that the causes of inconsistency in judicial decision-making were systemic and not always attributable to corruption:

What are the reasons for judicial protectionism? The first is that judges have discretionary powers. In a civil law system the judge has more discretion because of the need to apply general principles and each judge can form their own view of the rules. This can lead to inconsistency. Secondly, there is inconsistency in the laws themselves. There are national laws, local laws, and laws at many levels in between. This gives rise to conflicting decisions. Thirdly, enforcement is weak. This is not just the fault of the courts, other institutions matter. (Lawyer, Jiangmen, September 2014)

At the time of our final round of interviews in December 2015, a judicial reform process launched a few months before was in full swing. This was perceived positively by some respondents, as an opportunity to use reporting of cases and information exchange to make the judicial process more transparent. There was also the view that increasing penalties for judges who decided cases incompetently or corruptly would help to foster an atmosphere of judicial independence. But one interviewee commented:

It has been clear that unfair decisions and judicial protectionism are part of the problem. They are caused by a lack of judicial independence and authority. But there are some matters for concern in the recent judicial reforms. There is strong resistance to them. The current reform is entirely top-down and insufficient consultation with the judges. This may severely damage the commitment and professionalism of the judges particularly the younger ones. (Lawyer, Jiangmen, December 2015)

A range of views was reported on the feasibility of arbitration as an alternative form of dispute resolution. In one of our interviews, a part-time arbitrator presented a positive picture: arbitration was, he suggested, quicker than the multilayered court system, and commercial arbitrators were seen as having more business expertise than most judges. These advantages were seen as applying in particular to contracts with an international dimension. He also thought that arbitration had the potential to play a growing role in purely domestic disputes (lawyer, Beijing, October 2013). But, beyond the relevance of

international arbitration,<sup>69</sup> this was a relatively isolated view; according to other respondents, 'arbitration hardly ever works [because] there are not enough arbitrators and many parties don't know about it' (lawyer and entrepreneur, Beijing, November 2014), and 'arbitration is very rarely used' (in-house counsel, Foshan, September 2014). The reasons given were the high costs associated with paying arbitrators' fees and the difficulty of appealing an arbitration decision.

#### ***4.4. The financial market: state monopoly, inefficient rules and coping strategies***

Compared with the product market where government allows the rapid expansion of market mechanisms, much of China's financial sector still operates under a highly regulated environment shaped by the centrally planned system.<sup>70</sup> In the pre-reform period from 1957 to 1978, China's financial system consisted of a few institutions integrated within the vertical command chains: the People's Bank of China (PBOC), directed by the State Council handling industrial and commercial credit, deposits and currency issuance; the People's Construction Bank of China, led by the Finance Ministry, managing infrastructure investment funding; and the People's Insurance Company of China, later streamlined into the insurance department of PBOC, providing insurance services for foreign transaction.<sup>71</sup> Between 1979 and 1984 four commercial banks, namely Agriculture Bank of China (ABC), Bank of China (BOC), China Construction Bank (CCB), and Industrial and Commercial Bank of China (ICBC), were set up by separating these entities from PBOC and other line ministries, and providing for them to take over their commercial operations. Independent in their own operations but under PBOC's supervision, these banks remained wholly state-owned until 2005 when they started launching IPOs in overseas and later domestic stock markets. While institutional and retail investors were introduced leading to a diversification of shareholdings, ownership remains highly concentrated given the controlling stake still held by the Chinese state. From the late 1980s, China allowed joint stock commercial banks and other forms of cooperative banks to operate in both urban and rural areas, of which the controllers are largely SOEs and government-affiliated entities. While the establishment of Pingan Insurance (1988) and Minsheng Bank (1996) signalled the disruption

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<sup>69</sup>In international arbitration, the China International Economic and Trade Arbitration Commission (CIETAC) has the highest caseload in the world according to M Altenkirch and N Gremminger, 'Parties' Preferences in International Arbitration: The Latest Statistics of the Leading Arbitral Institutions' (5 August 2015), <http://globalarbitrationnews.com/parties-preferences-in-international-arbitration-the-latest-statistics-of-the-leading-arbitral-institutions-20150805/> accessed 15 December 2016.

