Task Force on Institutional Design for China's Evolving Market Economy

Introductory Essay

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This volume presents the results of a series of policy conversations among leading economists and legal scholars about the regulatory and institutional dimensions of economic development in China. The authors share the conviction that China is now entering a critical phase in its economic development and move to a market economy with Chinese characteristics, and that law and institutions are crucial components in the development equation. Early on, China recognized that it needed to have a distinctive form of market economy, appropriate to its distinctive circumstances and history. That has raised the question of the relevance of familiar debates about regulation and property rights among economists in the West to the Chinese experience and future.

Indeed, our discussions over the last three years have left us ever more hesitant to extrapolate from what we think we know about the relationship between law and economics in the West to what ought to characterize the institutional and legal framework for further development in China. Our hesitance arises from the realization that much "common sense" about the relationship between law and economics in the West is incorrect. If this could be said before the global financial crisis, it is even more so today, after the crisis, as even those in the West are questioning the assumptions underlying policy frameworks and those legal structures that govern economic affairs. The crisis has destroyed a large numbers of prevailing myths and shibboleths. As a result, we bring a deep skepticism about the desirability of extending popular, if largely mistaken, pieties about the legal prerequisites for strong economic performance in a market economy. Moreover, experts in the West disagree sharply about the ways in which law affects economic development and performance—and even about what we mean by "good" performance and how it should be measured.[1] Those disagreements suggest that alternative paths are open for China as it builds the legal and institutional framework for future development. In this volume, we aim to capture the tenor of those debates and frame those choices.

Taken as a whole, this volume explores the relationship between two intellectual conversations. The first concerns the nature of Chinese economic policy today. China is now entering a critical phase in its move to a market economy. There are, of course, a variety of types of market economy – the Scandinavian model differs from the Anglo-American, the Japanese, or the Continental European models. China has committed itself to developing a market economy with its own distinctive characteristics. Those distinctive features are now becoming visible and have more and more become subjects

[1] See, for instance, the recent report of the international Commission on the Measurement of Economic Performance and Social Progress.

of debate, both within and outside China, particularly where they diverge from what is understood in one or another place to be "best practice." Individual papers examine the details of specific development policies and institutional characteristics of the emerging Chinese market economy, assessing the record of the last years and highlighting elements which have – and have not – been successful.

The second conversation concerns the economic significance of particular regulatory arrangements and forms of property often associated with the Anglo-American economic tradition. Every market economy has distinctive legal and institutional arrangements. China does as well -- and will continue to. It is common for those living in a given market to feel some of these distinctive features are critical to the success of their economic model – even if they are the result of historical accident or cultural developments far from economic policy. And even if other nations have experienced superior economic performance with alternative arrangements.

Over the last decades, many economists in the United States – and in the international financial institutions -- have developed theories and launched empirical studies suggesting the superiority of specific legal and institutional arrangements they regard as characteristic of the Anglo-American mode of market economy.

One result of this intellectual work has been the emergence, starting in the mid-eighties of the last century, of a powerful orthodoxy about the "best practice" legal and institutional arrangements for market efficiency and growth. This legal orthodoxy has run parallel to – and often been linked with -- "neo-liberal" economic policy orthodoxy. Like their neo-liberal economic cousins, proponents of these legal arrangements were active in global debates about the institutional framework for national development. They have also been active in debates about Chinese economic policy, promoting these "best practice" legal and institutional forms as integral to China's transition to a market economy.

At the same time, however, these ideas have come under attack within the Western intellectual tradition. The challenges have been analytic and theoretical, as well as empirical and historical. They have, for instance even questioned whether the paradigmatic "best practice" legal forms actually do characterize the American economy. The neo-liberal law and economics tradition exaggerates the capacity of markets to operate efficiently and understates or ignores the necessity for legal and institutional arrangements. For instance, whenever information is imperfect or asymmetric—that is always—markets are not efficient, and there exist some interventions (including regulatory interventions) which are welfare enhancing. Economists and legal scholars have challenged the association of what we might call "neo-liberal law" with economic growth and efficient market organization. They have questioned whether they can be reliably linked, theoretically or empirically, to either market efficiency or growth, let alone both. East Asia's success—the most rapid growth in the history of the world—based on other premises provides evidence that the neo-liberal model is not necessary for growth; the failure of so many Latin American countries that attempted to follow its dictates p;rovides evidence that that model is not sufficient for growth. And the repeated crises confronting economies that have adopted that model—of which the current crisis is

only the most recent and most devastating—shows not only that what ever growth is produced may not be sustainable, and that the "model" is subject to high levels of instability, imposing costs that few developing countries can afford.

