

## **Law in China's Transition<sup>1</sup>**

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*Abstract.* China's gradualist approach to transition has resulted in a partially reformed economy within a communal property system that has grown well for nearly three decades. This path raises questions about the institutional foundations of China's increasingly decentralised economy. China's incremental reform process has been characterised by ill defined property rights and high transaction costs, and yet economic growth has been rapid. This paper attempts to explain legal reforms in China as a necessary counterpart to economic reforms. Legal and institutional reforms provide a contractually defined set of property rights which underlies the market in China. The development of institutional innovations such as the Household Responsibility System and the early passage of joint venture laws are examples. Establishing institutionally and contractually defined rights thus instilled the necessary incentives for economic development. This approach has the further advantage of helping to ensure stability as incentives are introduced gradually rather than quickly which would be the case if there was a rapid change in ownership. As economic development becomes more complex, however, legal reforms are also needed to regulate the market. Legal reforms enable further development, as economic transactions increase with better established institutional foundations. The outcome of this process should eventually be a better defined and supported market in China.

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## I. Introduction

It is often observed that China's economic growth of over 9% on average per annum for nearly three decades has taken place in the midst of uncertain property rights and arguably high transaction costs, which defies the usual depiction of markets in the traditional (Coasian or Walrasian) economic sense (see e.g., Jefferson and Rawski 2002). Its gradualist approach to transition has resulted in a partially reformed economy within a communal property state. This particular path raises questions about the foundations of China's increasingly decentralised economy, and its ultimate sustainability. With a rapid liberalisation approach to growth, property rights would be established quickly and allow for efficient exchange, in theory. By contrast, China's incremental reform process has left it with ill defined property rights and high transaction costs, and yet economic growth has been rapid.

This paper attempts to explain legal reforms in China as a necessary counterpart to economic reforms. Legal and institutional reform provide a contractually defined set of property rights which underlie the market in China, allowing it to grow despite having otherwise poorly established private property rights. Such legal/institutional reform also ensures stability which makes them not inconsistent with the aim of policymakers. Decentralisation coupled with the instilling of incentives was successful due to the ability to create expectations of protected private property where none would otherwise exist under a communal property system.

The development of institutional innovations such as the Household Responsibility System and the early joint venture laws serve as examples of the institutionally and contractually defined rights that characterise Chinese markets. These

fall within China's 'no encouragement, no ban' policy governing economic experimentation, so long as stability is maintained. As economic development becomes increasingly decentralised and more complex, legal reforms are further needed to regulate the market in an evolutionary process, including establishing regulatory agencies to oversee liberalised banking and financial sectors, for instance. Finally, legal reforms in turn permit further economic reforms, as economic transactions increase with better established institutional foundations. For example, corporatisation creates shareholder rights which leads to larger and more diffuse corporate structures and holdings.

This paper posits that these market-oriented incentives were created through an implicit set of property rights which gradually became explicit as decentralisation of the economy progressed. In other words, China's reform path allowed for the creation of a set of "contracted" rights which were implicitly defined through the various institutional innovations and later became legal reforms when increased marketisation required a more explicit set of rules. These legal and institutional reforms, moreover, helped to maintain the stability that is crucial to a partial reform process. Without stability, China would likely have experienced rapid liberalisation and quick marketisation that more is typical of the experience of other transition economies (Murphy et al. 1992). These reforms also do not mandate a change in ownership, which is again unlike the rapid marketisation of other transition economies for which the establishment of private property rights was an essential element of the market that arose. In China, institutional and legal reforms carved out areas where protection was extended to the right to retain profits or undertake investment by foreign firms, but did not require that the underlying property be designated as private. It was not until March 2004 that China recognised private property

in its Constitution and only three years later that a law was passed that gave equal protection to *de facto* private property as is granted to public property. The legal changes do not, however, create property rights in several fundamental areas of the economy, including land ownership, but rather grant protection where such rights are contractually defined as belonging to a party, including the contractually defined rights of home ownership.

