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17

Contract Law and Economic Reform

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It has become conventional wisdom amongst most economists that a legal system that provides effective protection of private property rights and enforcement of contracts is regarded as prerequisite to economic growth. As Nobel Laureate Douglass North stated, 'the inability of societies to develop effective, low-cost enforcement of contracts is the most important source of both historical stagnation and contemporary underdevelopment in the Third World.' [1] Nevertheless, this paradigm does not seem to be consistent with China's trajectory over the past four decades. Contract law in China remained rudimentary and fragmented till the passing of the Unified Contract Law in 1999, twenty years after the launch of economic reform. The Chinese court system has been plagued with lacking of independence, corruption and local protectionism which casts serious doubts on judiciary efficiency. Regardless of all these apparent institutional weaknesses, China's economy has achieved a rapid growth since 1978 and lifted millions of people out of poverty. Does this constitute a counter-example as some scholars[2] suggested to the 'law matters' thesis?

This chapter intends to explore the relationship between contract law and China's economic growth. It is structured as follows: Section I sets the scene by seeking to clarify the nature of the theoretical claims at stake; Section II briefly outlines the progress of China's economic reform; Section III introduces the development of China's contract law; Section IV starts with a theoretical discussion that is followed by a presentation of empirical evidence drawing on interviews and focus groups with entrepreneurs, managers and lawyers in Beijing and the Pearl River Delta, carried out between 2013 and 2015 Section V concludes the chapter.

I. CONCEPTUAL FRAMEWORK: THE CO-EVOLUTION OF CONTRACT LAW AND ECONOMY

In economic theory, national wealth results from production and exchange.[3] However, exchanges cannot be taken for granted. Whenever the full performance of an exchange requires time, the party who finishes first will find himself having to rely on the promise of the trading partner to get what he has bargained for. The trading partner, after receiving his agreed gains, finds it is in his interest to renege on the agreement. If there is no other institution to mitigate the risk arising from opportunism, only simultaneous exchange could take place. The institutions that assure

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[1] D North, *Institutions, Institutional Change and Economic Performance* (Cambridge, CUP, 1990) 54.

[2] See eg. F Allen, J Qian and M Qian, 'Law, finance and economic growth in China'' (2005) 77 *Journal of Financial Economics* 57; C Jones, 'Capitalism, Globalization and Rule of Law: An Alternative Trajectory of Legal Change in China' (1994) 3 *Social & Legal Studies* 195.

[3] A Smith, *The Wealth of Nations* (first published 1776, Ware, Wordsworth Editions, 2012).

enforcement of contracts include both formal and informal institutions. The existing literature is divided on the respective role of formal and informal institutions in economic growth.

A. Formal institutions as a perquisite to economic growth

The contract formalist approach to development taken by North regards formal contract enforcement as a necessary prerequisite to a nation's economic development. In the absence of effective formal enforcement, economic development is unlikely to occur. Over the past two decades, this view was very much in vogue, in part as a result of the growing use of metrics purporting to measure the quality of the rule of law. The World Bank's Rule of Law Index, a complex composite index built up from a wide range of data sources[4] on the operation of legal institutions, was invoked to show that the nature of a country's commitment to the rule of law significantly affected its level of economic development[5]. For instance, an improvement in the rule of law scores by one standard deviation from levels prevailing in Ukraine in the early 2000s would lead to a fourfold increase in per capital income over the long term.[6]

The independent effect of 'unbundled' formal contract enforcement institutions on economic performance is tested by Christopher Clague and his colleagues. They use contract-intensive-money (CIM) to test the types of governance (or institutions) that improve economic performance and assert that 'better institutions, especially with respect to contract enforcement, enable a society to obtain a wider array of (real) gains from trade'.[7] In a cross-country study, Levine et al. conclude that '[t]he degree to which financial intermediaries can acquire information about firms, write contracts, and have those contracts enforced will fundamentally influence the ability of those intermediaries to identify worthy firms, exert corporate control, manage risk, mobilize savings, and ease exchanges.'[8] Kenneth Dam reports additional empirical evidence from financial markets on the positive correlation between a strong and effective judiciary, acting as an important formal

[4] There is a literature that is very critical of the quality of the data sources on which the index is built. See, eg. P Legrand, 'Econocentrism', (2009) 59 *University of Toronto Law Journal* 215; A Perry-Kessaris, 'Finding and Facing Facts about Legal Systems and FDI in South Asia', (2003) 4 *Legal Studies* 649; L Taylor, 'The Law Reform Olympics: Measuring the Effects of Law Reform in Transition Economies', in T. Linsey (ed.), *Law Reform in Developing and Transitional States* (London, Routledge, 2007).

[5] See eg. W Max, in E. Shils and M. Rheinstein (eds), *Max Weber on Law in Economy and Society* (Cambridge, Harvard University Press, 1954); D North, *Institutions*, (n 1); D Rodrik, S Arvind and T Francesco, 'Institutions Rule: the Primacy of Institutions over Geography and Integration in the Economic Development' (2004) 9 *Journal of Economic Growth* 4; H de Soto, *The Other Path: The Invisible in the Third World* (New York, Basic Books, 1989); K Dam, *The Law-Growth Nexus: The Rule of Law and Economic Development* (Washington DC, Brookings Institution, 2006); R La Porta, F Lopez-de-Silanes, A Shleifer and R Vishny, 'Law and finance' (1998) 106 *Journal of Political Economy* 1113.

[6] D Kaufmann, 'Governance Redux: The Empirical Challenge', in M Porter et al (eds), *The Global Competitiveness Report 2003-2004* (New York, OUP, 2004).

[7] C Clague, P Keefer, S Knack and M Olson, 'Contract-Intensive Money: Contract Enforcement, Property Rights, and Economic Performance', (1999) 4 *Journal of Economic Growth* 185, 189.

