

**Formal Contract Enforcement and Economic Development in Urban and Rural
China**

Paper prepared for NYU Conference on Law, Commerce, and Development
April 11-12, 2008
NYU Law School, New York, NY

Xin He
School of Law, City University of Hong Kong, China
lxixin@cityu.edu.hk

Draft: Comments welcome.

Abstract

As more evidence suggests that formal contract enforcement in urban China has improved while the situation in rural areas remains dire, it provides an opportunity to test two hypotheses on the relationship between China's formal contract enforcement and economic development in the literature: whether effective contract enforcement is essential for China's economic development or vice versa--the economic development generates more demand for a mature contract enforcement. This paper argues that the latter hypothesis has more empirical support but it is still incomplete in capturing the relationship. While China's court system in urban areas has indeed become more effective, it largely comes from a combination of political concerns and adequate financial resources. Through the experience of China, this study demonstrates that politics and other contextual factors still play crucial roles in the relationship between law and economic development.

For a long time, a credible, low-cost, formal contract enforcement mechanism provided by the state has been widely regarded as essential for economic development because it encourages individuals and firms to expend effort, plan, invest, and bear risk.¹ These assertions, however, have been seriously disputed in the spirited debates about China's legal and economic development. Though China's economy has developed at a rapid pace for the past three decades, until recently, evidence consistently suggested that China was far from establishing a neutral and effective formal adjudicating organization.

But new evidence has recently shown that formal contract enforcement has significantly improved in urban China: the enforcement outcomes are reasonable, the enforcement process is relatively efficient, and the problem of local protectionism is not serious. These developments add further questions to the existing debates on China's growth without an effective formal mechanism of contract enforcement. Does the puzzle

¹ MAX WEBER, MAX WEBER ON LAW IN ECONOMY AND SOCIETY (Max Rheinstein ed.)(1954); DOUGLASS NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE, AND ECONOMIC PERFORMANCE, at 54(1990); OLIVER WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM at 2, 1985; THE MECHANISMS OF GOVERNANCE, 332 (1996).

exist because China's economy remains at a very low level, at which the importance of law cannot be demonstrated? If the recent improvement is true, is it the success of economic development that has led to the progress of the legal system, including the formal contract enforcement? To what extent is China's situation a direct challenge to the alleged link between an effective and formal contract enforcement mechanism and economic development? Are there any alternative answers to the puzzle of China's growth?

At one end of the spectrum are explanations which try to fit China's situation into the framework of the above-cited economists. According to them, the answer to the puzzle of China's growth is simply that China's economy remains at a very low level. At this stage, alternative mechanisms such as cultural, religious, and ethnic norms, and the state's commitment to economic reforms may accomplish the task of contract enforcement. The importance of the legal system has not yet been clearly demonstrated.²

The recent developments, if true, simply corroborate that law becomes important when economic development reaches a higher level. China's legal and economic developments are just another illustration of the importance of formal contract enforcement in economic development.

At the other end of the spectrum are those who contend that China's reform situation has substantially challenged the assertions of Weber and North. According to them, although they see a formal legal system and economic development in China as a bidirectional, or co-evolutionary process, there is no way to prove that the formal legal system has been essential to China's economic development; if anything, it is the success of economic development that has led to the development of the legal system, not the reverse.³ When the economy develops to a higher level, they argue, it creates more market demand for a formal legal system;⁴ it is this demand that leads to a more formal

² Dani Rodrik, *Introduction*, in *SEARCH OF PROSPERITY: ANALYTIC NARRATIVES ON ECONOMIC GROWTH* (D. Rodrik ed.), 8-15 (2002). See also Kenneth Dam, *China as a Test Case: Is the Rule of Law Essential to Economic Growth*, University of Chicago Law School Working Paper Series No. 275, 40-42, at <http://www.law.uchicago.edu/Lawecon/wp251-300.html> (last visited April 12, 2007); Michael Trebilcock and Jing Leng, *The Role of Formal Contract Law and Enforcement in Economic Development*, 92 *VIR. L. REV.*, 1519 (2006).

³ Donald Clarke, Susan Whiting, and Peter Murrell, "The Role of Law in China's Economic Development," at 51, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=878672, 2006.

⁴ This assertion is also echoed in KATHARINA PISTOR AND PHILIP A. WELLONS, *THE ROLE OF LAW AND LEGAL INSTITUTIONS IN ASIAN ECONOMIC DEVELOPMENT 1960-1995* (1999). They note, "The greater scope

and mature legal system in the reform period. And recent improvements, if true, are simply a vindication of such market demand.

While both sides offer plausible explanations and even some correlation evidence, the arguments of the debate have normally been based on a general description of China's economic and legal development. The reasoning process of both sides seems unavoidably abstract and even speculative. The disagreements about the importance of formal contract enforcement have raised empirical issues about which evidence of any kind has been very scarce.

To what extent has formal contract enforcement in urban China improved? What are the reasons and mechanisms behind such improvements? Is it the market demand that causes the improvements, or conversely, is it the improved legal system that is conducive to the economic development? To what extent has a better contract enforcement contributed to economic development?

These are all empirical questions about the pattern of change in China's legal system and its relationship to the economy, about how changes have occurred, and about how a better contract enforcement has evolved. These questions are important not only for the debate on China's so-called enigma, but also for a broader debate and relevant policy orientations between optimistic and pessimistic claims about the link between formal contract enforcement and economic development. When using statistical methods to decode country-wide or cross-countries contract enforcement, indicators have offered intriguing models: the work of one group of intrepid economists has given a strong impression that there is a causal link between the rule of law variable and the rule of law reforms.⁵ Under the auspices of international organizations such as the World Bank, and this optimistic claim that the rule of law, including formal contract enforcement, in achieving development has become the engine of the revived law and development

of market-based transactions ...enhanced the relevance of formal law for economic transactions. While previously state policies and bureaucratic guidance provided business with a high-level of certainty, this function now had to be provided by the legal system. In this sense the demand for formal law may be said to have increased." Page numbers?

⁵ ROBERT J. BARRO, DETERMINANTS OF ECONOMIC GROWTH: A CROSS-COUNTRY EMPIRICAL STUDY (1997); Christopher Clague et al., *Institutions and Economic Performance: Property Rights and Contract Enforcement*, in INSTITUTIONAL AND ECONOMIC DEVELOPMENT: GROWTH AND GOVERNANCE IN LESS-DEVELOPED AND POST-SOCIALIST COUNTRIES 67-90 (C. Clague ed.)(1997).

movement across the world.⁶ This method, as scientific as it is, however, is not immune to criticism: from the types and reliability of the variables to the real causal link that statistical regression tries to establish, the method has been seriously questioned.⁷ But a mere criticism of methodology seems far from adequate to reverse the position of underdog that the skeptics in this debate occupy; they surely need to provide more convincing evidence. The difficulties for the skeptics, however, are the paucity of empirical evidence and a detailed contextual analysis to either prove or refute the alleged correlation.⁸

This paper attempts to address some of the above empirical questions by offering an analysis of the evolution and mechanism of the development of formal contract enforcement in urban and rural China, a difference usually ignored or covered by cross-countries indictors. It will first lay out the empirical evidence of the developments in urban China's formal contract enforcement, and then explore the underlying reasons for such developments both inside and outside the courts. Factors inside the courts include institution building and staff professionalism, while those outside the courts include the development and diversification of the local economy. All these factors contrast starkly with the situation in rural China in which formal contract enforcement remains dire despite the fact that the same efforts inside the courts have been made. This analysis finds little evidence to support the claim that formal contract enforcement is essential for economic development, but there is more evidence suggesting that economic development has contributed to a better contract enforcement. The development and diversification of the local economy has altered the nature of the disputes and disputants, which has paved the way for the courts to enforce contracts in a more efficient and neutral manner. The paper finally argues that this reversal link cannot fully capture the reason for the improved contract enforcement in urban areas; the improvement comes about more from a combination of political concerns and sufficient financial resources.

⁶ Thomas Carothers, *The Rule of Law Revival*, 77 FOREIGN AFFAIRS 95 (1998); DANEIL KAUFMANN ET AL., GOVERNANCE MATTERS (World Bank, Working Papers No. 2196, 1999).