This paper will argue that the so-called “institutional innovations” which allowed the state to create property rights without a change in ownership was appealing in a gradualist reform path. Then, as decentralisation increased, the state created further contractually defined rights, such as the joint venture laws in the 1980s, which again extended incentives and granted protection to foreign investors without requiring widespread private property rights to be established. Finally, as the economy grows increasingly complex due to liberalisation, legal reforms enabled the market to be more decentralised and developed, such as through the creation of regulatory agencies, for instance, which enables capital market formation.

Membership in the World Trade Organisation (WTO) also introduced elements of international economic law which sped up the legal reforms and further decentralisation. In turn, the resultant economic growth increased the need for more laws and regulation. This process has culminated in an evolutionary framework in China that is not dissimilar to that of other economies when they undertook corporate development under an initially underdeveloped legal system (see e.g., Carlin and Mayer 2003), but has distinct elements such as the eventual need to extend protection to the *de facto* private property. Therefore, this paper argues that institutionally and contractually defined rights were sufficient to

support China's economic growth as it suited the gradualist transition approach since private property rights was not essential in the early part of the reform process. As China becomes increasingly marketised, there are limits to using informally defined rights and more need for explicit legal reforms. These contractually and institutionally defined rights have the additional advantage of not relying on formal mechanisms for enforcement as they are not clearly rooted in the Chinese legal system, but can be enforced informally through social and business relationships or sometimes through contractually defined measures such as binding arbitration. In other words, villagers know the implicit ownership of farm land while foreign investors are aware that their rights are defined in the contract. Although subject to the Chinese legal system, Chinese-foreign joint ventures are often entered into with trusted parties and are sometimes externally enforced through international arbitration procedures.

We will first discuss the role that institutionally defined implicit property rights plays in maintaining stability in a gradualist reform strategy. We then consider the institutionally created rights that instilled incentives into the agricultural and industrial sectors in China in the early part of the reform period, and the "contractually defined" rights that followed, which were granted to foreign investors and then to Chinese domestic residents notably in the privatisation of the housing market and the corporatisation of state-owned enterprises (SOEs) that took the form of contracts for leaseholds/freeholds and share ownership without granting private property per se. For instance, homeowners had a right of residence in their homes for a specified period but do not hold outright ownership. We consider the legal reforms that became necessary to foster further economic reforms, placing a significant emphasis on the complexities of a

decentralised market that require regulatory oversight in order to maintain a gradualist reform path. We conclude with some thoughts on China's legal framework and an assessment of the effect of this system of contractually defined rights, both implicit and explicit, on China's growth prospects.

## II. A Gradualist Reform Approach

China's gradualist reform path stands in contrast in many ways to a "shock therapy" approach. The latter aims to achieve economic efficiency and uses speed to establish policy irreversibility (see e.g., Boycko et al. 1995). The gradualist strategy undertaken by China instead emphasises practical adaptation to changing economic conditions and permits reform to occur on an experimental basis in a decentralised manner. There are, however, impediments to incremental reform from potential political opposition (Dewatripont and Roland 1995) and rent-seeking (Young 2000). The distortions caused by partial marketisation can also derail a gradualist transition path unless the government can impose quantity controls to maintain an administered segment alongside the market sectors (Murphy et al. 1992). For China, the government has established a market sector while maintaining an administered sector in a successful "dual track" transition. This approach is also less concerned with economic efficiency and more with maintaining stability, which can be welfare enhancing (Lau et al. 2001).