[8] R Levine, N Loayza and T Beck, 'Financial Intermediation and Growth: Causality and causes' (2000) 46 *Journal of Monetary Economics* 31.

contract enforcement institution, and economic development.[9] Various country-specific studies also suggest the benefits of contract law in facilitating successful and profitable transactions. For instance, a study by Kathryn Hendley et al., argues that law and legal contract enforcement institutions do add value to the Russian economy.[10]

B. Informal institutions are sufficient to promote economic growth

The need for a formal third-party mechanism for contract enforcement has been downplayed by an alternative school of thought. Starting with Macaulay's seminal work in 1963 in which he emphasized the role of repeat trading, reputation and inter-personal trust,[11] 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 behavior of the managers Macaulay interviewed[12]. An extensive literature on relational contract following Macaulay argues similarly that long-term dealing and the existence of communal and/or personal ties between contracting parties may be more effective in building trust than reliance on court-based sanctions.[13] The relative rigidity of the formal law and its tendency to lag behind economic and technological developments, leading to avoidance strategies, means that even in developed economies such as the US, contracting between business parties generally takes place in isolation from the court system which deals with a tiny fraction of commercial disputes.[14]

One reading of the contract informalists 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.[15] Indeed, based on his analysis of Japanese economic development, Upham claimed that 'the experience of Asian

[9] D Kenneth, 'The Judiciary and Economic Development' (2006) U Chicago Law & Economics Working Paper No. 287, papers.ssrn.com/sol3/papers.cfm?abstract_id=892030. Accessed 10 August 2019.
[10] K Hendley, 'Growing Pains: Balancing Justice and Efficiency in Russian Economic Courts', (1998) 12 *Temple International and Comparative Law Journal* 301, 330.
[11] Macaulay termed this the role of 'non-contractual' elements of business relations.
[12] S Macaulay, 'Non-contractual Relationships in Business: a Preliminary Study' (1963) 28 *American Sociological Review* 55.
[13] See, eg L Bernstein, 'Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry' (1992) 21 *Journal of Legal Studies* 115; 'Merchant Law in a Merchant Court: Rethinking the Code's Search for Immanent Business Norms' (1996) 144 *University of Pennsylvania Law Review* 1765; 'Private Commercial Law in the Cotton Industry: Creating Cooperation Through Rules, Norms, and Institutions' (2001) 99 *Michigan Law Review* 1724; J Landa, 'A Theory of the Ethnically Homogeneous Middleman Group: An Institutional Alternative to Contract Law' (1981) 10 *Journal Legal Studies* 349; J Landa, *Trust, Ethnicity, and Identity: Beyond the New Institutional Economics of Ethnic Trading Networks, Contract Law, and Gift-Exchange* (Michigan, University of Michigan Press, 1994); A Greif, 'Contract Enforceability and Economic Institutions in Early Trade: the Magribhi Traders Coalition' (1993) 83 *American Economic Review* 525; M Fafchamps, *Market Institutions in Sub-Saharan Africa, Theory and Evidence* (Cambridge Massachusetts, MIT Press, 2004).
[14] H Collins, *Regulating Contracts* (Oxford, Oxford University Press, 1999); D Chen and S Deakin, 'On Heaven's Lathe: State, Rule of Law and Economic Development' (2014) 8 *Law and Development Review* 123.
[15]D Chen, S Deakin, M Siems and B Wang, 'Law, Trust and Institutional Change in China: Evidence from Qualitative Field (2017) 17 *Journal of Corporate Law Studies* 257.

economies demonstrates that the strict judicial enforcement of property and contract rights is not necessary to economic growth.'[16] Franklin Allen et al., offered a further challenge to the rule of law paradigm.[17] On the basis of empirical studies of Asian systems, they argue that the rule of law is not merely unnecessary but is a potential barrier to development. They characterise the legal system as a monopoly which can be captured by private interest groups. The fixed costs of revising the law and modifying legal institutions become highly problematic in emerging markets which may lack effective state capacity but also have the potential for rapid growth, rendering laws out of date. As a result, businesses tend to sidestep the law, relying on reputation, relational contracting and inter-personal trust to support economic and financial transactions, in preference to state-backed legal enforcement through the courts.

C. Co-evolution of contract law and economic growth

The position of both contract formalists and informalists seem to be somewhat overstated, or at least to over-simplify their cases. Formal and informal institutions are not mutually exclusive, rather, effective contract enforcement often requires them to work together. Commodities, even simple ones, have many valued attributes. A contract governing a transaction is likely to stipulate the standards for some of its attributes, but it is often too expensive or technically difficult to stipulate them all.[18] The trading parties will nevertheless exploit those not covered by the contract. Therefore multiple enforcement mechanisms are needed to enforce different attributes of a transaction. A mixture of formal and informal enforcement mechanisms can be found in most contemporary economies, developed and developing.

However, it is important to draw a line between 'private ordering in the shadow of the law', that is, alternative forms of contracting which operate in the presence of the rule of law, and 'private ordering under a dysfunctional public order', that is, forms which operate in the absence of a neutral and effective mechanism for contract enforcement.[19] In developed countries where courts are used as a last resort, although only a small 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.[20] The law may

[16] F Upham, 'Mythmaking in the Rule of Law Orthodoxy', Democracy & Rule of Law Project at the Carnegie Endowment for International Peace, Rule of Law series, Working Paper (2002) No. 30

[17] A Franklin, J Qian and C Zhang, 'An Alternative View on Law, Finance, Institutions and Growth' (2011) repository.upenn.edu/fnce_papers/14. Accessed 10 May 2019.

[18] S Grossman and O Hart, 'The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration' (1986) 94 *Journal of Political Economy* 691.

[19] J McMillan and C Woodruff, 'Private Order under Dysfunctional Public Order' (2000) 98 *Michigan Law Review*2421

[20] S Deakin, 'Legal Evolution: Integrating Economic and Systemic Approaches' (2011) 7 *Review of Law and Economics* 659

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.[21]

By contrast, in developing markets which lack fully effective legal ordering, the costs of using alternative mechanisms of contract enforcement based on interpersonal trust may become a drag on growth as the economy develops. Relational contracting has the potential to create significant adverse, external effects such as excluding new entrants from trading or achieving price collusion.[22] There is an obvious trade-off between transaction and production costs in private ordering. As a result, specialization and division of labor are severely limited by the extent of a market defined by the personalized exchange process of a small community.[23] In the absence of effective formal contract enforcement, the domestic market may remain segmented for the long term, which impedes an economy from realizing its full potential. This implies a sequencing approach to building legal institutions: a given mix of public and private enforcement may work well at early stages of development but may not be sustainable over the longer term.[24]