<sup>70</sup>OK Tam, 'Ethical Issues in the Evolution of Corporate Governance in China' (2002) 37 *Journal of Business Ethics* 303.

<sup>71</sup>X Fu and S Heffernan, 'The Effects of Reform on China's Bank Structure and Performance' (2009) 33 *Journal of Banking and Finance* 39.

of the state monopoly in the mainland financial sector, it remains dominated by state-controlled banks (SCBs) which still absorb the vast majority of household savings.<sup>72</sup>

Since 1995, fiscal appropriation as the main source of SOE financing had been gradually replaced by bank loans.<sup>73</sup> Credit allocation and dispute resolution remained subject to administrative interventions, reducing the role of formal laws and regulations. The result, as one interviewee put it, is that 'in the area of commercial banking, it is a problem that there are few laws and that there are significant gaps. The law is lagging behind the practices' (lawyer, Beijing, November 2013). State ownership also enables direct bureaucratic inference in SCBs' lending and decision-making.<sup>74</sup> Thus it is no surprise to observe the continued lending bias towards the state sector, while private firms, in particular the SMEs, face limited credit access. Almost all the SME entrepreneurs we interviewed referred to difficulties in accessing bank loans, either because of a perceived 'lack of collateral' (entrepreneur, Beijing, November 2014) or simply because 'the banks are not interested in SMEs' (entrepreneur, Beijing, November 2014).

Can private actors overcome the inefficiencies of a state-dominated credit market? Allen and others claim that this could be done by informal financing, that is, personal lending based on personal relationships and social networks.<sup>75</sup> Consistently with this view, most private entrepreneurs we spoke to confirmed that their firms were self-financed or had borrowed from families and friends. However, this coping strategy can be costly:

Chinese banks live on the interest rates gap, pay low interest rates to depositors, and charge high rates. Banks don't pay high interest to borrowers, therefore people didn't want to put their money in the bank and SMEs can't get credit from the banks. So in economically active areas like Guangdong, Shanghai and Beijing, people turned to personal finance. Personal lenders charge high interest rates over the short term. The monthly rate alone might be 5%, implying 60% annually, but they usually don't require security or collateral, lending is based on personal relation, trust or previous dealings. Downstream lenders are also borrowers in the chain and this implies a domino effect – if one part fails the whole pack fall over. (Lawyer, Beijing, November 2014)

A recurrent theme in our interviews was the difficulties facing small and medium-sized enterprises (SMEs) in getting finance through formal channels. Entrepreneurs took the view that banks tended to favour larger, state-owned firms, and their demands for collateral were unreasonable; banks and lawyers advising them, on the other hand, commented that the quality of SMEs was

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<sup>72</sup>W Shen, *The Anatomy of China's Banking Sector and Regulation* (Wolters Kluwer 2014) 67–92.

<sup>73</sup>Wu (n 56).

<sup>74</sup>N Lardy, *China's Unfinished Economic Revolution* (Brookings Institution 1998); R Cull and L Xu, 'Bureaucrats, State Banks and the Efficiency of Credit Allocation: The Experience of Chinese State-owned Enterprises' (2000) 28 *Journal of Comparative Economics* 1.

<sup>75</sup>Allen and others (n 4).



often low. Whatever the cause, many small business owners were left dependent on types of informal finance that were both costly and high-risk. A Supreme People's Court ruling in 2015 capping the annual repayment rate on loans at 36% was seen as pro-lender, on the basis that interest charged below this level was not seen as legitimate. The high cost of servicing loans was seen as a constraint on growth since it left firms with virtually no surplus after paying wage and taxes. Reliance on informal finance triggered bankruptcies which occurred when owners simply abandoned their businesses:

There is a tendency for Chinese entrepreneurs to be excessive risk takers and in the current macroeconomic environment where there is difficulty getting formal finance they will go to loan sharks charging excessive rates, gangsters, and so on. When the cost of repayment becomes unbearable they often run away. There is a cultural issue here. Chinese people don't like to work as employees, they all want to be the boss. (Lawyer, Jiangmen, December 2015)

As much of the lending over course of the 1990s turned into non-performing loans,<sup>76</sup> government subsidies to loss-making SOEs reached untenable levels. In response the mainland stock markets were built up, more or less from scratch, to serve primarily as an alternative capital-raising source for the financially distressed enterprises.<sup>77</sup> In the US and the UK, stock markets were established by market participants in order to facilitate transactions. The early rules governing stock exchanges were entirely private, and were made and enforced by self-regulatory bodies, mostly the stock exchanges themselves. Stock exchange rules did not initially reflect the interests of minority shareholders, but over time market competition forced some regional exchanges to adopt rules protective of minority investors, since doing so served their own interests in generating higher volumes of share trading.<sup>78</sup> These rules were later absorbed into formal codes and statutes and in some cases came to be enforced by the state.

By contrast, China's stock exchanges were created by the government.<sup>79</sup> Regulations regarding securities market operation and corporate governance have often been designed and enforced in a manner intended to prioritise the government interests, in particular to channel funding for SOE restructuring.<sup>80</sup> This was particularly so under the quota system whereby scrutiny and approval of IPO applications were effectively under bureaucratic control. Under these circumstances, there were virtually no market pressures to

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<sup>76</sup>Lardy (n 74); Cull and Xu (n 74).

<sup>77</sup>Wu (n 56); Green (n 56).

<sup>78</sup>JC Coffee, 'The Rise of Dispersed Ownership: The Roles of Law and the States in the Separation of Ownership and Control' (2001) 111 *Yale Law Journal* 1.

<sup>79</sup>Walter and Howie (n 56); Chen, *Corporate Governance* (n 47).

<sup>80</sup>This may also lead to a conflict of interests for enforcement against SOEs: see T Zhou, 'Is the CSRC Protecting a "Level Playing Field" in China's Capital Markets: Public Enforcement, Fragmented Authoritarianism and Corporatism' (2015) 15 *Journal of Corporate Law Studies* 377.

meet private firms' financing needs, nor to safeguard the interests of minority shareholders.

The abolition of the quota system in 2001, together with the opening of the Nasdaq-type ChiNext section in the Stock Exchange (SZSE), together extended Chinese private companies' access to capital markets.<sup>81</sup> In 2011, the number of listed private companies exceeded 1,000.<sup>82</sup> An official from the policy and research department of SZSE told us in 2014:

As for 2014, around 40 per cent of the listed companies in the main section are private. Such a proportion is even higher and reaches almost 95 per cent in the ChiNext section. Overall, private firms account for 75 per cent of the listed companies in the SZSE. (Official, Shenzhen, September 2014)

However, private companies with needs for external finance are still being deterred by the complex process of IPO approval, which is effectively under central state control through the operation of the securities market regulator, the China Securities Regulatory Commission (CSRC). Interviews with private entrepreneurs, who had considered going public, reported that 'listing is difficult' and there is 'too much control over listing' (entrepreneurs, Beijing, November, 2014). This problem has been further exacerbated since the 2007–2008 global financial crisis given the regulators' concern that 'issuance of new shares is likely to dilute current share prices, thereby exerting negative impact on (domestic) stock market stability' (official, Shenzhen, September 2014). In this case, private companies often opt for 'buying a public shell' and overseas listing as alternatives to a domestic IPO (entrepreneur, Beijing, November 2014; official, Shenzhen, September 2014; fund manager, Shenzhen, September 2014). In the case of acquisition of public shells, we were told:

to pass M&A approval is difficult. Local governments may have particular understandings of approval processes. Government agencies compete with each other and may send conflicting signals. (Lawyer, Beijing, November 2013)

Meanwhile, the Hong Kong Stock Exchange (HKSE) came to be perceived as one of the favoured hubs for overseas listings (lawyer, Beijing, October 2013), possibly also due to its credible commitment to protect international investors.<sup>83</sup> One interviewee described his plan of listing in the HKSE in a few years' time. As HKSE mandate that at least one of the originators had to be non-Chinese, Chinese entrepreneurs often registered companies overseas, or acquired citizenship from convenient foreign jurisdictions, such as the British Virgin Islands.