Questions have also been raised about the universalizability of these legal forms, rooted as they are in quite specific cultural and political commitments. All of this raises questions about whether neo-liberal legal orthodoxy is at all appropriate for China today.

Of the two conversations – a Chinese conversation about economic direction and policy, and a Western conversation about legal and institutional orthodoxy – the Chinese conversation is the more significant. We are convinced that political, social and cultural values—including concerns about social harmony and the harmony between man and nature-- must drive economic strategy and shape the form of market economy China builds for itself in the coming decades. The appropriate legal question is what regulatory and institutional forms are appropriate for China's own evolving economic and political strategy.

Now is the time to engage that question. Discussions over the next few years will have a major effect in determining the kind of market economy into which China will evolve. That evolution will condition – and be conditioned by – the legal and institutional arrangements which are now being put in place. Legal arrangements entrench interests, conditioning the dynamic evolution of market forms. Legal frameworks governing property rights, competition, corporate governance, intellectual property, bankruptcy, contracts and more will influence what it will mean a generation from now to say the market economy is one with "Chinese characteristics." As a result, this is a particularly important moment to assess differences in the institutional arrangements and their consequences. What would normally be an academic exercise could turn out to have enormous impact for a quarter of the world's population.

Our authors straddle the two broad intellectual debates in a variety of ways. Some are more familiar with the Chinese economic experience and reflect here on the institutional and legal elements which have been – and ought to be – enshrined within it by focusing on specific policy areas and challenges, from decentralization to health care and urban policy. Others are more familiar with Western debates about the relationship between legal forms and economic performance. They reflect here on the lessons for and from the Chinese experience for our understanding of the links between economics and law. Our authors are not at all of one mind about either the nature of the Chinese market economy or the relationship between law arrangements and economic performance. Each of our authors has something important to contribute to our understanding of the potential significance of diverse legal forms for the future of Chinese market capitalism.

As a general matter, this volume leans against the view that "neo-liberal" legal (or economic) orthodoxy ought to guide Chinese reform. The majority of our authors share a commitment to developing an alliance between increasingly well known criticisms of neo-liberal economic orthodoxy – from which China has been an important dissenting

voice and alternative model – and less well known criticisms of neo-liberal *legal orthodoxy,* which has had a far more successful run of late in Chinese policy circles. At the same time, at least until the global economic crisis, a number of variants of "market fundamentalism" held sway especially within some economic and financial "experts." By bringing those two discussions together, we hope to foster an alliance between alternative economic and legal analytics, set in the context of Chinese experience. By doing so, we hope to contribute to discussion of fundamental issues about the relationship between economic life and the rule of law. The task going forward is to develop the concrete implications of this alternative view for the design of legal and institutional arrangements in the Chinese context.

The book is divided into four sections. In the first, we develop the conceptual foundations for our discussions by reviewing debates about both the nature of Chinese economic policy in light of the 11th five year plan, and the potential for an alliance between economic and legal criticisms of neo-liberal orthodoxy. The second part focuses on selected elements in current Chinese economic policy, exploring the relationship between institutional forms and patterns of economic life within the emerging Chinese market economy. In thinking about "economic policy" it is conventional to focus on areas which are – or might be – subject to one or another type of *regulation* or administrative action. At the same time, we need to recognize that the legal/institutional framework includes not just regulations, but the laws that relate to property, contracts, tort (liabilities), competition, corporate governance—indeed almost every aspect of a modern economy. We open this section, therefore, with reflections on debates within the West about the nature and desirability of "regulation" and, more broadly, governmental engagement in a market economy.

In broad terms, the neo-liberal orthodoxy, both legal and economic, has been hostile to economic regulation, and supportive only of specific rules thought necessary to "support" markets, e.g. that provide for clear assignment of property rights; other rules are broadly viewed as "distorting" the work of market forces. There is, for instance, a strong presumption that markets are competitive (hence there are high barriers to bringing predatory pricing cases); that markets can handle externalities and public goods on their own and that individuals should bear responsibility for protecting themselves (caveat emptor). This broad resistance to regulation has been criticized by both economists and legal scholars, partly because the boundary between "supporting" and "distorting" market forces is notoriously hard to draw, and partly because the underlying economic presumptions have been undermined by research over the past three decades. Moreover, while the "neoliberal" orthodoxy focuses on efficiency, standard economic theory never provided any presumption that market outcomes were "socially acceptable," consistent with any principle of social justice or solidarity. The Chicago legal response was that issues of equity and efficiency were separable, and the former should be handled by the political process, independent of the structure of the legal/institutional framework. Again, the underlying theoretical basis—that efficiency and equity concerns were separable—has been undermined by critiques of the underlying neoclassical model of the last thirty years. In practice, the legal and institutional structures provide some of the most important "social protections" in modern societies. The regulatory failures of the financial system in America has resulted in wiping out a significant fraction of the wealth

of America's poorest families, unlikely to be made up for by redistributions. The institutional framework has, simultaneously, played an important role in the creation of large inequalities—again, not typically offset by political action. We enter the examination of Chinese regulatory practice informed by the history of these debates.