This chapter adopts a co-evolutionary model of law and economy relations and argues that contract law is both cause and effect of sustainable economic development.[25] According to this framework, formal legal institutions associated with contract meet needs which arise in the context of an economy which is moving from interpersonal trust with small numbers exchange to large-scale, impersonal transacting. In this approach, legal institutions are endogenous to the economic growth path of a particular country. It follows that they are unlikely to be functional in the absence of certain social and commercial practices to which public enforcement is complementary. For successful transplants of formal institutions to occur, therefore, a certain pre-existing level of development is needed. Once functioning legal mechanisms are in place, however, they have the potential to foster further growth. Thus the relationship between legal institutions and economic growth is one of incremental coevolution.[26]

II. A BRIEF OVERVIEW OF CHINA'S ECONOMIC REFORM

[21] Macaulay (n 12).
[22] See eg Upham (n 16); A Dixit, *Lawlessness and Economics: Alternative Modes of Governance* (Princeton, Princeton University Press, 2004) 66; J Rauch, 'Business and Social Networks in International Trade' (2001) 39 *Journal of Economic Literature* 1177; C Gray, 'Reforming Legal Systems in Developing and Transition Countries' (1997) 34 *Finance and Development* 14.
[23] P Bardhan, 'Institutions Matter, but Which Ones?' (2005) 13 *Economics of Transition* 499.
[24] D Chen, *Corporate Governance, Enforcement and Financial Development: The Chinese Experience* (Cheltenham: Edward Elgar, 2013); 'Developing a Stock Market without Institutions - the China Puzzle' (2013) 13 *Journal of Corporate Law Studies* 151.
[25] Chen and Deakin, 'On heaven's lathe' (n 14).
[26] ibid.

Prior to 1979, China maintained a centrally planned economy just like its former socialist counterparts. A large share of the country's economic output was directed and controlled by the state, which set production goals, controlled prices, and allocated resources through most of the economy. By 1978 nearly three-fourths of industrial production was produced by state-owned enterprises (SOEs), according to centrally planned output targets. Private enterprises and foreign-invested firms were generally non-existent. Foreign trade was limited only to obtaining those goods that could not be made or obtained in China. Since most aspects of the economy were managed and run by the central government, there were no market mechanisms to efficiently allocate resources, and thus there were few incentives for enterprises or workers to be productive or be concerned with the quality of what they produced. As a consequence, at the dawn of reform, the national economy was almost completely collapsed.

In 1978, the Chinese government decided to break with its Soviet-style economic policies and launched an economic reform. However, China rejected the 'shock therapy' that was later adopted in the Eastern European and former Soviet Union economies.[27] Instead, it took a gradualist approach.[28] The economic reform can be divided into four stages roughly. The first stage is from 1979 to 1984. In this stage, the reform did not involve a commitment to markets. Rather, it was essentially an attempt to improve the planning system. The main reform measures include initiating price and ownership incentives with farmers, which allowed them to sell a portion of their crops on the free market; establishing four special economic zones along the coastline[29] in order to attract foreign investment, boost exports, and import high technology products into China; tolerating the growth of an 'individual economy'—i.e., economic activities by self-employed individual entrepreneurs with fewer than eight employees; and reforming SOEs by adopting a 'contract management responsibility' system (CMRS)[30] that allowed managers and workers to

[27] Shock therapy refers to a radical reform project which is founded on Neo-Liberal theory. It normally entails the sudden release of price and currency controls, withdrawal of state subsidies, and immediate trade liberalization within a country, and usually also includes large-scale privatization of previously public-owned assets. See eg. D Lipton and J Sachs 'Creating a Market Economy in East Europe, the Case of Poland' (1990) 1 *Brookings Papers on Economic Activity* 75; K Murphy; A Shleifer and R Vishny, 'The Transition to a Market Economy: Pitfalls of Partial Reform' (1992) 107 *Quarterly Journal of Economics* 889-906; P Gowan, 'Neo-Liberal Theory and Practice for Eastern Europe' (1995) 213 *New Left Review* 3.

[28] A gradualist reform builds on a self-grown order and a carefully prepared sequence of steps, each preparing the ground for a small introduction of the next one. See eg. M Dewatripont and G Roland, 'The Design of Reform Packages under Uncertainty' (1995) 85 *American Economic Review* 1207; M Gavin, 'Unemployment and the Economics of Gradualist Policy Reform' (1996) 3 *The Journal of Policy Reform* 239.

[29] They are Shenzhen, Zhuhai, Shantou and Zhuhai.

[30] In a typical CMRS contract, the state transferred the full control right over the SOE to a delegated manager through a contract. In return, the manager was responsible to deliver a pre-determined 'rent' to the government. The 'rent' could either be a fixed amount that increased annually over the course of the contract or a fixed percentage of the profit, which varied between 5 and 20 percent. Most of the contracts adopted the former arrangement, where the exact amount was negotiated between the manager and the state on a case-by-case basis. Any residual profits were then at the disposal of the manager for purposes of investment, improving employees' benefits and so on. With rare exceptions, the typical length of these contracts was three years. However, because neither the state nor the manager was willing to bear the risk of long-term contracts, they re-negotiated the terms of contracts at the end of each year. See M Shirley and C Xu, 'Empirical Evidence of Performance Contracts: Evidence from China' (2001) 17 *Journal of Law, Economics and Organization* 168.

retain the profits of over-fulfilment after meeting the fixed target.[31] During this period of time, the state sector was still the absolutely dominant power in the economy and market activities were ad hoc and provisional.

The second stage took place from 1985 to 1989, in which the market was more fully and openly embraced as a critical component of the economy. Economic policy making was decentralized in several sectors, especially trade. Economic control of various enterprises was given to provincial and local governments, which were generally allowed to operate and compete on free market principles, rather than under the direction and guidance of state planning.[32] Town-village enterprises (TVEs)[33] arose as a consequence of this, and became the most vibrant part of the Chinese economy during the 1980s and early 1990s. By contrast, reform in state sector was disappointing and the SOEs were continually making losses.

The third stage was from 1989 to 2001. This stage first saw an attempt to undertake a significant rollback of economic reforms after the 1989 incident.[34] But the attempt did not last long and momentum for reform had begun to build anew after Deng Xiaoping's Southern Tour (*nan xun*) in 1992.[35] During this period, 'private' economy was increasingly accepted and rapidly displaced TVEs to become the driving force of China's economy ever since. By contrast, the state sector experienced a significant crisis which led to a policy of 'let go the small and grasp the big', i.e. to

[31] ibid.