The elements of the gradualist strategy undertaken by China include: minimise implementation costs instead of maximising economic efficiency; minimise political opposition to market-oriented reforms; practical adaptation to changing economic conditions; and includes allowing reforms to occur on an experimental basis in rural areas

and regions. Young (2000) argues that the reform process itself creates rent-seekers and therefore opposition to the process develops as reforms progress. Minimising implementation costs would therefore be a consideration and there is a rationale for the “easy to hard” reform sequence posited by Fan (1994). Lau et al. (2000) in turn argue that China’s “dual track” reforms are welfare-improving as the non-state sector generates the potential for transfers to the state sector. Addressing political opposition would be part of this process. Murphy et al. (1992) find that coordination failure and managing the diversion problem can allow partial reform to succeed in China, although it sacrifices economic efficiency which would be achieved with “big bang” reforms, such as price liberalisation. Finally, Qian and Xu (1993) argue that the coordination structure of China permits experimentation to take place without affecting growth as a whole.<sup>2</sup>

These theories suggest that the policymaker’s objective function would include concerns about both economic efficiency and the implementation cost of reform, including political opposition, and would be practically driven. National output,  $Y$ , is determined by undertaking economic reforms at some rate,  $p$ . The policymaker’s objective function is given by:

$$U(p) = Y(p) - b(p) - c(p)$$

where  $p$  is the pace of economic reforms,  $b \in [0, 1]$ , denotes political opposition to reforms and increases with  $p$ , and  $c$  is the cost of implementation. The function  $Y$  is

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<sup>2</sup> It is also important to take into account initial conditions. The preconditions to achieving gradualism in China included: political stability to maintain a “dual track” in the early phase of the reform period; the state sector being not yet stagnant so as to not preclude incremental reforms and so that economic growth can outpace transfers to state sector; and the presence of a large, surplus rural labour force to accompany liberalisation of private economic activity. As to whether this strategy is applicable to other economies will hinge in large part on the relevance of these initial conditions. For one, political stability is required to provide sufficient control over the economy so that quantity ceilings can be maintained and goods are sold at both administered and market prices (Murphy *et al.*, 1992). Second, on the eve of reform, the state sector must be sufficiently viable so that the requirements of continuing transfers from the state sector do not surpass the growth in the non-state sector. Finally, the presence of a declining sector, such as agriculture, whereby the surplus labour can be utilised in new private economic activities can proceed.

characterised by:  $Y' > 0, Y'' < 0$ . This suggests that output will increase with economic reforms at a decreasing rate. Note that:

$b' > 0, b'' > 0, c' > 0, c'' > 0$ . Therefore, output falls as  $b$  rises (opposition rises) and  $c$  rises (administrative costs of reform rises) at an increasing rate. And,  $p$  rises as  $b' \downarrow$  and  $c' \downarrow$  (political and administrative costs fall).

The policymaker maximises utility:

$$Max_p = Y' - b'Y - c' = 0.$$

This implies that the policymaker will choose the pace of reform such that the marginal benefit and marginal cost of reform are equal:  $Y' = b' + c'$ . Indeed, the partial reform approach suggests a constant re-balancing of costs and benefits from growth, though the structural problems in the economy are becoming more difficult due to this particular approach to transition.

*Proposition 1 If  $b' = c' = 0, p \rightarrow \infty$ , then the policymaker will choose 'big bang' to maximise income.*

If political opposition is minimal and there are no implementation costs, then “big bang” would be optimal. However, these costs are not negligible in China as political concerns and the costs of implementation, particularly from the powerful provinces, are considerable and would warrant a gradualist process. The 14 year period required to pass the Property Law that gave equal protection to private and public property is an example of the both the political nature of reforms and the costs of implementation of a law that should give better safeguards to property and reduce the corruption in the process.



Proposition 2 As  $b' \nearrow$ , then stringent opposition to reforms will result in a slower pace of economic reforms ( $p$  falls).

If, however, there is political opposition, then reforms will slow. The powerful provinces and localities in China can delay the implementation of reforms, such that the progress of reform slows. China's 'no encouragement, no ban' policy permitted regional experimentation under a generally permissive reform path that laid out general aims, most visible in the Five Year Plans, and rolled out reforms that were seen to be successful and not cause instability, e.g., foreign direct investment (FDI) policy. The regional dispersion and decentralised approach evident in FDI policy highlight the "experimentation" approach that China has undertaken in incentivising different regions to introduce market-oriented reforms, which reduces opposition to central mandates.