The third and fourth parts turn from regulation to *rights* and other entitlements, particularly relating to property. Again there is a legal and economic neo-liberal orthodoxy which advocates "clear and strong" property rights as the necessary foundation for a successful market economy. We begin by examining this orthodoxy in light of the history of disputes about property rights and their relationship to economic, social and political forms in Western economies. The remaining chapters examine various aspects of the legal orthodoxy – the primacy of "formal" over "informal" rights, the significance of "independent" judiciaries, the importance and meaning of "land reform," and the necessity for "strong" protection of intellectual property. The papers show that the issues are far more complex than is often depicted in officical policy discourse—and this complexity sheds considerable light on the Chinese experience and debate.

We dwell far longer on issues pertaining to property rights than we do the details of regulatory policy. This may seem strange in a book about contemporary Chinese economic policy. Economic policy seems far more a matter of institutional arrangements and the details of regulation than of property rights. Private law – contracts, property, the law of obligations – is generally considered part of the *background* for economic policy making. We are convinced, however, that at this juncture, a rigorous assessment of the nature of property rights is warranted. The orthodoxy has emphasized that property rights must be "clear and strong" for efficiency and growth. This orthodoxy oversimplifies the nature of the choices before us in designing a property rights regime, obscuring more than it illuminates. It is not that we argue that one should set out to create a system of "unclear and weak" property rights. Rather, that there are inevitably ambiguities; that in practice, more often than not, advocates of "clear and strong property rights" are really arguing that when ambiguities arise, they should be resolved in a particular way—normally in favor of owners of particular classes of assets. The financial crisis in America has provided ample illustration of these problems. The problems in sorting out the claims on homes going into foreclosure—with a legal context that seemingly had "strong and clear" property rights has resulted in paralysis: mortgages are not being restructured, to the potential disadvantage of virtually all stakeholders, with great losses to the efficiency of the economy, and with the poorest Americans suffering the most harm.

The orthodoxy is correct, however, in its insistence that background entitlements are absolutely central to the operation of markets. How they are allocated can make all the difference over time. As a result, it is absolutely critical to focus on the allocation of property and other background entitlements as China sets up the framework for its own distinctive market. These background rules – to which we might add corporate law and rules about payments and finance – structure the players who will participate in markets and how they interact, settling their respective powers and obligations while establishing an initial allocation of resources, income streams and risk.

It is critical to understand that the background rules structuring market arrangements are not natural entitlements – they are social arrangements designed to promote social objectives. This is most obvious in the case of newer legal innovations like "intellectual property" or "limited liability corporations." These are social constructions, the merits and designs of which have to be constantly evaluated and reevaluated. But it is no less true of "property" and "contract." In every market economy, each is a complex legal regime reflecting a history of social, political and economic conflict and debate. The legal structure of property, of corporate authority, of contract and finance, everywhere reflects a complex series of trade-offs. It is not the case, as the neoliberal economic orthodoxy would have one believe, that there is a particular set of rules that is Pareto optimal—best for all stakeholders; and even if there were a set of rules which were Pareto optimal at one point of time—under one set of economic and social conditions—there is no assurance that it would be in another, as economies change and evolve. Establishing a regime of background rules balances the interests of various potential market players. There are winners and losers. Background market rules often institutionalize these initial gains and losses in ways which compound differences over time. Different institutional designs can lead to quite different outcomes.

There is another dimension to these discussions that too has become more apparent in this crisis. Legal and institutional regimes are constantly evolving. This occurs through political, judicial, and "regulatory" processes. But even judicial and regulatory processes are political in nature—they are affected, for instance, by political currents and of necessity by appointees. The institutional and legal structures create vested interests and help form coalitions, that shape these processes. We have seen how they helped shape, in America a process that led to deregulation and bailout; and those same processes are helping to shape the post-crisis regulatory debate.

Similar issues—in different forms—will arise as China moves forward in the process of creating its market economy. It is therefore terribly important that early decisions are made with a view toward their dynamic impact on the operation of the market. This volume aims to clarify the choices which are now available to China as it establishes what will become the long term framework for its own distinctive market economy.