[32] These changes were brought in by a number of key decisions of the Party. In October 1984, the Third Plenary Session of the 12th Central Committee passed the 'Decision on Economic System Reform' (*Jingji gaige de jueding*). The Decision confirmed that the 'socialist commodity economy' was the ultimate goal of reform and laid out the requirements to fully develop a commodity economy: first, establish a rational price system; second, separate government and enterprise, and separate ownership and management authority. The 'Suggestions for the 7th Five-Year Plan' (*Diqige wunian jihua de jianyi*) passed at the special 1985 Communist Party Congress stated that enterprises should be transformed into autonomous units responsible for their own profits and losses, and the market economy system should be basically completed.

[33] Most of them were in fact privately owned, but registered as collective (typically paying a 'management fee' to local government) in order to qualify for benefits available only to the public sector and for protection against local government predation. See B Krug and H Hendrischke, 'Entrepreneurship in China: Institutions, Organisational Identity and Survival: Empirical Results from Two Provinces' (2002) ERIM Report Series Reference No. ERS-2002-14-ORG. www.ssrn.com/abstract=370955. Accessed 5 March 2017.

[34] After the Tiananmen crackdown, the conservatives in the party gained the upper hand. The collapse of the Soviet Union handed them another convenient justification to block economic and political reforms. A considerable conservative faction vehemently discredited further reform, claiming that it would bring the party to its knees. To them, the Tiananmen tragedy of 1989 and the Soviet disintegration were all products of 'peaceful evolution,' which they viewed as *the* clear and present danger.

[35] Deng's Southern Tour, which occurred during January and into February 1992, can be interpreted as belonging to the tradition of Chinese leaders going above the heads of government to appeal directly to the people. Deng's message on the tour was simple and repeated in each of the places he visited: China's continuing opening up and reform were inevitable and could not be stopped. See eg. R Evans, *Deng Xiaoping and the Making of Modern China*. (London, Penguin Books, 1995); M Martin, *China and the Legacy of Deng Xiaoping, from Communist Revolution to Capital Evolution* (New York, Brasseys, 2003).

privatize small-medium sized SOEs and only retain control over the large ones, especially those in upstream industries.[36]

The fourth stage is from 2001 till present. This stage was marked by China's accession to World Trade Organization (WTO) in December 2001 which brought economic reform to another level. The WTO requirements of market opening and non-discrimination placed upon China brought the nation into a period of greater trade liberalization, weakening state-run enterprises and giving more power to private interests. Removing trade barriers encouraged greater competition and attracted Foreign Direct Investment (FDI) inflows that helped China to fully integrate into the world economy.

In the past four decades, China has achieved a remarkable economic growth. From 1979 to 2016, China's annual real GDP averaged 9.6% .This has meant that on average China has been able to more than double the size of its economy in real terms every eight years.[37] China has also become the second largest recipient of Foreign Direct Investment (FDI) only after U.S.[38] and the 'world factory' of global manufacture.

III. THE EVOLUTION OF CHINESE CONTRACT LAW

A. Law on the books

A striking feature of the Chinese legal tradition is that it is chiefly penal or criminal in nature, as a corrective for the untutored.[39] As a result, although China had a very advanced commercial life in history, it never had a commercial code (let alone a contract law) till early 20th century. Private commercial transactions were mainly governed by local customs.[40] The first separate civil code, Draft Civil Code of the Great Qing (the Da Qing Min Lü Caoan) was promulgated in 1902 which was patterned after the German model via Japan.[41] From 1919 to 1930 the Chinese Nationalist

[36] This took place between 1997 and 2003, the number of SOEs decreased by almost half, from 262,000 to 146,000. Finance Yearbook of China, quoted from W Mako and C Zhang, 'Why is China so Different from Other Transition Economies?' in W Lieberman and D Kopt (eds.) *Privatization in Transition Economies: The Ongoing Story* (Bingley, Emerald Group Publishing, 2007).

[37] M Wayne, 'China's Economic Rise: History, Trends, Challenges, and Implications for the United States' (2018) Congressional Research Service, www.crsreports.congress.gov/product/pdf/RL/RL33534/96. Accessed 5 May 2019.

[38] J Suokas, 'China Remains Second Largest FDI Recipient in the World' *gbtimes* 22 January 2019, www.gbtimes.com/china-remains-second-largest-fdi-recipient-in-the-world.

[39] S Lubman, *Bird in a Cage: Legal Reform in China after Mao* (Stanford, Stanford University Press, 1999); R Peerenboom, *China's Long March toward Rule of Law* (Cambridge, CUP, 2002).

[40] L Chen and L DiMatteo, 'History of Chinese Contract Law' in L Chen and L DiMatteo (eds.) *Chinese Contract Law, Civil and Common Law Perspectives* (Cambridge, CUP, 2018) 3.

[41] It was followed the German Bürgerliches Gesetzbuch, (Civil Code, BGB) by dividing the code into five books, namely 'General Principles', 'Law of Obligations', 'Law of Things', 'Family' and 'Succession.' See H Chang, *The Legal History of Contemporary China* (Hong Kong, The Commercial Press, 1973) 283; H Yao 'The Modernization of Chinese Civil Law and the Contemporary Tasks' (2008) 3 *Gansu Social Science* 127.

government instituted European codes.[42] But in 1949, the communist government came to power and repealed these codes. After the founding of People's Republic of China (PRC), there was no formal contract law for thirty years from 1949 to 1981. The 'Provisional Measure Concerning Contract Making by the Government Offices, State-run Enterprises and Co-operatives' was enacted to govern economic activities between governmental bodies, SOEs and cooperatives in September 1950. But even this provisional measure was abolished during the Cultural Revolution (1966-1978).[43] All major economic activities were directly controlled by the central government.[44]

Market exchanges started to reemerge and develop in China after 1978. In December 1981, the Chinese legislature enacted the Economic Contract Law (ECL) to act as a 'reliable law' for all economic activities. The ECL was a significant move towards a more decentralized, market-oriented economy. However, it only applied to Chinese domestic contracts and not to those involving foreign persons or entities. Moreover, its classification as 'economic law'[45] as opposed to civil law meant that its role was to implement state economic policies.[46] With the furtherance of economic reform, on 21 March 1985, the Law on Economic Contracts Involving Foreign Interests was passed to cover contracts between Chinese entities and foreign parties.