⁷ Kevin Davis, *What Can the Rule of Law Variable Tell Us About Rule of Law Reforms?* 26 MICHIGAN JOURNAL OF INTERNATIONAL LAW, 141 (2004-2005). For more work skeptical of the optimistic link, see Frank Upham, *Speculations on Legal Informality: On Winn's 'Rational Practices and the Marginalization of Law*, 28 LAW & SOCIETY REVIEW, 233-241 (1994); *Mythmaking in the Rule of Law Orthodoxy*, CARNEGIE ENDOWMENT FOR INTERNATIONAL PEACE WORKING PAPERS No. 30(2003).

⁸ Kathryn Hendley, *The Rule of Law and Economic Development in a Global Era*, in THE BLACKWELL COMPANION TO LAW AND SOCIETY (A. Sarat ed.), 605-23 (2004).

Enforcement Improving in Urban Areas

While enforcement is often portrayed as notoriously difficult in China, recent systematic empirical studies have found significant improvements in urban areas. Overall, more than half of creditor-plaintiffs receive 100% of the amount owed, and three quarters are able to receive partial enforcement.⁹ More specifically, these studies demonstrate that a significant portion of contractual cases are voluntarily withdrawn by the plaintiffs or settled through judicial mediation. In a study based on 66 randomly selected debt-collection contractual cases in the Pearl River Delta, 22 cases, or 33%, were voluntarily withdrawn or settled through mediation.¹⁰ In a Nanjing-based study, of 76 cases, 50% were voluntarily withdrawn or settled through mediation.¹¹ A survey of 190 cases in Shanghai found that this number was 20%.¹² In such cases, creditors usually recover in full the amount owed or agreed in the settlement. These numbers show that the courts do not at all act as a rubber stamp: resorting to the courts itself is an effective way to make the defendant comply with the judgments.

Among the cases that go to final judgment, some will result in voluntary compliance with the judgment; some will result in applications for compulsory enforcement. Of the 66 cases surveyed in the Pearl River Delta, 37, or 56%, resulted in applications for compulsory enforcement. In the study in Shanghai, 77% of the winning plaintiffs applied for compulsory enforcement.¹³

The majority of plaintiffs who seek compulsory enforcement are able to recover all

⁹ Xin He, *Enforcing Commercial Cases in the Pearl River Delta of China*, in JOURNAL OF EMPIRICAL LEGAL STUDIES, forthcoming.

¹⁰ Id.

¹¹ See Donald Clarke et al, *supra* note 3.

¹² See Minxin Pei et al., “A Survey with Corporate Litigants in Shanghai,” on file with author, 2007.

¹³ See He, *supra* note 9; Pei et al., *supra* note 12. The official statistics indicate that nationally the rate of compulsory enforcement was 17.3% in 2004. See ZHONGGUO FALÜ FAZHAN PAOGAO(1979-2004) [CHINA LEGAL DEVELOPMENT REPORT(1979-2004)] (ZHU JING-WEN ed.) (2007): 248. As this number indicates the ratio between the cases involving actual compulsory action and the cases getting into the compulsory enforcement procedure, the standard is different from that used in these empirical studies. It is thus understandably lower.

or part of the judgment amounts. In the Pearl River Delta study, seven such cases were fully enforced; 21 such creditors, or 57%, recovered something. In the Shanghai-based study, 21% of the cases that asked for court enforcement were fully enforced, and 81% of the creditors gained something.¹⁴ In the Nanjing-based study, among 25 cases for which the enforcement results were recorded, 55.5% were successful while 18.5% failed.¹⁵ Overall, the main reason for non-enforcement is that defendants are judgment-proof: they are insolvent or their assets are encumbered.¹⁶ No legal system is able to enforce judgments in such circumstances.¹⁷

Although cross-country comparisons can be misleading, these results from urban China are better than what have been found in American, British, and Russian courts. Overall, 70-80% of plaintiffs in the studies based on urban China recover something through court. According to an investigation of Iowa small-dispute courts, 71% of the creditors got nothing through litigation, 24% got fully paid, and 4% recovered something in between.¹⁸ Another survey based on Denver's small dispute courts found that 55% of the creditors got nothing, and the rest only recovered an average of 31% of the awarded amount.¹⁹ Another study of 11 small-dispute courts in New Jersey found that only 37% of the debts were fully performed while 5% received partial payment. The situation for cases other than small disputes and landlord-tenant disputes was even worse: 25% of the

¹⁴ Pei et al., *supra* note 12.

¹⁵ Quoted from Clarke et al., *supra* note 3, at 42. It is unclear, however, whether the success or failure of enforcement refers to the complete success or failure.

¹⁶ For a study on the enforcement of international arbitration awards in Chinese courts, see Randall Peerenboom, *Seek Truth from Facts: An Empirical Study of the Enforcement of Arbitral Awards in the People's Republic of China*, 49 AMERICAN JOURNAL OF COMPARATIVE LAW, at 277-278 (2001).

¹⁷ According to recent official statistics, of 2,100,000 cases applying for compulsory action in the courts nationally in 2006, the courts took compulsory actions in 460,000 cases. As the standard used in these statistics are unclear, it is hard to compare them with all these detailed empirical studies. These numbers nonetheless were used to push through an amendment of the Civil Procedural Law, which tries to deal with the difficulty of judgment enforcement. See *Amending the Procedural Law to Solve "Two Difficulties,"* in CAIJING, July 12, 2007, at <http://www.chinavalue.net/Media/Article.aspx?ArticleId=9150&PageId=2> (last visited on March 19, 2008).

¹⁸ Suzanne E. Elwell & Christopher Carlson, *The Iowa Small Claims Courts: An Empirical Analysis*, 75 IOWA L. REV. 2, 521 (1990).

¹⁹ Arthur Best et al, *Peace, Wealth, Happiness, and Small Claim Courts: A Case Study*, 28 FORDHAM URBAN L. J. 2, 365 (1994).

civil judgments were fully enforced, 7% were partially paid, and 68% did not recover anything or the creditors dropped the lawsuits.²⁰ According to Hendley's research on 100 non-payment cases in three courts in Russia, 64% of the creditors recovered something while 33% were fully paid. On average, each creditor recovered only 46.7% of the awarded amount.²¹ The situation in England and Wales is not very different either. Badwin found that after six months of effectuation of adjudication decisions, only 31.9% of the creditors had recovered the full awarded amount.²² It would appear that enforcement in China may be less problematic than in many jurisdictions, including in rich countries such as the U.S. and the U.K., and transitional countries such as Russia. Moreover, in the World Bank's Doing Business 2008 survey, which measures the time, cost, and number of procedures involved from the moment a suit is filed until payment is made, China ranked 20th out of 178 economies in enforcement of contracts.²³ Of course, the reasons for a certain percentage of claimants "recovering something through court" may be very different. A higher percentage may be due to the more careful behavior of claimants who only go to court to sue solvent debtors. A lower percentage may be explained by certain practices of legal expenses insurances who may make a promise of cover without taking into account the solvency of the debtor. Nonetheless, while it is dangerous to jump to conclusions solely based on these results, it is fair to say that China's situation in urban areas is not all that bad.

The Rise of the Private Sector

What explains the recent improvements? It seems that many factors have contributed to this change. An immediate and predominant reason is the changed nature of the economy. In urban and more developed areas, many SOEs and collective enterprises have been privatized in the Restructuring and Transformation Processes, and private enterprises, individual business operators, and limited liability companies have become the major driving force of the economy. Economic activities among them have multiplied and they have thus been involved more in commercial disputes.

²⁰ See Committee on Post-Judgment Collection Procedures in the Special Civil Part, *Report to the Supreme Court of New Jersey*, NEW JERSEY L. J., 2 (1993), quoted from Donald Clarke, *Power and Politics in the Chinese Court System: The Execution of Civil Judgments*, 10 COLUM J. OF ASIAN L.1 (1996), 1-125, at 34.

²¹ *Id.*

²² JOHN BADWIN, SMALL CLAIMS IN THE COUNTY COURTS IN ENGLAND AND WALES: THE BARGAIN BASEMENT OF CIVIL JUSTICE? 128-134 (1994).