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<sup>81</sup>X Li and I MacNeil, 'Experimentation in Securities Market Structure and Regulation in China: From State to Market' (2016) 16 *Journal of Corporate Law Studies* 241.

<sup>82</sup>The All-China Federation of Industry and Commerce 2011 Report, *China Daily*, 9 February 2011.

<sup>83</sup>Details of the underlying motivations (raising capital, bonding etc.) have been explored by FX Huang and H Yeung, *Chinese Companies and the Hong Kong Stock Market* (Routledge 2014).

Another way of overcoming limited capital access for private companies, in particular those in such emerging industries as the IT sector, has been to access venture capital ‘which is dominated by overseas investors’ (entrepreneur, Beijing, November 2014). A Beijing-based interviewee who had recently received financing from venture capital commented that ‘over the past decade VC has become well accepted; it’s not difficult’ (lawyer and entrepreneur, Beijing, November 2014). Angel capital was also cited by several Beijing-based respondents as a potentially flexible and supportive form of finance for high-tech start-ups, although one which provided relatively small amounts of funding.

Thus, to some extent, it seems that these innovative means of raising finance work well as they provide more flexibility and as there is some trust in the enforcement of these agreements. However, a lack of transparency in the operation of the main stock markets was seen by some respondents as a potential barrier to the further growth of venture and angel capital, in so far as these forms of financing depend on the feasibility of an IPO to enable investors to recoup their returns:

Both venture capital and private equity [meaning private investment] have grown rapidly, but both VC and PE are interested only in investing in companies with the possibility of a listing driven by a high price-earnings ratio, so the listing is just used to cash out. The approval system for IPOs creates incentives for bribery of the CSRC. This is called ‘private equity corruption’. (Lawyer, Beijing, December 2015)<sup>84</sup>

One reason for this that shareholder protection laws, while strong in principle, do not work well in practice. There was recognition that ‘a great progress has been made, in particular over the last decade, in securities laws, M&A’ (lawyer, Beijing, November 2013). However, some respondents commented that the laws are not well drafted, as already noted.<sup>85</sup> Some cases even reported the perverse incentives caused by the laws:

the disclosure rule is based on good intentions and on the principle of substantive disclosure. However, companies can’t always meet the requirements placed upon them so they cook the books. (Lawyer, Beijing, November 2013)

Problems were also reported with enforcement. A number of interviewees identified gaps between the laws on the books thus:

Enforcement is the key problem. The CSRC rules require companies to disclose a lot of substantive information so that investors can take a long-term view of a company. The disclosure rules are tougher, formally, than their American

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<sup>84</sup>See also Lin Zhang, *Venture Capital and the Corporate Governance of Chinese Listed Companies* (Springer 2012) 73–88 (referring to ‘lack of efficient exit channels’); Lin Lin, ‘Venture Capital Exits and the Structure of Stock Markets: Lessons from China’ (2017) *Asian Journal of Comparative Law* (forthcoming) (identifying correlation between stock market and venture capital development in China).