China became a signatory to the Convention on Contracts for the International Sale of Goods (CISG) on 30 September 1982[47]. The Convention was ratified on 11 December 1986. The Law on Technology Contracts[48] came into effect in the following year as a result. Furthermore, the term 'contract' as opposed to 'economic contract' was first adopted in the 1986 General Principles of Civil Law (GPCL). Thus, from 1981 to 1998, economic transactions in China were artificially divided into three different types with each governed by a specific law. It is not surprising that

[42] These codes remain effective in Taiwan, since Taiwan was never under the governance of the CCP. QM Kong, LY Hu and JP Sun, *History of Chinese Civil Law* (Jilin, Ji Lin Renmin Press, 1996) 6.

[43] From 1949 to 1953, 148 laws and regulations were promulgated, which governed a wide spectrum of political, civil, family, and social activities; but no new codes were established. The new legal system of China developed employing the principles of the former Soviet Union's decidedly socialist legal system. See, T Hsia and W Zeldin 'Recent Legal Developments in the People's Republic of China' (1987) 28 *Harvard International Law Journal* 252.

[44] China adopted the command-economy system from the Soviet Union, under which the government owned all large factories and communication enterprises. Planners (The State Economic Planning Commission) issued commands that assigned production targets to firms and directly allocated resources and goods among different producers. Although prices lost their significance as the primary signal that directed resource allocation in the economy, the government still controlled the price system and set relative prices to channel resources into government hands. There were still two types of nominal contracts, one was between enterprises called 'industrial economic contract' and another was between industry and agriculture, called 'commercial economic contract'. But they were not real contracts in any sense, rather, they were instruments used by the state to consolidate the national economy and fulfill the economic plan. See B Naughton, *The Chinese Economy, Adaptation and Growth* (Cambridge, MIT Press, 2017) 70; G Hsiao, 'The Role of Economic Contracts in Communist China' (1965) 53 *California Law Review* 1029.

[45] 'Economic contracts' was a concept transplanted from the Soviet Union.

[46] See L Wang and C Xu, 'Fundamental Principles of China's Contract Law' (1999) 13 *Columbia Journal of Asian Law* 1. The ECL covered ten particular types of contract including sales, labor, carriage of goods, storage, tenancy, loan, property insurance and scientific and technologic cooperation, building and supply of electricity.

[47] This was to govern contracts in international trade

[48] It classified a technology contract into four categories: technology development contracts; technology transfer contracts; technology consultant contracts and technology service contracts.

these laws were filled with contradictions, redundancies and other problems.[49] Further, natural persons were excluded from entering these 'economic contracts,' rather, they could only form 'civil contracts' under GPCL.[50]

The chaotic state of contract law created a strong appeal for a uniform contract law to avoid confusion and uncertainly. China's accession to World Trade Organization (WTO) further strengthened this need. As a consequence, the Chinese Contract Law (CCL) was promulgated at the Second Session of the Ninth National People's Congress (NPC) on 15 March 1999.[51] The CCL is the result of the codification and harmonization process of all the previous contract law regimes.[52] The previous contract laws relating to specific contracts were repealed simultaneously with the promulgation of the CCL.

The drafting of CCL[53] is based on China's local conditions, but also draws on the experience of other countries, in particular German law.[54] Moreover, the legislators referred extensively to the Principles of International Commercial Contracts drafted by the International Institute for the Unification of Private Law (UNIDROIT Principles),[55] and the United Nations Convention for the International Sale of Goods (CISG).[56] One of the most notable results of the new law is, to a large extent, to subject all market players (including foreign parties) to the same set of rules and to put them on an equal footing. In addition, three fundamental principles of contract law (freedom of contract, good faith, and promoting the making of transactions) that have long been recognized in other developed markets are particularly emphasized in the new law.[57]

B. Formal Enforcement of Contracts

Despite the development of contract law, China has failed to develop a neutral, effective adjudicating system to enforce contracts. The lack of judicial independence and authority, and judicial corruption and incompetence are regarded as major factors that account for the courts' ineffectiveness.

The lack of independence of the courts is first reflected in the control exercised by the Chinese Communist Party (the CCP) over the various respects of the courts' operations. Until very recently,

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[49] F Chen, 'The New Era of Chinese Contract Law: History, Development and a Comparative Analysis' (2001) 27 *Brooklyn Journal of International Law* 153.

[50] In September 1993, the Economic Contract Law (ECL) was amended to bring contracts signed by individual industrial and commercial households within its ambit.

[51] The CCL has 129 articles dealing with fundamental contract issues (General Principles) and 299 articles dealing with fifteen types of contracts such as sale, gift, and construction contracts (Specific Provisions).

[52] Chen and DiMatteo, 'History of Chinese Chinese Contract Law, (n 40)

[53] The Legislative Affairs Committee of NPC is responsible for the legislation. About a dozen contract and civil law experts led by Professor Huixing Liang (of the Chinese Academy of Social Science) were commissioned to draft the code. See H Liang, 'The Reception of Foreign Civil Law in China' (2003) 1 *Shang Dong University Law Review* 5

[54] ibid.

[55] See B Ling, *Contract Law in China* (Hong Kong, Sweet &Maxwell Asia, 2002) 16

[56] ibid.

[57] ibid.

each level of the CCP organization had a Party's Political-Legal Committee (PLC)[58] which directly makes decisions on important policies and issues related to the courts and law enforcement. In many cases, the PLC even determines the outcomes of major court cases[59]. In terms of judicial appointments, although the Judges Law provides that the NPC at the same level elects the president of the court, vice presidents and other judges are chosen by the corresponding NPC's standing committee.[60] However, in reality, the NPC only acts as a rubber stamp and the appointments of key personnel in the court system are controlled by the Party Organization Department[61]. In order to show their loyalty to the Party so as to climb up the bureaucratic ladder, the majority of judicial personnel would choose to accept or even seek Party interference in decisions.[62] Furthermore, 'if the courts try to go their own way and not involve the party organization, they may find their judgment unenforceable. A single telephone call from the Party Secretary could bring the execution of judgments to a halt.'[63]

Interference from government is another serious threat to the independence of the courts.[64] Since the courts remain one bureaucracy among many and have low status in the political system,[65] very often, other government agencies may ignore courts with impunity and consider themselves bound only by orders issued by their superiors.[66] More importantly, the courts heavily rely on governments at the same level for finances, material supplies and other welfare benefits for court officials and their families. Hence, it is very difficult for courts to go against the wishes of local governments even should they wish to do so. The so-called 'local protectionism' is particularly problematic in administrative cases and commercial cases involving locally based SOEs or large

[58] The PLC usually includes the deputy party secretary in charge of political-legal matters, the president of the Court and Procuratorate and the heads of various ministries or bureaus including public security, state security, justice, civil affairs and supervision. The PLC is one department within the Party answering to the Party Committee at the same level and the PLC at the next highest level. Most PLC members have little formal legal training, having risen up through the Party ranks.