²³ <http://www.doingbusiness.org/ExploreEconomies/?economyid=42> (last visited on March 14, 2008).

This change is clearly indicated by court users. In a study based on data from the late 1990s, Pei shows that state-owned enterprises (SOEs) and government agencies were the major court users, because these enterprises and agencies could effectively mobilize political power to influence court decisions for their own benefits through their close connections with the courts and the government. Private enterprises, on the other hand, rarely had resources to do so, and were often discriminated against for ideological reasons, so they did not use the courts very much.²⁴ But in the most recent Pearl River Delta study, 59% of the litigation parties were private enterprises and privately owned limited liability companies. While some litigants were SOEs or were controlled by SOEs, most of them were banks or credit unions. No party or government agency was found in the data.²⁵

The change in the nature of the economy and in the court users has significant implications for the adjudication and enforcement of commercial litigation. First of all, litigation parties are more or less on an equal footing in litigation. As economic reforms deepened, the original discrimination against private enterprises in court based on ideology lost its foundation. Secondly, the financial income of local governments greatly increases as a result of the rise of the private sector. This increase also allows the courts to enjoy sufficient financial resources, because under China's court finance structure, the courts basically rely on local governments for their income. With sufficient financial resources, the courts are capable of successfully implementing various judicial reforms including institutional building and staff professionalism, which are key to the improved performance in judgment enforcement.²⁶ Thirdly, as will be shown, local protectionism seems to have been diminished.

Diminished Local Protectionism

Local protectionism has long been regarded as a chronic headache in enforcing judgments in China. It exists mainly because local governments have to rely on local enterprises, especially local SOEs, for financial resources. Moreover, the salaries, bonuses, benefits, and even jobs of court staff also rely on the financial income of local governments. They thus have incentives to protect the interests of local enterprises in the litigation with enterprises outside their local jurisdictions. Further, the appointments of

²⁴ Minxin Pei, *Does Legal Reform Protect Economic Transactions? Commercial Disputes in China*, in ASSESSING THE VALUE OF LAW IN TRANSITION ECONOMICS (Peter Murrell ed.) 180-210 (2001).

²⁵ See He, *supra* note 9.

²⁶ *Id.*

directors of some courts are controlled by local government and party officials.²⁷ They thus have power to exercise intervention for the sake of local protectionism.

But recent studies show that local protectionism is not very serious in urban areas. In the Pearl River Delta study, for example, there was generally no difference in the court decisions and the final enforcement outcomes between cases initiated by local and non-local plaintiffs.²⁸ Furthermore, virtually no creditors interviewed in the research mentioned that local protectionism was a big problem. Indeed, many non-local creditors emphasized that the working style of the court was much better than what they had encountered in hinterland areas. Similar results have been found in studies conducted in big cities such as Beijing and Shanghai.²⁹

While the point that local protectionism has become less serious might not be conclusive, some observations can be made. First, the economy in many cities and the more developed areas are more diversified: SOEs have lost their traditional dominant role. Local governments' income has come more from taxing the private sector than from SOEs and collective enterprises.³⁰ For similar reasons, there is little danger of social instability if SOEs are pushed into bankruptcy. The fate of a single company is less important to the local government, which has a broader interest in protecting its reputation as an attractive investment environment. Local governments thus become less dependent on SOEs and have less incentive to assist them in their disputes in court.

Second, financial reforms of the judiciary have decreased the incentive of the courts to engage in local protectionism. Under the reformed financial policy introduced in late 1990, separating income from expense, the courts shall submit all their administrative income, including litigation fees, to local governments, and get their expenses from the governments through a separate budget. Local governments in more developed areas, with increased income from taxing a rising private sector, usually provide courts with

²⁷ Donald Clarke, *Power and Politics in the Chinese Court System: The Execution of Civil Judgments*, 10 COLUM J. OF ASIAN L.1, 1-125(1996).

²⁸ See He, *supra* note 9.

²⁹ Randall Peerenboom, *Seek Truth from Facts: An Empirical Study of the Enforcement of Arbitral Awards in the People's Republic of China*, 49 AM. J. OF COMP. L., at 277-278, 2001. See also, Mei Ying Gechlik, *Judicial Reform in China: Lessons from Shanghai*, 19 COLUM J. OF ASIAN L., at 100, April 2006.

³⁰ The work report of the local government shows that the industry and commerce tax reached 2.63 billion yuan in 2006, while the business profit of the local SOEs only had 0.65 billion yuan. And the annals (nianjian) in the Pearl River Delta also indicate that the products of large private enterprises were 24% of the overall industrial products, 14(2006).

adequate funding. Thus, the courts there have no direct financial reliance on local enterprises and they also need not provide special protection for these enterprises in return, as they did before.³¹

Third, higher courts, rather than local government or party officials, have played a more determining role in court appointments and promotions. Although formally the candidates recommended by higher courts must obtain the final approvals of local party committees and people's congresses, the candidates are more directly controlled by the higher courts. In the Pearl River Delta region, it is the higher courts which recommend director candidates for lower-level courts.³² As a matter of fact, directors of lower-level courts and division directors of higher courts are required to rotate from time to time. They thus have to be concerned more with the requirements of the judiciary, which means that they would not always bow to the pressures of local government or party officials and offer protection to local enterprises.

Fourth, many courts in urban areas have been inundated by a huge amount of cases. Other than a few exceptions, national statistics indicate that the litigation rates in coastal and developed provinces are generally higher than that of hinterland provinces.³³ There are frequently reports that urban courts are burdened by heavy caseloads.³⁴ To better handle these heavy caseloads, the court procedure in urban courts has been better streamlined. As shown in the Pearl River Delta study, the courts have little time or energy to pay extra attention to some not-so-significant disputes of mid- or small-sized

³¹ Xin He, *Court Finance and Court Responses to Judicial Reforms: A Tale of Two Chinese Courts*, unpublished manuscript, 2008.

³² Zhu Suli also reported the similar practice based on fieldwork in Hubei Province. See SULI, BRINGING LAW TO THE COUNTRYSIDE, AT ?(2000). In a recent media report, high ranked court officials will be exchanged to different areas, in an effort to constrain widespread judicial corruption. See “Quanguo sifa gaoguan da tiaozheng (A Reshuffle of Provincial-Level Court Directors),” <http://www.jcrb.com/gssfgg/> (last visited on Mar 10, 2008). This national and systematic move itself suggests that the appointments come more from a higher level than from local Party officials. The extent to which this has been a national practice, however, remains unclear as our informants in Xi'an, Shaanxi province said that as of 2008, local Party officials still had more say in appointing court directors.

³³ ZHONGGUO FALÜ FAZHAN PAOGAO(1979-2004) [CHINA LEGAL DEVELOPMENT REPORT(1979-2004)] (ZHU JING-WEN ed.), at 50-51(2007).

³⁴ E.g., the former vice president of the Supreme People's Court said courts are overburdened by the increasing lawsuits. See, “E zhi lanyong sushong qunxiang”, (“Constraining the Tendency of Litigation Right Abuse”), Speech by Liu Jiashen, *Renmin fayuan bao*, (the People's Court News), July 13, 2002.

enterprises.³⁵

To be sure, due to the unchanged political structure between the courts and the government or the Party, local protectionism still remains a problem in some cases, especially in disputes where the amount in dispute is very large and in cases involving large SOEs, particularly in cities where the local economy is not very diversified. The latter reason also explains why local protectionism is more of a problem in rural areas, where the economy is less developed and the private sector is smaller.

Reforms to Improve Enforcement Have Had a Positive Impact

Under the pressure to improve the situation of judgment enforcement, the courts have adopted various measures. The first and foremost measure is to set up a separate and relatively independent enforcement bureau within the courts. Until the 1990s, enforcement was not separated from the adjudications and was conducted by the adjudication staff.³⁶ After the enforcement division was first separated, it became a division equal in the administrative hierarchy to other divisions. During the current decade, when the judiciary tried to pacify widespread complaints against their poor enforcement record, the enforcement division was elevated to a bureau. Elevation to a bureau, where the director usually has the same rank as a vice director of the courts, means that more resources will be available for enforcement. This measure will also allow the courts to improve enforcement efficiencies because the elevated bureau is in a better position to deploy various resources.