<sup>85</sup>See section 32 above.

counterparts. On paper this should work but in practice the law is not really obeyed. (Lawyer, Beijing, November 2013)

One of the other officials we interviewed attributed this to structural shortcomings of the mainland financial market:

We have increasingly realised that the current information disclosure regulations, which for a long time has been used to merely fulfil the regulator's supervisory aims, will fail to meet investors' requirements in the near future ... The mainland (stock) markets are essentially a seller's market where listed companies have few incentives to provide adequate information disclosure (for public investors) ... (Official, Shenzhen, September 2014)

There was also a widespread view that the mainland stock markets provide opportunities for rent seeking by corporate insiders and government officials. Several respondents mentioned the risk of expropriation by insiders during the IPO stage, which led many retail investors to cash out their holdings following IPOs (lawyer, Beijing, October 2013). When our final interviews were conducted in December 2015, the system of registration of IPOs through the CSRC was being liberalised, but some thought that this would make little difference:

The Chinese stock market is not like other stock markets. The CSRC will still have power and the stock exchange itself will ration IPOs. (Academic, Beijing, December 2015)

At the same time, several interviewees took the view that capital market transparency was increasing as a result of growing liquidity and higher trading volumes, and that notwithstanding present difficulties, this trend would continue. Some thought that the price setting process was becoming more impersonal and less susceptible to political and bureaucratic influence. As in the case of some of our product market interviews, respondents saw a decreasing role for personal relations in financial market dealings, and contrasted *guanxi* with marketisation:

*Guanxi* will be less important in the future. In less than five years, you will depend on yourself, not *guanxi*. This is because marketisation is happening. There is less and less chance to make certain money through *guanxi*. In five years, the market will have competed away *guanxi* ... Product markets are the most marketised, then futures, then shares. (Private investor, Beijing, November 2014)

Whether *guanxi* stays important depends on how quickly the Chinese economy and society develop towards openness. *Guanxi* will become less important as the market and the rule of law develop. The market rules and *guanxi* rules are two different systems. (Insurance company executive, Beijing, November 2014)

[*Guanxi*] is a big factor. But more and more people are beginning to see that the key factor is how the company performs, not personal contacts ... *Guanxi* will continue to be important if the government plays a role in allocating assets. (Asset management company executive, Beijing, November 2014)

Overall, with respect to financial markets in general the following picture emerges: in China, development of credit and stock markets remains highly regulated and policy-driven. While it is sometimes possible to avoid restrictions, for example, through an overseas listing or by way of searching for alternative forms of credit, the law is not seen as supportive in this area. As far as there are protective rules, those often do not work adequately. Shareholders of Chinese companies may enjoy a similar level of protection to those in other countries in terms of written laws,<sup>86</sup> but do not regard themselves as well protected in practice. Reflecting on the 'law and finance' view, it can therefore not (yet?) be said that law is a main determinant of financial market development in China.

Some market participants believe that the depth and transparency of the market are increasing over time and that as this process continues there will be less of a role for rent-seeking. Thus there is scope for a shift to more legally driven and impersonal forms of exchange in financial relations. However, capital markets are not seen as having reached the same stage of development as product markets in this regard, and continuing government involvement in asset allocation is seen as a barrier to marketisation.

#### ***4.5. The role of the state in maintaining economic development***

Our interviewees were not state officials and were not otherwise directly engaged in the political process. Nevertheless, as legal professionals and business owners they were well placed to reflect on the role of the Chinese state in economic development. These are issues which were publicly discussed in China during the period of our interviews, in particular after the launch by central government of a concerted 'anti-corruption campaign' in 2014. Our interview responses reflect the kind of debates which, we can infer, were going on in legal and business circles, below the level of public discourse, at this time.

Broadly two sets of views were held. On the one hand there was a belief in the power of the Chinese state, in the form of both central and regional governments, to maintain the conditions for economic growth, as it was seen to have done over the preceding three decades. This was expressed, for example, in the following way:

Belief in the government is still strong. The Chinese stock market is not a free market. Because people believe in the government, they will believe in the market. Step by step the market will become more free but we are a long way off that. (Lawyer, Guangzhou, December 2015)

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<sup>86</sup>See the quantitative comparison in D Katelouzou and M Siems, 'Disappearing Paradigms in Shareholder Protection: Leximetric Evidence for 30 Countries, 1990–2013' (2015) 15 *Journal of Corporate Law Studies* 127.