[59] The decision of the PLC normally takes a form of a meeting minute instead of an official document. The decision is implemented through the president of the court who is a member of the PLC. For major cases, for instance, a case that is considered to be critical to social stability, the PLC make decisions before the court even begins. The judges simply go through the hearing as a formality and announce the PLC's verdict at the end.

[60] 1995 Judge Law Art 10; 2005 Judge Law Art 51.

[61] See eg R McGregor, *The Party: The Secret World of China's Communist Rulers* (New York, Harper Perennial, 2010) J Burns, 'The Chinese Communist Party's Nomenklatura System as a Leadership Selection Mechanism' in K Brødsgaard and Y Zheng (eds.) *The Chinese Communist Party in Reform* (London, Routledge, 2006).

[62] For instance, the head of the court may take initiative in reporting cases to the PLC, or to the Party Commission at the same level.

[63] D Clarke, 'Power and Politics in the Chinese Court System: The Enforcement of Civil Judgements' (1996) 10 *Columbia Journal of Asian Law* 1, 50.

[64] Although it is difficult to distinguish government interference from party interference in China, given that the majority of government officials are Party members.

[65] In the Chinese political system, the rank of the chief officer determines the rank of the institution he/she heads. Although the president of a court at any given level of government is not technically subordinate to the head of government at the same level, the court president's official rank is typically just below, and not equal to, that of the head of government.

[66] D Chow, *The Legal System of the People's Republic of China in a Nutshell* (St Paul, West Group, 2003) 223.

private companies (given their economic significance).[67] The courts are often unsympathetic to plaintiffs from other provinces. Civil judgments rendered in other provinces are often refused enforcement.[68] The lack of judicial independence and authority gives rise to severe obstacles in enforcing judgments. As publicly conceded by the former president of the SPC, Xiao Yang, 'the difficulty of executing civil and commercial judgments has become a major 'chronic ailment' often leading to chaos in the enforcement process. There were few solutions to the problem.' 'China's courts lack the authority and stature to command obedience to their decisions, especially where such decisions affect other government branches and officials.' [69]

Judicial corruption is another major obstacle that obstructs the courts from playing a meaningful role in enforcement. Although reliable statistics of judicial corruption are not available, the successive reports submitted to the NPC by Supreme People's Court (SPC) provide some indications. In 2005, it reported that nearly 470 judges were punished for corruption in each of 2003, 2004.[70] On 17 March, 2010, the former vice president of the SPC, Huang Songyou was sentenced to jail for life for taking bribes of 4 million yuan in a case also involving four judges in the SPC.[71]

The level of judicial competence is also a big concern. Prior to the 1995 Judges Law, there were no objective qualifications in terms of legal training that all judges had to have. Judges might come from military officers (particularly during the 1970s and 1980s), from governmental agencies, or from lower-level personnel within courts, such as bailiffs, with only a minority from law school graduates or law professors, researchers. The overall low level of competence of the judiciary resulted in many incorrectly decided cases. In 1999, appellate courts supervised and reviewed 96,739 cases, and corrected the judgement in 21,862 cases.[72] Since 1995, the authorities have taken a number of steps to improve judicial competence and professionalism, such as requiring all judges to pass a national examination, and raising the academic standards to qualify as a judge.[73] There

[67] For instance, a judge in Fujian who executed a judgment against a local enterprise found his daughter transferred the next day by her employer, the country, to an isolated post on a small island. D Tang (eds), *Several Theoretical and Practical Problems in Civil Adjudication* (Jilin, Jilin Renmin Press, 1991) 391.

[68]Clarke, 'Power and Politics', (n 63); Chow, *The Legal System of the PRC*, (n 66); Peerenboom, *China's Long March*, (n 39).

[69] China Law & Development Consultants, 'Enforcement of Civil Judgments: Harder than Reaching the Sky' [2004] 2 China Law and Governance Review 10. www.chinareview.info/PDFs/Issue%20No%202%20.pdf Accessed 1 June 2019.

[70] See SPC 2005 Annual Working Report. It must be pointed out here that this number constituted only a small fraction of the judges that got caught. The majority of them received administrative penalties or were punished by Party rules. For instance, in 1998, former SPC president Ren Jianxin claimed that only 376 judges were punished on criminal grounds between 1992 and 1996. However, it was reported that 1,654 judges received administrative penalties, 637 were punished by Party rules in the single year of 1997. See *Supreme People's Court Annual Working Report* (1998), (1999). In addition, the judges who received any form of penalties account for a small proportion of the corrupt judges. Thus, the real extent of judicial corruption is likely to be strikingly larger.

[71] Xinhua net, 'The Former Vice President of the SPC was Sentenced to Jail for life' 17 March 2010 www.news.sina.com.cn/c/2010-01-19/125119499756.shtml. Accessed 10 August 2019.

[72] Supreme People's Court Annual Working Report (2000).

[73] The educational qualifications set by the Judges Law do not apply to the judges who were in office at the time of its passage.

has been a significant improvement of judicial professionalism in the last decade, however, for most of the reform era, the judicial system suffered from poorly trained judges.