The courts have implemented the civil adjudicating procedure reform, separating adjudication from petition filing and judgment enforcement, in a way to standardize and streamline the civil procedure.³⁷ As mentioned above, the reforms have made it possible to trace the process of cases being enforced and also to hold individual judges accountable for the cases that they are assigned to handle.

The courts have also encouraged plaintiffs to take preemptive action to protect themselves. As shown in the Pearl River Delta study, to make the enforcement easier, the enforcement bureau of the courts requires judges in the petition filing and adjudication divisions to inform plaintiffs of the availability of the Asset Preservation, a procedure whereby plaintiffs, by providing security, can ask the courts to freeze the assets of the

³⁵ He supra note 9.

³⁶ See supra note 33.

³⁷ The Five Years Reform Outlines, promulgated by the Supreme People's Court in 1999.

other party.³⁸ This procedure has been very useful both during the enforcement phase and prior to enforcement, because litigation parties are more likely to resolve their disputes through mediation or voluntarily withdraw their suits when the defendants know that they will not be able to delay or avoid enforcement should a judgment be rendered against them. That is also why a very high percentage of plaintiffs in the Pearl River Delta study complied with the payment order when the cases were just filed in the courts.³⁹

Some courts have also increasingly relied on judicial imprisonment to enhance compliance with judgments.⁴⁰ According to the law, whether judicial imprisonment can be imposed depends on whether the debtor “has the capability to pay but refuses to pay.”⁴¹ Some courts, however, have interpreted “the capability” in its broadest sense. For example, the debtor’s capability to borrow money from relatives or friends to pay is also regarded as the debtor’s capability to pay. Others frequently exercise their discretion in taking such action. The measure has forced some debtors and their relatives to try their best to get the debts paid. This measure is more widely used when local banks and credit unions are the plaintiffs, which usually maintain a very close relationship with the courts.

Professionalism of Court Staff

Increased professionalism of court staff has also had a positive impact on enforcement. The Judges Law, amended in 2001, requires all judges to pass the National Uniform Judicial Exam, leading to more qualified judges. In addition, judges’ salaries have generally been increased, in part due to sufficient financial resources being supplied by local financial departments. The income level of judges has generally been much higher than the local GDP per capita.⁴² Becoming a judge has become attractive to many law graduates who prefer to have a stable income but a less demanding workload than they would have in a law firm.⁴³ Subsequently, many courts have been able to recruit graduates and postgraduates of law schools.⁴⁴

³⁸ Article 7 of the Procedure Law.

³⁹ He, *supra* note 9.

⁴⁰ He, *supra* note 9.

⁴¹ Article 7 of the Procedure Law.

⁴² In the Pearl River Delta study, it indicates that the average salary is roughly double of local per capita GDP. See also Gechnik, *supra* note .

⁴³ Gechnik, *supra* note .

⁴⁴ Author’s interview with judges in Guangdong provinces. See also Gechnik, *supra* note .

The judiciary has also imposed strict requirements on the behavior of court staff. In addition to the general requirements specified in the Judges Law (Amended 2001, Articles 32-35), more detailed regulations, such as measures for holding adjudicating staff responsible for wrongfully deciding cases (*cuoan zhuijiu zhi*) (SPC 1998), have been issued by various courts across the country.⁴⁵ A stipulation of post responsibilities of a District Court in Guangzhou, Guangdong province, lists four measures for assessing the court staff (or judicial cadres): virtue, capability, diligence, and performance (Article 3).⁴⁶ While virtue and capability are measured by abstract terms such as active participation in political and professional education, measurements of diligence and performance are quantified in detail. There are also various internal requirements of the working style of court staff, some of which are quantified by the complaint and appeal rates.⁴⁷ In many courts, judges' career and income will be directly affected by these rates. Some courts, for example, will deduct the salaries of judges when the timelines of handling cases specified in the Civil Procedure are not maintained, while in others, any corruptive behavior will be severely penalized.⁴⁸ All these requirements remind us of the bureaucratic nature of the Chinese courts, and these practices are very much in line with other administrative organs.

It seems that both the court performance and staff professionalism have improved. According to the Pearl River Delta study, for example, over 98% of judgments are rendered within the time limits stipulated by the Civil Procedure Law, while the national

⁴⁵ Reports of this sort are too many to be listed here. A search of “Responsibilities of Wrongfully Decided Cases” on Google will generate numerous pages. I list only two examples for illustration purposes. “Responsibilities for Wrongfully Decided Cases in a Chongqing Intermediate Court” was reported in Mingpao, Section A15, September 4, 2007. According to the report, judges may lose their jobs for committing such mistakes as abusing discretion or having typos in their judgments. See also “The Measures of Responsibilities in Urumqi, Xinjiang for Wrongfully Decided Cases,” at [http://www.xinjiang.gov.cn:8080/1\\$005/1\\$005\\$007/305.jsp?articleid=2005-7-18-0022](http://www.xinjiang.gov.cn:8080/1$005/1$005$007/305.jsp?articleid=2005-7-18-0022) (last visited on September 6, 2007).

⁴⁶ “The Stipulation with regard to Post Responsibility of Panyu District Court, Guangzhou Municipality (Trial),” in *The Compilation of Regulations and Institutions of Panyu District Court, Guangzhou Municipality*, Volume 1, pp. 181-88, June 2004 (no press or ISBN series number).

⁴⁷ For a more detailed examination of these requirements and their impact on judicial behavior, see Xin He, *Routinization of Divorce Law Practice in China: How Institutional Constraints Influence Judicial Behavior*, in *International Journal of Law, Policy and the Family*, 2009 forthcoming.

⁴⁸ Gechlick 2006, *supra* note.

average figure is 95%.⁴⁹ Evidence from surveys and interviews with litigants suggests that their impression of the courts is very positive: over 63% of litigants in the Shanghai-based study believed that judges deserved high ratings (“dignified conduct and high professional quality”).⁵⁰ In the Pearl River Delta study, many litigants said that the judges were patient and clear in explaining the court procedure. In a survey of business professionals in Shanghai and Nanjing between 2002 and 2004, almost three out of four gave the court system a very high to average rating, compared to 25% who rated the system low or very low.⁵¹ In still another survey, Ethan Michelson found that Beijing respondents are more trusting of the courts than their Chicago counterparts, and evaluate the performance of the courts more positively. Respondents in Beijing were twice as likely as Chicago residents to agree with the claim that courts are “doing a good job.” Moreover, whereas over 40% of Chicago residents *disagreed or strongly disagreed* that the courts generally guarantee everyone a fair trial, only 10% of Beijing residents and 28% of rural residents held similar negative views. And whereas 43% of Chicago residents disagreed or strongly disagreed with the statement that judges are basically honest, only 9% of Beijing residents and 29% of rural residents held similar views.⁵²

Another indicator of the improved performance of formal contract enforcement is that private enforcement in the areas has become less popular. While enforcement by private organizations is legalistically not allowed under Chinese law, there are numerous reports on this in the media, which suggests that this business might have been booming

⁴⁹ See He, *supra* note 9.

⁵⁰ See Pei et al., *supra* note 12.

⁵¹ Clarke et al., *supra* note 3.

⁵² Email communication with Professor Ethan Michelson, based on a 2001 survey he conducted with sociologists from Renmin University of 1,300 Beijing residents. The Chicago numbers are from a 1990 survey. See TOM TYLER, *WHY PEOPLE OBEY THE LAW* (1990). To put these numbers in a broader comparative context, barely half of Belgians believe court decisions are just, while 60% lack confidence in the judiciary. Over 40% of British citizens have little or no confidence in judges and the courts. See Mike Hough and Julian V. Roberts, *Confidence in Justice: An International Review*, *Findings* 243, at <http://www.homeoffice.gov.uk/rds/pdfs04/r243.pdf> (2004). In France, only 38% of the public trusts the judiciary, with only 21% believing judges are independent from economic circles and only 15% believing they are independent from political powers. *L'opinion des Français sur la justice, Réalisée en 1997 par l'institut CA à la demande de la Mission de recherche Droit et Justice*, at http://www.vie-publique.fr/dossier_polpublic/presomption_innocence/annexes/sondage1.shtml (last visit on November 26, 2007).

as a response to the weak enforcement of the courts.⁵³ Recent empirical studies, however, suggest that the room for private enforcement is rather limited. In the Pearl River Delta study, of the 66 plaintiffs, only three clearly mentioned that they had hired private enforcers. Five others mentioned that they had thought about hiring them, but did not take any real action. The reasons for hiring private enforcers include the bad reputation of the courts, a lack of knowledge of the complexities of court procedure, and the costs involved with using the courts. As a result, when potential litigants have experienced the courts and have more knowledge of the niceties of court procedures, and especially of the improved performance of the courts, they tend to use the courts more often than private enforcements.