In this regard, the distinct qualities of the Chinese state are explicitly acknowledged:

The Chinese government does not work in the same way as in the West where politics is divided along bipartisan lines. There is more consistency in China. Continuity is expected from all governments for the next 10, 20 years. There will be only slight adjustments over the detail of law and policy. (Lawyer, Beijing, November 2013)

Several respondents commented on the importance of the state for maintaining confidence in the economy and in particular markets, including the financial market, and in stimulating the conditions for the private sector to develop further, as in the suggestion, from more than one interviewee, that it was up to the government to take action to improve access to formal finance for SMEs.

Thus the idea the Chinese state can, by virtue of its non-Western characteristics, more effectively guarantee the conditions for economic development or societal coordination<sup>87</sup> has some resonance in contemporary experiences.

It was, however, not the only view we heard. Some respondents were of the opinion that economic development would in the end require a broader legal and institution evolution:

The economy is currently in difficulty and China's future depends on whether it can make the transition to being an innovative economy. Although the government is promoting transition, the future depends on whether there is a fundamental political change. Innovation is closely related to freedom of speech. Only if people have security of property and freedom of speech will there be a successful transition and sustainable growth. (Lawyer, Beijing, December 2015)

Recently China has been experiencing unprecedented difficulties. This will probably not change over the next 3–5 years but over 10 years things will have improved. There are still many market opportunities which have not been realised. But in order for this to come about, China has to adopt some fundamental reforms. It needs a real market economy. This means that the government should reduce its interventions in the market. The market share of the SOEs should go down. There should be a more complete and effective legal system to ensure security of transactions. The priority should be judicial reform. The necessary step is to strengthen the independence and impartiality of the judges. That is more important than technical legal reforms. If just one case is not impartially decided, it can have a huge influence on the confidence of investors. (Lawyer, Guangzhou, December 2015)

For others, China's evolution towards a model incorporating elements of the Western model of the rule of law was less a goal, more a prediction:

There has been a fundamental change in institutional development and in judicial practice. China is getting close to other countries. I am confident that this trend will continue. (Lawyer, Foshan, December 2015)

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<sup>87</sup>Allen and others (n 4); Gilson and Milhaupt (n 4).

*Guanxi*-based trade still exists to a certain extent so China is regarded as a country with the rule of men, not rule by law, but I believe that this is changing and I am confident of the future. (Lawyer, Foshan, December 2015)

It is not possible to say that one of other of these views represents a minority or majority position, simply to note that all were present and actively being debated during what many regard in China regard as a critical moment in the transition process.

## 5. Conclusion

In this article we have reported findings from interviews with entrepreneurs, managers, lawyers and bankers in China, carried out between November 2013 and December 2015, on the theme of law and trust in contractual dealings, and on the relationship between the legal system and finance, in particular as regards the role of contract, corporate and financial law. Our findings shed new light on the relationship between economic growth and the development of a rule of law state in contemporary China.

We do not find evidence to support the claim that China's growth, now or in the recent past, has depended on the absence of law and on the presence, instead, of interpersonal trust or *guanxi*. While this may have been the case at the start of the period of market-based reforms several decades ago, our interviews suggest that legal and business actors increasingly see costs attached to the use of *guanxi* as the basis of contractual relations in China. In particular for business actors in emerging sectors such as IT, *guanxi* has negative connotations associated with clan or network relations, which can tip over into corruption. The deadweight costs of *guanxi* are being lessened to the extent that more formal market relations, based on impersonal trade, are becoming established. This is likely, however, to be a slow process, which is conditional upon the capacity of the courts to operate independently from the executive power. Nevertheless, to the extent that practices embodied in the idea of the rule of law are endogenous to economic development, there is reason to believe that China, because of its recent growth path, is well placed to make the transition to impersonal exchange in contractual relations in the near future.

By contrast, with respect to financial markets, the situation is considerably different from that in developed economies. In Europe and North America, financial markets largely evolved spontaneously or on the basis of private action and self-regulation. In China, however, the state has led their development. In the case of the capital market, there is much less room to contract around inefficient formal rules than in product markets. Market actors perceive that a shift may be taking place towards more transparent and impersonal exchange in financial markets, but recognise that financial transactions lag behind the product market in this respect.