The limited role of formal contract enforcement found support in several empirical studies.[74] For instance, in his study of caseloads between 1999 and 2006, Liebman found caseloads 'have grown only modestly, if at all'.[75] The total number of cases heard in 2006 was only 2 percent higher than in 2005, and the total number of first instance cases actually decreased by 2 percent between 1996 and 2006. He concluded that 'the modest increases are striking when set against the backdrop of China's rapid economic growth and widespread reports of a surge of civil disturbances in China'.[76] Similarly, He Xin found during 1996 and 2001, economic cases in fact dropped 25 percent.[77]

IV. CHINA AS A TEST FOR A CO-EVOLUTIONARY MODEL

A. Theoretical discussion

China's recent trajectory illustrates the relevance of a co-evolutionary perspective on economic development. Until the 1978 reform, private property was effectively extinct in PRC and all means of production were vested in the state or its inferior form, the collective. Strictly speaking, there were no transactions in the sense of commodity exchange. All economic disputes were settled by the government in its capacity as common owner. A contract law that governs market transactions therefore became completely redundant. Even prior to the effective abolition of the legal system during the Cultural Revolution, the legal system had ceased to function in any meaningful sense, as central planning determined the content of economic policy.

The irrelevance of formal contract law persisted into the early part of the reform era. Due to its gradualist approach, China's state sector largely remained intact till mid-1990s. Although the ECL was enacted as early as December 1981, disputes between SOEs were still generally resolved under the old administrative mechanism rather than legal mechanisms. The private sector gradually emerged from the margins of state sector, typically starting as small, family-owned businesses with a focus on local markets.[78] The limited scale of the market set up a classic scenario for informal institutions to function. In the Chinese context, it is *guanxi* (interpersonal relationship) that acted as an alternative to formal contract law. In *guanxi*-based transactions, oral contracts prevailed and detailed written contracts were rare. Disputes were typically settled by negation rather than litigation.

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[74] Unfortunately, there has been little systematic research on China's economic caseloads.
[75] B Liebman, 'China's Courts: Restricted Reform' (2007) 191 *China Quarterly* 620, 621
[76] ibid.
[77] H Xin, 'The Recent Decline in Economic Caseloads in Chinese Courts: Exploration of a Surprising Puzzle' (2007) 190 *China Quarterly* 352.
[78] This is exemplified by Wenzhou, the birthplace of private sector. See, eg K Forster, 'The Wenzhou Model for Economic Development: Impressions' (1990) 3 *China Information* 53; C Bramall, 'The Wenzhou Miracle, an Assessment' in P Nolan and F Dong (eds) *Markets Forces in China: Competition and Small Business-the Wenzhou Debate* (London, Zed books, 1990).

The irrelevance of formal contract law to the private sector was furthered by 30 years of a planned economy and 10 years of the lawless Cultural Revolution, which rendered the very concept of contract or courts strange to the society. People had little knowledge in drafting contracts or experience in commercial lawsuits.[79] In addition, until September 1993, individual industrial and commercial households were excluded from the ambit of ECL, and they had no legal recourse when they encountered contract disputes since the courts were unwilling to recognize their claims. For foreign-invested companies, between 1983 and 1995, Hong Kong accounted for 59 percent of accumulated FDI in China, 56 percent of which was received by Guangdong province. The majority of Hong Kong investors originated from Guangdong and had various familial or lineage-based links to communities based there. Thus, transactions and disputes between HK investors and their domestic trading parties were mainly governed by interpersonal trust or *guanxi* rather than formal contract law.[80]

The rapid expansion of market relations in China in the first two decades therefore cannot be attributed to the contract law system. Rather, trust-based mechanisms of the kind identified by the literature on informal contracting – the threat of loss of future trading opportunities and the costs of exclusion from dense, interpersonal networks – enabled the economy to grow.

Since late 1990s, in particular after China's accession to the WTO, the limits of *guanxi* have become clear and the continued growth of the economy has created a strong demand for formal legal institutions. The number of SOEs declined by half by 2003 and the remaining ones became much more market-oriented. The majority of the SOEs were corporatized, and some were even listed on domestic or overseas stock markets. Although state control remains,[81] direct administrative interference has significantly reduced. With an increase in managerial autonomy and hardened budget constraints, SOEs except for those in upper stream industries now have to compete with other SOEs and private enterprises under market rules. Compared with private enterprises, SOEs tend to place more emphasis on formality, i.e. written documents, and are more willing to take disputes to the court as this can shield managers from accountability when things go wrong, and also because SOEs are less sensitive to legal fees.

Private enterprises expanded rapidly beyond the scope of local markets. In the absence of an effective legal framework, continuous relying on *guanxi* as a safeguard has become increasingly costly. *Guanxi* is a localised phenomenon and its benefits are generally confined to members of closed networks. *Guanxi* engenders high transaction costs as firms have to invest in building interpersonal ties each time they enter a new market. The larger the firm, the greater the investment it has to make in *guanxi*. At some point the deadweight costs of the *guanxi* system begin to

[79] Including lawyers, as it took at least a decade for experienced commercial lawyers to emerge
[80] Governed since 1985 by the Law on Economic Contracts Involving Foreign Interests.
[81] It is now via the State-owned Assets Supervision and Administration Commission (SASAC) which was established in 2003, acting as the representative of state ownership and as the supervisory body of SOEs.

outweigh its benefits. As a result, a demand for formal legal rules which would limit the costs of relying on *guanxi* has developed.[82]

Similar demands also emerged amongst foreign investors. Since the mid-1990s, China has become increasingly attractive to foreign investors beyond just Hong Kong or Taiwan-based investors. Unlike Hong Kongese or Taiwanese, these investors have no familial or lineage-based links in China, nor are they familiar with Chinese culture. It is therefore difficult (if not completely impossible) for them to rely on *guanxi* to conduct business. A set of formal legal rules that offer a level playing ground to all market players and acceptable to foreign investors was badly needed.

The combined result of these demands is the enactment of CCL. Distinct from previous contract laws that were basically a top-down response to the social pressures associated with economic growth, the CCL is endogenous to the economic growth that reflects a shift in the demand for formal legal institutions. Moreover, whilst many of its components are borrowed from mature market economies, they also reflect social practices within China and are tailored to meet the needs of market actors based there. The combined effect is a rise of the relevance of formal contract law to the economy: written contracts are widely adopted, even in small businesses; and courts play an increasingly important role in disputes resolution. Although there is a lack of empirical data, it is not unreasonable to infer a positive correlation between CCL and China's economic growth since millennium.