This situation is related to the fact that local business has been better regulated with the development of the local economy. When local enterprises have become more and more formal, neither the employees nor the bosses of these enterprises would hire private enforcers in their own names, because none of them wants to be involved in this “illegal” activity. The effectiveness of private enforcers lies in their potential illegal threats, but their illegality also creates certain risks for their potential clients. That is why many interviewed creditors in the Pearl River Delta study thought about hiring private enforcers, but few actually did so. The illegal nature of the private enforcement is both their missile and their Achilles’ heel. It is this feature that determines that their presence has become diminished. Indeed, only a few small enterprises would hire private enforcers. While the formal and informal remedies have their own market shares, it is clear that the formal ones remain dominant. Accordingly, it seems unfair to assert that the debt collection business in urban China is flooded by private enforcers.⁵⁴

In sum, reasons both outside and inside the courts all contribute to the improvement in enforcement. Inside the judiciary, various reforms measures of institution building and staff professionalism have been implemented, which have had a positive impact on formal contract enforcement. Outside the courts, the urban economy is now more diversified, with the private sector playing a dominant role. The incentive for

⁵³ According to a report in CCTV, a search of private debt collection in baidu.com, the largest search engine in Chinese, will come out of 776000 relevant links, and many such private debtors are too busy to take more business during the period of the Spring Festival. In <http://news.cctv.com/law/20070124/104981.shtml> (last visited in March 10, 2008).

⁵⁴ See *supra* note 53. For a treatment of Russia’s situation of private enforcement, seen Kathryn Hendley et al., *Law, Relationships and Private Enforcement: Transactional Strategies of Russian Enterprises*, in 52 EUROPE-ASIA STUDIES 4, 627-56, June 2000.

governments to engage in local protectionism has diminished. When the local economy has been developed and diversified, the diversified and increased financial resources also help implement the judicial reform measures.

Enforcement Remains Dire in Rural Areas

While the situation in urban areas has improved, enforcement is predictably more difficult in rural areas where the economy is less developed and diversified, and the issue of judicial corruption and competence is more serious. While no systematic empirical data are available yet, a few clear patterns have been identified.

First, rural courts generally lack adequate funding. While China in general has developed rapidly, there are huge regional and urban-rural differences.⁵⁵ When the per capita GDP in coastal Guangdong province reached almost 28,077 yuan in 2006, in hinterland Gansu province, this number was just 8749.⁵⁶ The income gap between rural and urban areas has also widened.⁵⁷ As courts' funding is closely related to the financial situation of the local economy, when the local economy has not been fully developed and diversified, local governments basically cannot collect enough revenue to support themselves. As mentioned above, the court finance still largely relies on local governments' revenue. When the overall revenue of the local government is insufficient, naturally the courts cannot be adequately funded.⁵⁸ While systematic statistics are not available, some sporadic reports indicate that the problem could be rather serious. With regard to the two courts that I investigated through fieldwork, the per capital financial budget of the court in Guangdong province was roughly 30 times higher than that of the

⁵⁵ Shaoguang Wang, *For National Unity: the Political Logic of Fiscal Transfer in China*, in CHINA'S WEST REGION DEVELOPMENT: DOMESTIC STRATEGIES AND GLOBAL IMPLICATIONS (Ding Lu & William A W Neilson, eds.) (Hackensack, NJ: World Scientific Publishing, 2004).

⁵⁶ At <http://www.stats.gov.cn/tjgb/> (last visited on March 14, 2008).

⁵⁷ National Bureau of Statistics of China, "2006 Annual State Statistical Report," at http://www.stats.gov.cn/tjgb/ndtjgb/qgndtjgb/t20080228_402464933.htm (last visited on March 14, 2008).

⁵⁸ See Xin He, *Recent Decline in Chinese Economic Caseload: Exploration of a Surprising Puzzle*, THE CHINA QUARTERLY Vol. 190, 2007, at 352-74; see also Xin He 2008 Manuscript, *supra* note 31. The scant situation for the court funding is also related to the view that the function of the courts is not important. For a longtime the major function of the courts—dispute resolution—was regarded as marginal by political leaders, and law enforcement function of the courts is regarded as only complementary to that of the Police and the Procuratorate.

court in hinterland Hunan province. In the courts of Jiangxi province, central China, deficits had been consecutively recorded from 1997 to 2000.⁵⁹ Although the budgetary funds increased by 28.6% each year during the period, they were still far too low to cover all the expenses of the courts required for normal operation. The same report also shows that of the 112 lower-level courts in the province, only 9% had their per capital budget reach 25,000 yuan, the minimum required for normal operation; 30% of the courts had less than 20,000 yuan, and 61% less than 16,000 yuan.⁶⁰

While the financial reform policy “separating income from expense” is also implemented in rural areas, this policy cannot really change the reality that rural courts still heavily rely on their litigation fees, enforcement fees, and the criminal monetary penalty (*fajing*) to survive. The policy only changes how the limited revenues are distributed between the courts and the local government. In fact, it only gives more leverage to the local government. After the introduction of the policy, the local government of course will require the courts to turn in all the fees and fines collected by the courts, and the government in some regions even requires the plaintiffs and defendants to pay relevant fees and fines through banks, a more convenient way for the government to control the funds.⁶¹ But after the funds are collected by the government, they may not allocate adequate funds back to the courts in the separate budget, especially when the overall revenues of the regions are insufficient. Some local governments will intercept the fees collected by some courts despite the fact that the funds for the courts are inadequate.⁶²

As a result, when the policy separating income and expenses was initially introduced in rural areas, the requirement of handing in fees was well-implemented, but the requirement of allocating funds was not: the courts were only placed in a more disadvantageous position. But this situation could not really sustain itself because many courts soon changed their strategies. Some courts hide the fees, and some might just refuse to turn in. After all, the normal operation of the courts needs to be maintained, and this genuine need is always an effective bargaining chip in the negotiation with the local

⁵⁹ Jiangwu Xue & Yongling Zhang. *Fayuan jingfei baozhang wenti de fenxi yu sikao: Jiangxi fayuan jingfei baozhang qingkuang diaocha baogao* [An Analysis on the Judicial Budget: An Investigation Report from Courts in Jiangxi], RENMIN SIFA [The People's Judiciary], No. 8(2001).

⁶⁰ The per capita GDP of the province only reached 9,439 yuan in 2005. See China net, <http://english.china.org.cn/english/features/ProvinceView/184162.htm> (last visited on Feb 5, 2008).

⁶¹ Xue and Zhang, *supra* note 59.

⁶² *Id.*

government and a powerful defense against audit inspection. Moreover, if the allocated budgetary funds of the courts are not correlated to the fees, the courts will soon lose incentives to collect fees and the overall revenues of the local governments will decrease.