Proposition 3 As  $c' \nearrow$ , then the utility of the policymaker is determined by the cost of reform and would warrant gradualism ( $p$  falls).

A notable example is the continued support of loss-making SOEs. Restructuring is a costly process in terms of unemployment and violating implicit social contracts built up over time, both of which could cause instability. Therefore, share issue privatisation (SIP) may slow the reforms, but prevents the restructuring (*gaizhi*) and layoff (*xiagang*) policies from causing disruption that could derail the gradualist transition path. SIPs are essentially a form of corporatisation, which grant legally defined shares but do not

necessarily entail outright change in ownership, as many of the corporatised firms are under state ownership and control.

This reform strategy is not without problems. Fan (1994) argues that a “dual track” process will lead to convergence of the two tracks without causing a shock, which is a clear example of the trade-off between efficiency and implementation costs in transition. However, it also highlights the challenges of this approach and its reliance on stability in the system. The next section puts forth our arguments as to how legally and contractually defined rights alongside institutional innovations discussed above can serve to achieve this balance between incentivising behaviour while also maintaining stability through controlling the costs and opposition to reform in a gradualist path.

### III. Institutionally and Contractually Defined Property Rights

#### *The Institutional Innovations*

As discussed earlier, China does not have a system of formal property rights conventionally defined and only recognised the existence of private property in March 2004, when the concept was included in its Constitution. Yet, China’s phenomenal growth has taken place through the creation of residual claimant rights in its partially marketised economy, *e.g.*, notably the Household Responsibility System implemented to great success in the late 1970s and early 1980s, and the Contract Responsibility System instigated in the mid 1980s.

In the rural economy at the start of reform in 1979, the Household Responsibility System created a system of effective residual claimants in the rural areas who were given

appropriate incentives to share risk with the state and retain some returns from their labour based on profitability. Rural township and village enterprises (TVEs) were also subject to a two-tiered compensation structure whereby profits could accrue to the rural industry so long as sufficient remittances or transfers went to the state. This system was extended in a qualitatively different manner to urban areas and to foreign investment in the form of contractually defined rights. Second, China's "dual track" transition in which one part of the market was liberalised while another was kept under administrative control depended on the creation of rights to retain returns from the marketised part of the economy. A "dual track" approach that did not create incentives for the risk-averse actors beholden to the principal or state in a transition economy would not have been feasible. In other words, prior to this "institutional innovation," collectivisation meant that there was little incentive for farmers to produce output as their work points were allocated on the basis of a day's labour irrespective of effort. The creation of these implicit property rights can be likened to a sharecropping system where there is a residual ownership right to instil incentives while not granting private property to the farmers. This process of creating and defining some form of property rights shaped and explains China's successful use of a gradualist or incrementalist approach to marketisation. With this change in incentives, output increased tremendously and 1984 witnessed a bumper crop (Riskin 1987).

Institutional innovations within the state sector were also important. Decentralization has occurred in almost all areas of decisionmaking in production, pricing, investment, trade, expenditure, income distribution, taxation and credit allocation. The main institutional innovations were the 'Budgetary Contracting System'

(BCS), the ‘Contract Responsibility System’ (CRS), and permitting direct borrowing (Riskin 1984). Since 1980, under the BCS, the central government shares revenues (taxes and profit remittances) with local governments. For local governments which incur budget deficits, the contract sets the subsidies to be transferred to the local governments. Fiscal decentralisation further gave scope for regional experimentation, another key element to China’s gradualist path as it permitted increased market-oriented activity while limiting the possibility of instability from arising given the nature of China’s semi-federal structure (Qian and Xu 1993).