We also see complex attitudes to the issue of the role of the state in China's future economic and institutional development. There is no single view: some of our interviewees see the Chinese state as a distinct model, unlike its Western counterparts, which by virtue of its particular capacities is in a position to underpin continuing economic development, as it has done since the start of the reform era. The state's role in coordinating expectations, in particular by maintaining confidence in the economy while providing institutional continuity, was highlighted in several interviews. At the same time there was a view that economic development was being held back by the absence of a western-style rule of law, and that China's future depended on the ability of the state to manage this transition.

While it remains to be seen how this process will unfold, we see evidence to confirm the suggestion that the Chinese version of the rule of law will in future involve less reliance on *guanxi*, and a greater emphasis on judicial independence and objectivity. We also think that our findings are broadly consistent with the view that the emergence of the rule of law as a self-sustaining social norm is both cause and effect of market-led economic growth.

## Acknowledgements

The authors are at the University of Sheffield (Chen), the University of Cambridge (Deakin; Wang) and Durham University (Siems). For the underlying project on Law, Development and Finance in Rising Powers, based at the Centre for Business Research (CBR) of the University of Cambridge see [www.cbr.cam.ac.uk/research/research-projects/law-development-finance-in-rising-powers/](http://www.cbr.cam.ac.uk/research/research-projects/law-development-finance-in-rising-powers/). We gratefully acknowledge funding from the ESRC's 'Rising Powers' Programme (ES/J012491/1). We are also grateful for comments received in the course of presentations of earlier versions of this work at the Annual Conference of the World Interdisciplinary Network for Institutional Research (WINIR) in Rio de Janeiro, the Annual Conference of the Law and Society Association (LSA) in Seattle, the Chinese Academy of Social Sciences (CASS), the National University of Singapore (NUS), the School of Oriental and African Studies (SOAS), and Tulane University. The remaining errors are entirely our responsibility.

## Disclosure statement

No potential conflict of interest was reported by the authors.

## Funding

This work was supported by the Economic and Social Research Council [grant number ES/J012491/1].

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## Appendices

### Appendix 1. List of interviews and focus groups

Interviewee(s)	Mode	Date	Location
Academic and lawyer	Interview	October 2013	Beijing
Academic and lawyer	Interview	October 2013	Beijing
Lawyer	Interview	October 2013	Beijing
Academic and arbitrator	Interview	October 2013	Beijing
Academic	Interview	October 2013	Beijing
Academic and arbitrator	Interview	October 2013	Beijing
Lawyer	Interview	October 2013	Beijing
Lawyer	Interview	October 2013	Beijing
Lawyers (4)	Focus group	November 2013	Beijing
Lawyers (4)	Focus group	November 2013	Beijing
Lawyer (1)	Interview	November 2015	Beijing
Academics (7)	Focus group (1)	November 2013	Beijing
Academics (4)	Focus group (2)	November 2014	Beijing
Academics (4)	Focus group (3)	December 2015	Beijing
Managers (3)	Focus group	November 2013	Beijing
Entrepreneur and lawyer (real estate)	Interview (1)	September 2014	Guangzhou
	Interview (2)	December 2015	Guangzhou
Lawyers (9)	Focus group (1)	September 2014	Foshan
Lawyers (6, 3 new)	Focus group (2)	December 2015	Foshan
Manager (finance)	Interview	September 2014	Foshan
Official (local government)	Interview	September 2014	Foshan
Lawyers (3)	Focus group	September 2014	Foshan
Entrepreneur (manufacturing)	Interview	September 2014	Foshan
Manager (finance)	Interview	September 2014	Shenzhen
Official (stock exchange)	Interview	September 2014	Shenzhen
Manager (bank)	Interview	September 2014	Jiangmen
Lawyers (9)	Focus group (1)	September 2014	Jiangmen
Lawyers (8, 4 new)	Focus group (2)	December 2015	Jiangmen
Entrepreneurs (3) (construction)	Focus group (1)	September 2014	Jiangmen
Entrepreneurs (3) (construction)	Focus group (2)	December 2015	Jiangmen
Lawyer	Interview	September 2014	Jiangmen
Lawyer and entrepreneur (IT)	Interview	November 2014	Beijing
Entrepreneur (restaurant)	Interview	November 2014	Beijing
Entrepreneur (restaurant)	Interview	November 2014	Beijing
Entrepreneur (IT)	Interview	November 2014	Beijing
Entrepreneur (IT)	Interview	November 2014	Beijing
Entrepreneur (IT)	Interview	November 2014	Beijing
Investor (private fund)	Interview	November 2014	Beijing
Trader (securities)	Interview	November 2014	Beijing
Manager (finance)	Interview	November 2014	Beijing
Manager (finance)	Interview	November 2014	Beijing
Manager (finance)	Interview	November 2014	Beijing
Lawyer and judge	Interview	November 2014	Beijing