Eventually, the local government will have to allocate a certain amount of fees collected by the courts back to the courts. Usually, the more the courts turn in, the greater the amount that will be returned. The ultimate result of this game is that allocated funds will be determined by the collected fees, and the policy of separating expenditures from income goes all the way back to the original situation that expense and income are linked. The two lines of income and expenditures eventually reconverge as one line, or one curved line at best.⁶³

While China's overall caseloads have generally increased during the reform period, this again has not happened in all the areas. According to some estimates, only 10% of the basic-level courts are burdened by heavy caseloads, while the remaining 90% of courts are not adequately fed.⁶⁴ To have the financial ends met, these courts have to make efforts to scout potential cases.⁶⁵ Subsequently, each court division and even individual judges in some courts are assigned a financial goal. Under this pressure, some judges have to persuade or cajole potential litigants to file lawsuits. For the sake of litigation fees, they have also taken on many difficult disputes which the courts are incapable of dissolving.⁶⁶ Moreover, rural courts often rely on the resources and facilities provided by the litigants who ask the courts to enforce their judgments. As a result, the courts treat different cases differently. They have little incentive to aggressively enforce cases that have little potential to enhance their own bottom line. But the courts will aggressively enforce cases filed by some institutional plaintiffs, such as local banks, for the sake of litigation and enforcement fees. Naturally, these institutional players and others who can provide potential financial income for the courts are favored in this process.⁶⁷ Moreover, when the local government's revenue is not sufficient in these areas, it is not only the courts which try to scout the disputes. The public security offices, and the legal service providers under the justice department also need to feed themselves with

⁶³ Liao and Li 2004; Zhu 2007: 257.

⁶⁴ Zhu ed., *supra* note 33, at 259.

⁶⁵ Yixin Wang, *Chengxu, zhidu, zuzhi: jicheng fayuan richang de chengxu yunzhuo yu zhili jiegou zhuanxing*, (Procedure, Institution, and Transformation: the Transformation of Routine Procedure and Management Structure in Basic-level Courts). CHINA SOCIAL SCIENCE, No. 3, 2004.

⁶⁶ He, *supra* note .

⁶⁷ He, *supra* note .

fees generated from providing dispute resolution services, and the courts have to compete with them.⁶⁸ As all of the formal dispute resolution mechanisms are commercialized, it is not surprising that the courts will take some cases which they are incapable of successfully solving and enforcing.⁶⁹

Second, the professionalism of these courts is adversely affected by the dire financial situation. One of the direct consequences of inadequate funding is that the salary level is very low in rural courts. Moreover, many judges are not able to get their salary paid in time, and many others are not able to receive all their promised salary increments.⁷⁰ In the hinterland Shanxi province, the budgetary funds of the courts could only cover the fees for staffing and a small portion of the administrative expenses; in more than half of the counties of the province, the courts had to delay the payment of the court staff's salary.⁷¹ A national survey indicates that 1423 courts delayed the salary payment to their staff, about 40% of Chinese courts; the number of months when the salary payment was delayed reached 5536, and the delayed amounts involved 0.23 billion yuan, affecting 122,430 court staff members, 40% of the total work force of Chinese courts.⁷² At the same time, as a natural result of the rural courts' remuneration being much lower than that of their coastal counterparts or than the average income of practicing attorneys, many seasoned staffers in rural areas have left their courts.⁷³ With the threshold of becoming an entry-level judge having been raised but without sufficient funding, some courts in the hinterland are not able to recruit qualified judges.⁷⁴ Some

⁶⁸ Yuling Fu, *Guojia, shichang, shehui: dangdai zhongguo de falu yu fazhan* (State, Market, and Society, Law and Development in Contemporary China, HONG FAN PING LUN (Journal of Law and Economics), (2005).

⁶⁹ He, *supra* note 31.

⁷⁰ Yong He, *Faguan huang he jie?* (Why is there a Dearth of Judges?" SOUTHERN WEEKEND (September 15, 2005).

⁷¹ Shulin Guan, *Guangyu fayuan jiangfei baozhang wenti de diaocha yu sikao* [An Analysis on Judicial Budget], SIFA XINGZHENG GONGZHUO TONGXUN [Juridicature Herald] No. 2, 14-15(2004). In Jiangxi province, this percentage reached 78%. See Xue and Zhang, *supra* note 59.

⁷² People Courts' Daily, *Laizi jiceng de husheng*[Voice from the Grassroots] (Mar. 14, 2002).

⁷³ He, *supra* note 70; Zhu Suli, *An Examination on the Recruitment Mechanism of Judges*, in his DAOLU TONGXIANG CHENGSHI [All Roads toward Cities], 249-88(2004).

⁷⁴ The passing rate for the Uniform Judicial Examination has been how much? In various years. See Zhu ed., *supra* note 33. And among the passed examinees, they are disproportionately distributed in coastal and urban areas. It is frequently reported that no even one examinee could pass the exam in many hinterland

others have not wanted to take on new employees since the funding has been more or less constant every year.⁷⁵ As a result, professionally trained law school graduates are usually not recruited. Nevertheless, time and again some “blue blood” with hard connections but without professional law training has squeezed into the courts in one way or another, despite the reluctance of the courts. It seems that the overall professional quality and morale of the courts’ personnel in these areas has been going downhill, which further aggravates the enforcement situation.

Third, some reforms aiming to formalize civil procedure have further increased the functioning cost of the courts. For example, after the adjudication is separated from the petition filing and judgment enforcement, a case must be examined twice or three times inside the courts, which certainly involves further costs. Formalization of civil procedure also increases the complexity and the cost of the adjudicating procedures, which used to be done in an informal, convenient, and economical way.

Moreover, as part of the judicial reforms, the formalization of civil procedure leads to some unintended consequences that may not be conducive to effective judgment enforcement.⁷⁶ Originally, when both the adjudication and enforcement were conducted by one adjudicating staffer, whether the judgment could be executed was a question that the staffer must have borne in mind in adjudicating. To a certain extent, this made the enforcement easier. After the separation, however, the staffer who awards the judgment cares little about the enforcement because it is, by and large, none of her business. While the formalization of civil procedure, including the separation between the adjudication and the enforcement, was designed partially to reduce corruption, corruption might have in fact increased. This is because, when judgment enforcement becomes more difficult, the enforcement officers have more bargaining chips when rent seeking.

Furthermore, formalization and standardization of court procedure have to a certain extent tied the court’s hands, though the litigation parties’ rights might be better protected. The court can no longer exercise its power as it did in the past, and its actual capability of enforcement weakens. On the other hand, however, the financial pressure forces the court to proactively scout for potential cases. When the court and its staff are trying to find more cases, fewer of the cases can be resolved or executed.

provinces. For a critique on such a requirement for judges’ recruitment, see Suli, *supra* note 73; see also Bjorn Ahl, *Advancing the Rule of Law through Education?* 42 ISSUES & STUDIES, at 184 (2006).

⁷⁵ He, *supra* note 31.

⁷⁶ He, *supra* note 31.

When the formal contract enforcement is weak, it is clear that many enterprises and individual entrepreneurs interviewed were heavily relying on self-protection measures in business transactions. In our recent study based on a hinterland city in Western China, most interviewed litigants usually required their business partners to fulfill their contractual obligations within certain time limits. In this constant process of business transactions, they understood each other's credit situation very well. Whenever a trading partner defaulted, they would simply halt further transactions. In this way, they prevented the amounts at issue from becoming larger. A very low percentage of interviewees mentioned that they usually conducted business with familiar clients who had a good credit history or were of a considerable size. Have lost confidence in the courts, it seems that a higher percentage of creditors in rural areas than in urban areas have hired underground debt collectors to recover their money, even though any open or private enforcers are technically illegal. Moreover, believing that the courts are incompetent, the public have become more tolerant of the use of these illegal agencies. This further affects the authority of the court in adjudication or enforcement. Some people who are subject to enforcement openly resist the courts' action, claiming that the courts just want money without providing justice.⁷⁷ This situation has become more serious since the state's power has further pulled out of rural areas. According to my own interviews, in the eyes of rural people, a court is just another branch of the government. The judgment enforcement of the courts, therefore, is no different from tax collection by township governments.⁷⁸

In this context, any factors that help improve the enforcement situation in urban areas are not very useful in rural areas. Since the economy in rural areas has not been fully developed or diversified, and local governments still rely heavily on a few SOEs for financial income, local protectionism remains. Whenever there are significant and complicated cases affecting local enterprises, the courts will receive or seek instructions from the local Party committee and the government. Many local governments also make it clear that court decisions relating to the reconstruction or bankruptcy of local SOEs, and those related to the compensation or the re-employment of the laid-off workers, would be mediated by the government and the Party committee directly. The courts also have to maintain a close relationship with local governments for the sake of obtaining more funding. As a result, it is difficult for the courts to resist the pressure of local

⁷⁷ Author's interview in both Hunan and Shaanxi provinces in 2007.