The CRS in 1985 permitted SOEs to pay a fixed amount of taxes and profits to the state and retain the remainder. In principle, so long as the SOEs deliver the tax and profit remittances specified in the contracts, they are free to operate. This resulted in increased profitability of SOEs in the 1980s through the reorientation of incentives of managers (Groves et al. 1995).

China’s growth is often attributed more to factor accumulation than to improvements in productivity or technological advancement. Creating property rights expectations and claims in specific sectors and regions drove the process of reallocating surplus or redundant labour. The reallocation process was responsive to managerial incentives in the state sector and also to market-oriented incentives created in the non-state sector. Enterprises were permitted to act on some informally defined set of contractual property rights so that they could engage in economic activity, including agreements with suppliers, leasing buildings, and sales relationships. These informal property rights were not always defined by the state. The long-standing use of *guanxi* or inter-personal relationships in China underpin business networks by creating trust and

reducing transaction costs in an economy characterised by uncertainty. This was particularly important in encouraging business activities in a credit-constrained economy, since small and medium enterprises did not have the right to borrow funds from banks until late in the reform process, so many relied on relationships to secure inventory and finance expansion.

Since 1985, state grants for operating funds and fixed asset investments were replaced by bank loans, the final element of the institutional innovations. Local governments and SOEs are allowed to borrow directly from banks. Six years later, local governments and SOEs were permitted to borrow from household and other institutions. By liberating one “track” of the dual track system, there was scope for these institutionally defined rights to foster a profit incentive to SOEs and state-owned banks which helped boost output again without creating private property rights in the ownership of these enterprises and banks.

#### *Contractually Defined Rights*

This system of informal property rights extended to China’s treatment of multinational corporations investing and establishing primarily manufacturing facilities. Since the “open door” policy began and its take-off in the early 1990s, China has rapidly become one of the world’s top destinations for foreign direct investment. For most of the reform period especially prior to WTO accession, the predominant form of FDI was Chinese-foreign joint ventures, where the Chinese and foreign partners set up either equity or cooperative joint ventures. Equity joint ventures partitioned returns on the basis of the invested capital in the joint venture while returns were contractually defined in cooperative joint ventures. Both forms of joint ventures, however, were vested in

essentially a set of contractually defined rights. The uncertainty that might have been generated by the lack of recognition of private property such as those held by joint ventures, though, did not seem to serve as a deterrent to FDI. Because of the lack of private property rights in the rest of the Chinese economy, the joint venture laws in some ways provided more protection to foreign-invested enterprises than accorded to Chinese non-state firms, such as *getihu* (sole proprietorships) and other non-state owned enterprises (Huang 2006).

This system of contractually defined rights was not limited to foreign investment. In 1998, China undertook privatisation of housing, whereby the formerly allocated housing through work units was sold off at preferential prices to urban residents (Li 2005). By 2001, the housing market was effectively privatised. However, the rights of the owners of the housing were limited to residing in the flat or house for a designated period of time. This contractually defined right is akin to a leasehold and thus not an explicit designation of ownership. However, the expectation of housing owners is that they will have the right to renew their contract and the passage of the 2007 Property Law largely confirms this expectation. Investment, moreover, is high in the housing market despite the lack of protection of private property and uncertain land ownership. These contracts also carry enforcement risk; however, the implicit social contract that arises means that should expectations not be fulfilled, there is the possibility of social instability as has been seen when housing is confiscated for government development.

Another example of these contractually defined rights is the corporatisation and effective privatisation of state-owned enterprises through a process of share issue privatisation (SIP) (Sun 2002). Since 1992, many SOEs have become shareholding

companies where the ownership is in the hands of shareholders and a portion of the shares are traded on domestic and international stock exchanges. Again, stock ownership is based on a contractually defined obligation rather than a clear announcement of private property as would be expected with mass privatisation of state-owned enterprises. By corporatising its enterprises, China has managed to instil profit incentives without a change in ownership and while maintaining controls over the tradability of shares listed on the domestic stock exchanges. This was effective in sustaining SOE growth for a while, but it became clear that further reform was needed and a large-scale restructuring (*gaizhi*) programme was undertaken in the mid 1990s that has paved the way for the later effective privatisation of Chinese SOEs. One of the consequences of China's form of privatisation is that shareholders require and expect protection of these contracted rights, so regulatory agencies such as the China Securities Regulatory Commission (CSRC) was established from 1992, as well as other regulatory agencies such as the China Insurance Regulatory Commission (CIRC) in 1998 and the China Banking Regulatory Commission (CBRC) in 2003.