### Appendix 2. Aide-mémoire

The aide-mémoire reproduced below was circulated to interview and/or focus group participants or its contents summarised in advance of the meeting and used to structure discussion. It consists of a brief contextual introduction and the identification of main themes and questions for discussion.

#### Context

This aide-mémoire is intended to provide a structure for interviews to be conducted in the context of a research project which considers the role of law in economic

development in the Chinese economy. In recent years economists have become increasingly interested in the role of the legal system and legal institutions in economic development, and in the related proposition that law and the legal system may at least to some extent be determinants of economic growth.

The intention here is to try to ascertain, by a series of interviews with people with a variety of perspectives, the extent to which the legal system is generally supportive of economic activity in each of the subject countries. It is hoped that a comparative survey of countries with different histories and trajectories will yield more general insights into the relationship between law and the economy which will contribute to our understanding of how to create an optimal legal environment for economic activity.

The approach is predicated on the assumption that legal and economic systems which are evolving fairly rapidly are capable of delivering insights which would not emerge through the observation of more static systems.

The topics and questions listed below should not be treated as exhaustive, however, and participants should feel free to raise any other relevant issues which are not explicitly mentioned below.

#### *Law on the books*

Is the legal framework complete? Are the laws clear and consistent? Are they adapted to the needs of the market? Does the law on the books allow businesses to conclude the transactions they want to conclude?

#### *Legal evolution*

Does the legislation evolve to meet the needs of the market, and to address defects in the legislation (such as lack of clarity, contradictions, provisions which have unintended effects)? What are the processes for legal development and do they function adequately?

#### *The courts*

Are judges competent, reliable and predictable? Do the courts operate efficiently, diligently and without undue delays?

#### *Regulatory environment*

Is the regulatory framework market friendly? In other words are the regimes for tax, customs, exchange control, competition, financial and securities market regulations and setting up and running a business unduly onerous, restrictive and/or difficult to comply with, or do they broadly support orderly market activity?

#### *Administration/bureaucracy*

Do administrative agencies operate efficiently, transparently and even handedly? Are they helpful and supportive? If not, is this a problem?

#### *Access to finance*

Is finance readily available to business on reasonable market terms? Is the financial sector generally flexible and supportive to business? Do financial institutions have the legal instruments they need (in particular the ability to take and enforce security) to be able to offer attractive terms to business?

#### *Alternatives to the legal system*

Is the legal system an appropriate and effective system for upholding property rights and enforcing performance of obligations, or are there alternative or complementary means which are sometimes more effective?

*Protection of rights*

Does law have an essentially protective function, or is it also used as an indirect means of achieving particular ends?

*Attitudes to lawyers*

How are lawyers perceived, and what is expected of them? Are they seen primarily as helpful, obstructive or irrelevant?

*Challenges*

What are the main areas to be addressed to make the legal system more supportive of market activity?

*Any other issues*

For discussion.