However, as discussed earlier in this chapter, the gap between 'law in the books' and 'law in action' in China remains substantial and legal norms often lack both enforcement and legitimation effects. This results in a prisoner's dilemma: although effective enforcement and observance of laws would be in the long-term interests of all market actors, it is not necessarily in the interests of individual players. Parties have strong incentives to tilt the interpretation and application of legal rules in their own favour. Unless there is an independent court system which has the remit of ensuring that laws are impartially and neutrally enforced, the potential of formal contract law in reducing transaction costs and providing a basis for impersonal exchange will not be realized.[83] The ineffectiveness of contract law has imposed a severe constraint on China's sustainable growth: it has to heavily rely on international trade due to effective foreign laws but fails to explore the potential of its national markets. This export-oriented model has increasingly reached its limits and given rise to fierce conflicts with other trading partners, especially the U.S. since financial crisis 2007. Although the Chinese government is attempting to transform its economy to a more domestic market driven model, in the absence of effective enforcement of contracts, it has only made very limited progress thus far.

B. Empirical Findings

[82] Chen and Deakin, 'On heaven's lathe', (n 14).
[83] ibid.

i. Interview methodology

In the final part of this chapter, I report the results of interviews and focus groups conducted in Beijing and Guangdong province between September 2013 and December 2015. This 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. More specifically, we were interested in finding out from lawyers and entrepreneurs 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.

Altogether we spoke to 77 individuals, 26 in individual interviews and the rest in a total of nine focus groups. 20 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. The questions were based on a semi-structured questionnaire which was distributed to the interviewees in advance of the interviews. Some of the questions were factual ones. We also asked questions about the interviewees' perceptions of the operation of legal institutions and their interpretation of changes in the legal environment over time.

ii. 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 necessarily provide legal certainty. 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.

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 realize 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 number of registered lawyers in Hunan as compared to 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.

iii. **guanxi** *versus contract formality*

A number of the interviews explored the law and practice of business dealings in product markets. The findings of these interviews throw light on the role of *guanxi* and formality of contracts in today's China.

A well know proposition expressed by numerous legal scholars, economists and sociologists is that China's style of informal institution, *guauxi*, replaces formal ones.[84] In our interviews some responses also emphasized the importance of non-legal factors. For exampleas interviewees 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

[84] See eg. G Redding, *The Spirit of Chinese Capitalism* (New York, Walter de Gruyter, 1990). M Yang, *Gifts, Favors and Banquets: The Art of Social Relationship in China* (Ithaca, Cornell University Press, 1994).

> 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 often don't use it' (lawyer, Foshan, September 2014). Another view was that *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)

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 contracts 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 (encompassing 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.

iv. 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 earlier, similar statements of US entrepreneurs are reported by Macaulay.[85] 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.[86]

Our interviews suggest a mixed picture on this point. 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.[87]

Nevertheless, interviewees also expressed 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

[85] 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'. Macaulay, (n 12).
[86] Chen et al, 'Law, trust and institutional change in China', (n 15).
[87] 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, Cambridge University Press, 2008).

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:

> '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 mentioned the practice of judges favoring of local parties in disputes. A number of entrepreneurs gave us instances of what they regarded as this 'local protectionism', for instance:

> '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.' (Entrepreneur, 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 that had been 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)

V. CONCLUSION

The relationship between contract law and economic development has been discussed extensively in the existing literature. On one end, formal contract law is regarded as a prerequisite to economic development given its importance in securing transactions; on the other, it is rejected as only marginal or even irrelevant due to the presence of alternative institutions. However, both sides seem to overstate or oversimplify their cases, a view more close to truth is that the economy and contract law are co—evolutionary. Contract law is both the effect and the cause of economic development. This chapter has used China's developmental experience over the past four decades to test the existing literature, with a particular focus on the co-evolutionary view.

China has achieved a remarkable economic success since 1978. Its legal system has also made great strides during the same period. A first sight of this may lend some support to the 'law matters' argument. However, a closer look suggests that formal contract law had little relevance to economic growth in the first two decades (1978-1999): the quality of law was poor and lacking of trained legal professionals for its implementation. More fundamentally, there was little demand for its use. SOEs relied on administrative mechanisms for dispute resolution and the private sector (both domestic firms and Hong Kong- based overseas investors) resorted to *guanxi* for transaction security.

The first two decades' records seemed to be consistent with informalists' view that economic growth is likely to occur in the absence of formal contract law. However, with the deepening of reform and the expansion of the market, reliance on *guanxi* has gradually revealed its limits. Further development requires a contract law that provides equal protection to all market participants regardless of their identities. CCL was therefore enacted as a response to this demand and it has gained increasing importance in commercial life since 1999: written contracts are commonly used by companies and more disputes end in court. The first conclusion that can be drawn from China's experience is that the development of Chinese contract law is a result of economic growth, not the reverse.

China maintained a rapid growth rate since the millennium and has become the world's second largest economy. Contract law, in the second two decades, played a role in fostering this growth, to some degree. However, due to lack of judicial independence and widespread corruption, the role

of contract law has been largely limited, which in turn imposed a serious constraint on China's sustainable development. The second conclusion drawn from China is that, a properly designed contract law is able to facilitate economic growth, but its full potential can only be realized in a functional public order. Taken together, it confirms the co-evolutionary view on contract law and economic development.

This co-evolutionary view is supported by our fieldwork in Beijing and Pearl Delta. Our interviewees explicitly expressed the view that 'the law responds to economy', 'law is becoming more important as the economy develops', not the reverse. This can be further illustrated with reference to regional differences in legal development, which, according to interviewees, is caused by the level of economic development. In relation to informal institutions, *guanxi*, they stated that 'with the rise of the legal system, *guanxi* may become less important but will continue to exist in the future and will still play a role.' Some further identified the dark side of *guanxi* as 'there is a very high social cost to it' and '*guanxi* is dragging the economy down'. The necessity of formal law to further economic growth is well recognized and described as 'essential' for business and communication. They confirmed that written contracts are now commonly in use, their terms have become more detailed and complex. However, the limitations of contract law imposed by weak enforcement is also obvious, as reflected in interviewees' words 'keep out of the courts, it's not worth'.

Overall, our fieldwork suggests that China's experience is far from unique, instead, it is largely consistent with the findings of current literature. Of course, this is not to say that the Chinese contract legal system will fully converge to one or the other western model. It will inevitably shaped by the deeply-rooted Confucian culture and communist history. Nevertheless, this does not make it an outlier within the existing literature.