### *Enforcement*

China has successfully established a system of contractually defined and institutionally structured rights encompassing the set of so-called “institutional innovations” – the market-oriented institutional reforms governing households, firms and even local governments – as well as with respect to foreign investors and the domestic non-state sector. This system of institutionally and contractually defined, but arguably informal, property rights stimulated China's impressive economic growth during the

reform period despite the lack of recognition of private property per se and within an incomplete legal system particularly with respect to enforcement.

In a system of contractually or institutionally created rights, enforcement would seemingly be of considerable significance, yet China's legal and regulatory systems lagged, and still lag behind, the set of contractually defined obligations underpinning its economy. Clarke (2003) emphasises the security of property rather than enforcement as important in China, and informally, but still defined, property would be consistent with this view. Indeed, the studies of social capital/networks in China and elsewhere reinforces the notion that socially acknowledged ownership rights are secure through informal enforcement rather than a formal process, reducing the importance of the formal legal system and the effectiveness of its enforcement procedures (Greif 1993; Allen et al. 2005). For instance, Ho (2006) finds that collectively owned land is subject to period division among a village and that these rights to the land are well known, expected and respected despite a lack of private ownership of land in China. However, the recent reforms to the property laws in China will protect these informal rights through formal channels, which perhaps signal the limits to a purely informal institutional framework.

A further advantage of a system of contractually defined rights is that arbitration can be specified as an enforcement mechanism. Although arbitration is not a possibility for all transactions, particularly those related to SOEs, it provides another avenue of specifying conflict resolution that does not rely on the courts but can utilise an agreed set of terms and laws. China International Economic and Trade Arbitration Commission (CIETAC) is often used by international investors, for instance, and has a better reputation than the Chinese court system.



#### IV. Legal Reforms Enabling Further Economic Decentralisation

Much of China's growth can be traced to so-called institutional innovations (Naughton 1995) or coordination structures that permit "experimentation" (Qian and Xu 1993) or indeed factor redeployment, primarily labour. The notion underlying better use of input factors, experimentation, and decentralised decisionmaking can be linked to a process of defining property rights in an economy notable for a lack of private property. This stands in contrast to the standard premises underlying efficient markets, which include the key concept of well-defined property rights. Rather than viewing China as an exception to this rule, this paper views the path of China's economic growth as one which has created contractually defined and institutionally created property rights along the way so as to permit market forces to act to provide appropriate incentives for private actors to trade and exchange in a partially marketised economy.

Although decentralisation and regional experimentation have been enabled by the creation of incentives distilled through the creation of contractually defined and institutionally permitted property rights, the further growth of the Chinese economy will likely require more legally defined rights as the marketisation process continues and increases in complexity. There are the pressures of international economic law (Jefferson 2002) and those arising from shareholder systems and accumulation of *de facto* property rights in assets that underscore the need for explicit legal protection. These reforms, furthermore, have the effect of enabling economic reform, since increased security of property should increase the diversity of uses of property, including fund managements and investments, trading shares, and improving housing, for instance. Further economic

reform is also likely to in turn stimulate more legal reforms, where economic decentralisation could generate the need for more regulations (see also Chen 2003 for an argument that China's capital markets and legal system develop following a "crash-then-law" sequence).