⁷⁸ Xin He, *Limited Judicial Independence in Contemporary Rural China*, 6 AUSTRALIAN JOURNAL OF ASIAN LAW 3, at 1 (2004).

governments and SOEs.

Testing the Two Hypotheses

It seems that in urban China, the role of the courts in local economic activities has become more important: the courts there are capable of enforcing the judgments in a relatively effective and efficient manner; local protectionism has declined; many litigants, who regard the courts as competent and efficient, are willing to resolve future disputes through the courts. But in rural China, the situation of formal contract enforcement has had little improvement: most of the problems well documented in the literature persist, such as weak enforcement, undue political influence, corruption, low morale, and low quality of court staff. The different evolutions in China's rural and urban areas nonetheless provide an opportunity to test two hypotheses on the relationship between China's judgment enforcement and economic development: whether effective judgment enforcement is essential for China's economic development, or vice versa—whether the economic development generates more demand for and induces more formal contract enforcement.

There seems to be a correlation between economic development and formal contract enforcement. When the courts are not doing well in rural areas, the level of economic development there is low; when the courts are doing better in urban areas, the level of economic development there is high. But to what extent is a reasonable contract enforcement provided by the courts essential or even indispensable for economic development?

This link is difficult to establish. Empirical evidence discussed in the previous sections suggests that the economy will develop with or without a healthy formal contract enforcement. One or two decades ago, before urban China's economy had taken off, the quality of formal legal institutions was not as good as it is today. Indeed, they were very much similar to how they are in rural China today. But that has not prevented urban China's economy from taking off. There have been many alternative mechanisms that help enforce contracts. Some social norms shared by the business circle and the informal private enforcers are still in effect, though their functions are limited.⁷⁹ The most

⁷⁹ There are numerous relevant works in the literature, see e.g., Xin He, *Explaining the Development of Migrant Business in Beijing*, 12 ASIA & PAC. MIGRATION J. 3, 385-406 (2003); Janet Landa, *A Theory of the Ethnically Homogeneous Middleman Group: An Institutional Alternative to Contract Law*, 10 J. OF LEGAL STUDIES, 349 (1988); Linda Lim and Peter Gosling, *Strengths and Weakness of Minority Status for South*

important mechanism found in this study, in both rural and urban areas, was the control over the amounts of delivered goods and related payment for them: no further supply of goods without payment for previous batches of goods. It should be noted that this control can be effective beyond certain enclosed communities, like what has happened in urban China. The degree of population mobility in urban China has been very high, with lots of business operators from all over the country. These business people can hardly be characterized as groups from the same ethnicity, religion, origin, or culture. But they still do not have to use the courts to solve their disputes: the controls on the supply of goods already minimize business risks in most circumstances.⁸⁰ Due to this control mechanism, the amounts at issue are kept small, and the risk to business has been minimized.

When the deals become bigger and disputes are significant and complicated, local governments start playing crucial roles in dispute resolution including enforcing contracts. Under this situation, the courts' roles are only supplementary. They are usually asked to participate in and streamline the process—for instance, to facilitate the arbitration process of the mass workers' compensation, or to freeze the immovable property of those runaway enterprises where the investors have disappeared.⁸¹ The court is only one of many alternative mechanisms for enforcing contracts. When a mechanism becomes less effective, or more expensive, other mechanisms will become more desirable.

Consequently, contracts do not necessarily have to be enforced by a court when the economy has or has not developed beyond a certain level. Of course, it is not clear how “a certain level” is defined in the literature. But when the courts have become more desirable and important, the importance only suggests that potential litigants are less likely to use other alternatives in dispute resolution. As seen in the above empirical evidence, formal mechanisms in urban China are squeezing out informal mechanisms: the

Asian Chinese at a Time of Economic Growth and Liberalization, in D. Chirot and A. Reid (eds.), THE ESSENTIAL OUTSIDERS 285-95, 309-11 (1997); Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. OF LEGAL STUDIES, 115 (1992).

⁸⁰ This control is similar to but also significantly different from using reputation as a basis for determining supply. Both control and reputation help to consolidate the mutual reliance between trading partners. But the significant difference between them is that even when reputation is not working, business managers can always protect themselves through controlling the supply of goods in the course of business transactions. It is the structure embedded in business transactions that is an important alternative to formal court enforcement.

⁸¹ Lee Ching-Kwan, *From the Specter of Mao to the Spirit of Law: Labor Insurgency in China*, 31 THEORY AND SOCIETY 189-228 (2002).

courts there have left less room for private enforcers. In this sense, improved formal contract enforcement provides business operators with a cheaper alternative, thus reduces the transaction cost of the local economy and contributes to the further development of the economy. But this change does not in any sense suggest that contracts cannot be enforced without formal courts.

The evolution of contract enforcement in both urban and rural China seems to indicate a pattern of contractual dispute resolution. In a society which evolves further beyond a close-knit community, with the degree of population mobility increased but without a strong state power, it is the structure embedded in business transactions that becomes crucial in enforcing contracts. When the degree of population mobility further increases and the deals become bigger and more complicated, some non-law approaches adopted by government officials become important in providing transaction safety. Along this line, the elements of formal, rules-based adjudicating organizations in contract enforcement might increase, but only as one of many alternatives. In sum, unlike what has been asserted by neo-institutional economists, this study shows that a formal, neutral, and effective adjudicating organization seems unlikely to be essential in economic development.⁸²

One may argue that, generally, a lack of formal contract enforcement and other clear legal rules and enforcement may have taken a toll on China's overall development during the reform period.⁸³ Even if this is true, the consequences have not been significant. The stagnation and underdevelopment of rural areas has largely been due to the poor infrastructure, the low priority such areas have in the state's development plan, the lack of human resources, and ultimately, the lack of investment.

The limited role of the courts can be more generally seen in the area of foreign investment, an area which most economists believe is one of the most important engines of China's economic development and is closely related to long-term formal contract enforcement. When investors make their investment decisions, the enforcement capability of the courts is only a tiny consideration among many far more important ones.⁸⁴ When investment started pouring into coastal China in the late 1980s, for example, the quality of legal institutions was very poor. They invested in urban China also because of the state's preferential policy, the good infrastructure in the urban areas, and the convenient transportation system. After the central government initiated a campaign to open up the

⁸² WEBER, NORTH, WILLIAMSON, *supra* note 1.

⁸³ RANDALL PEERENBOOM, CHINA'S LONG MARCH TOWARD RULE OF LAW , at 474-75(2002).

⁸⁴ PEERENBOOM, *supra* note 83, at 466.

west this decade, there has also been an increase of investment in rural and hinterland China,⁸⁵ despite its generally poor quality of legal institutions. In sum, the effectiveness of formal contract enforcement is probably a very minor concern when investors make their investment decisions. They have solved disputes through channels other than the courts, and that is why the economic caseloads of the courts have not been increasing dramatically although the local economy has so increased.⁸⁶

Then does the second hypothesis—the reverse causal link—make sense? Would the economy make more, or different, demands on the courts and formal contract enforcement as it develops? This proposition has at least partially been vindicated in urban China. As seen in the above empirical evidence, court users are generally private-owned enterprises and the case docket is full of routine debt-collection cases. These changes pave the way for the courts to handle the cases in a more neutral way. Although the political status of courts remains weak in relation to other dominant political powers, the above changes make direct and blunt intervention less necessary.