In particular, China's incomplete legal system, particularly its poor enforcement, has come under scrutiny. For instance, the legal system for patenting exists, but there is a lack of effective enforcement, particularly with respect to piracy, which has raised the ire of foreign investors. International economic law adds another dimension of pressure as other countries who are members of the WTO want China to better adhere to international rules and standards with China's accession in 2001. The WTO established a framework for international economic law that includes several provisions relating to the governance of trade-related aspects intellectual property rights (TRIPs), in particular. The combination of these factors led to several revisions of the patent laws and regulations to make legal protections more evident and enforceable.

A further example that illustrates the evolutionary process which law tends to take in China, which is also seen in common law countries, is with respect to the protection of shareholder rights. When shareholding companies were created as part of the SOE reform process and became publicly listed starting in the early 1990s, there was a need for more explicit protection of shareholder rights. This was also the process in countries such as the UK when laws came into effect with the creation of stock markets that permitted dispersed ownership (Carlin and Mayer 2003). Before then, informal relationships were sufficient to ensure shareholder protection and governance. However, as the market developed, there was a need for more formal, legal and regulatory

protection of ownership rights. In China, corporatisation in particular has created a class of shareholders which has generated a need for legal protection. Also, corporation, rather than privatisation, has resulted in listed companies which require regulatory oversight due to their publicly held nature. China's "share issue privatisation" also creates the need for legal provisions governing mergers and acquisitions (e.g., an M&A law was passed in 2002) and other regulations related to the development of a capital market, such as securities regulations, for instance.

The rapid adoption of legal reforms in the past few years follows from the economic decentralisation and growing complexity of a marketising economy. There is also an international element as international economic law plays a role in the expectations of investors which can result in pressures to adopt additional legal measures. It highlights the limits of informal measures but also reflects the complementary nature of laws and markets, seen in other developed countries, particularly ones with a common law system. Enforcement continues to be an issue, but the adoption of laws alongside more informal designations of property rights begin to build the institutional foundations of a market system, albeit in a gradualist manner. This process, although imperfect which is again not unlike the experience of common law countries, should help induce further economic decentralisation and market developments and activities. In other words, although legal reforms are a product of a confluence of factors, they also contribute to enabling economic growth and reform. Legal measures will likely exist alongside more informal institutions in China, but that is again not atypical for even market economies, which often use social capital or trust to reduce transaction costs.

However, their role in China's particular transition is a factor that can help explain its successful growth.

## V. Conclusion

A long-standing puzzle in China's economic growth is how it has managed to instil market-oriented incentives without establishing property rights, which are fundamental to a well-functioning market. This paper has argued that China has created a system of institutionally and contractually defined property rights which serve this purpose. Although they are not wholly efficient, this approach serves the stability function necessary in a gradualist reform path. It also has the advantage of permitting enforcement to be specified either implicitly in the relational social contracts of the parties or explicitly in agreeing to arbitration which relieves the burden of using China's underdeveloped legal system. Examples include the Household Responsibility System, the joint venture laws, corporatisation of SOEs, among others.

There are, however, limits to this informal system. As decentralisation progresses and the market becomes more complex, there is a greater need for explicit protection of property. The rights established create an impetus for legal reforms which has the effect in turn of stimulating more economic activity. For instance, where corporatisation has created dispersed shareholders, legal and regulatory protection has arisen. This should lead to further development of the capital markets, as well as the banking sector, which enables further economic development and market decentralisation. International pressures also contribute to highlighting the limitations of China's system, as has been seen in the push for better enforcement such as the protection of intellectual property

rights. Domestically, the passage of a number of laws, such as the Property Law of 2007, underscores the drive for legal reform.

In conclusion, this paper argues that legal reforms, along with institutionally and contractually defined rights, are a necessary complement to China's economic reforms. They provide the incentives that motivate economic growth and are consistent with a gradualist reform approach that relies on stability. Although imperfect, the growing number of protected rights in China attests to the eventual move toward a better defined legal system that will characterise and support a burgeoning marketising economy.

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