The increased caseloads, arguably one of the consequences of economic development or economic reforms, also create demand for changes in the institutional building of the courts, which are indispensable for better contract enforcement. While caseloads have recently been stabilized, the general trend in the commercial area has been for an increase in litigation with an expansion of the range on justiciable disputes, while mediation has decreased and arbitration has remained relatively stable and limited.⁸⁷ The increased caseloads certainly exposed weaknesses of the court system and the enforcement mechanism. A number of procedural reforms can be regarded as a response toward the demand. These reforms in urban areas, including to the case management system, to rules regarding evidence, and to time limits for the completion of cases and various stages of the litigation process, have tried to increase the efficiency and fairness of the process.⁸⁸ The courts have also streamlined both their adjudication and

⁸⁵ David S. G. Goodman, *The Campaign to ‘Open Up the West’: National, Provincial-level and Local Perspectives*, THE CHINA QUARTERLY, V. 178, June 2004, at 317-334; Eduard B. Vermeer, *Shaanxi: Building a Future on State Support*, THE CHINA QUARTERLY, V. 178, June 2004, at 400-425; Christopher A. McNally, *Sichuan: Driving Capitalist Development Westward*, THE CHINA QUARTERLY, V. 178, June 2004, at 426-447.

⁸⁶ See He, *supra* note 58.

⁸⁷ See *supra* note 33, at 21, 26.

⁸⁸ Supreme People’s Court Drafting Group, *Reform of the People’s Court: A Review and Future Prospects* (2007).

enforcement procedure, and tried to professionalize their staff, who are more capable of handling the disputes under the reformed procedures.⁸⁹ On the other hand, the improved formal contract enforcement also exposed the weaknesses of the informal mechanisms for enforcing contracts, thereby increasing reliance on the formal legal system and correspondingly increasing demand for changes to the system.⁹⁰

The Supply Side of Formal Contract Enforcement

It is true that in urban areas, the efforts in institutional building and staff professionalism could be regarded as a response to the demand for better contract enforcement. But all these efforts occur not only in urban areas, but in rural areas as well. The courts in the less-developed hinterland areas are experiencing similar institutional reforms, such as separating petition filing from adjudication, and the same requirements for enhancing staff professionalism. But in these areas, there is no developed economy as a cause; the same judicial reforms occur anyway despite the poor economic development in these areas. And more importantly, these judicial reforms occur despite the fact that the reform measures may have aggravated the courts' institutional qualify. The improved contract enforcement in urban areas, therefore, must be explained by reasons other than the economic development there. In other words, economic factors are not able to fully account for the improved contract enforcement.

Indeed, China's judicial reforms including the institutionalization and staff professionalism cannot be isolated from their background. When the Supreme People's Court promulgated two 5-year reform outlines in 1999 and 2005, the State Council issued two directives: "The Decision to Comprehensively Further Administration in Accordance with Law" in 1999 and "Implementing Outlines to Comprehensively Further Administration in Accordance with Law" in 2004. When the courts have made efforts to streamline their procedures, the directives of the State Council have also required the establishment of clear and transparent administrative procedures. When the courts have increased the threshold for recruiting entry-level judges by the National Uniform Judicial Exam, the government has also introduced the uniform entrance examination for civil servants. And passing this exam is also a prerequisite for becoming entry-level judges. In other words, even though there are some unique aspects of judicial reforms due to the

⁸⁹ Hua-Ling Fu and Richard Cullen, *From Mediatorial to Adjudicatory Justice: The Limits of Civil Justice Reform in China* (2008 forthcoming)

⁹⁰ PEERENBOOM, *supra* note 83, at 468.

specialized function of the judiciary, reforms similar to institutionalization and professionalism in the courts have occurred at all levels and branches of the government.

Moreover, even though China's judiciary has incorporated some elements of Western judiciary, the reforms in the judiciary generally follow less a model of Western judiciaries than the typical bureaucratic model of rationalization. Numerous reform measures of the judiciary are indeed consistent with those inside the government. For example, judges are being treated as civil servants, including in respect of their selection, promotion, and supervision; the courts' efforts to improve efficiency and to separate the different sections in the adjudication process are also in line with those of the government, such as transparency and efficiency.⁹¹ Even the new scale of litigation fees has to be laid down by the administrative branch. All these reforms are more administrative in nature than judicial.⁹²

It is hard to believe that all these similarities are merely coincidental. Although nominally the judiciary is not an administrative branch of the government, it does perform important administrative functions and it is a very important administrative component of the social control mechanisms of the ruling party.⁹³ Indeed, one can easily see the inherent link between the judicial reforms and the administrative reforms in this context: both reforms have been launched nationally by the ruling party. As these reforms are not imposed by alien powers, more likely than not they are intended to play some necessary and important social and political functions. The development of the judiciary shall be located in the context of a historical state-building process.⁹⁴ In fact, the institutional and professional developments, together with the more general policy on administration in accordance with law, can be regarded, arguably, as a response to the ruling party's need to govern the society under a changed socio-economic environment. In the late 1990s, China experienced enlarged income gaps between the rich and the poor,

⁹¹ See the outlines of five years reforms promulgated by the Supreme People's Court and the Outlines of Administration in Accordance with Law promulgated by the State Council.

⁹² The Scales for Litigation Fees promulgated by the State Council have been effective since April 1, 2007, and have simultaneously invalidated the 1989 regulation promulgated by the Supreme People's Court.

⁹³ Xin He, *Administrative Law as a Mechanism for Political Control in Contemporary China*, in CONSTITUTIONALISM AND JUDICIAL POWER IN CHINA (M. Dowdle and S. Balme eds.)(2008).

⁹⁴ Kanishka Jayasuriya, *Introduction: A Framework for the Analysis of Legal Institutions in East Asia*, at 1-2; Jianfu Chen, *Market Economy and the Internationalization of Civil and Commercial Law in the People's Republic of China*, 69-94. Both in LAW, CAPITALISM AND POWER IN ASIA: THE RULE OF LAW AND LEGAL INSTITUTIONS (Kanishka Jayasuriya ed.)(1999).

mounting social conflicts between the haves and the have-nots, and deepening confluences between officialdom and business. Economic reforms have unleashed a variety of social forces and conflicts that cannot be contained within a traditional state structure.⁹⁵ After the economic reforms, the state could not continue to tightly control everyone's economic behavior. With the retreat of the state, it has less effective control over the society.⁹⁶ All these factors seem to form the most likely midwife for the birth of "administration in accordance with law," because this way of governing is believed to be more capable of dealing with these forces and reining the country.⁹⁷ This is why reform of the judiciary now has a slogan "the judiciary for the people," rather than strictly following the Western model in which the judges are distanced from the litigants. This is also why judicial mediation and voluntary withdrawal are once again encouraged, a fast about-turn from the emphasis on adjudication in accordance with the law, when the Western adjudication style of adjudication has indeed generated more complaints than expected.⁹⁸ And this is also why these reforms were launched in rural and hinterland areas where such reforms, by disrupting the old order without providing a new one, may simply cause more problems than they solve.⁹⁹ Only in this context can one understand all these unusual or unnecessary reform measures in China's judiciary. Judicial reforms are thus one of many efforts of the state to resolve disputes in the reform era when the ruling party crosses the river by touching the stone.¹⁰⁰ In this sense, judicial reforms are only a not-so-important part of a huge wave of "the administration in accordance with the law," as defined in the State Council's reform outlines.¹⁰¹

After the position of the central government is discerned, the dynamics between local governments and the development of court capacity become more understandable. When the policies of judicial reforms and "administration according to law" are implemented at the grassroots level, the reform efforts toward the institution building and

⁹⁵ Xueliang Ding, *Institutions, Amphibiousness and the Transition from Communism: the Case of China*, 24 BRITISH JOURNAL OF POLITICAL SCIENCE 3, 293-368.

⁹⁶ VIVIENNE SHUE, THE REACH OF THE STATE: SKETCHES OF CHINESE BODY POLITICS (1988).

⁹⁷ He, *supra* note 93.

⁹⁸ Fu and Cullen, *supra* note 89.

⁹⁹ XIAOTONG FEI, FROM THE SOIL: THE FOUNDATIONS OF CHINESE SOCIETY (Trans. by Gary G. Hamilton and Wang Zheng)(1992). See also Suli, *supra* note 32.

¹⁰⁰ RANDALL PEERENBOOM AND XIN HE, DISPUTE RESOLUTION IN CHINA: PATTERNS, PROBLEMS AND PROGNOSIS, Oxford: Foundation of Law, Justice and Society (2008).

¹⁰¹ See The State Council, *supra* note, .

professional development of the courts have a better chance of being realized in urban areas because local governments and the region there are more generally richer. It is the adequate financial resources in the developed region that make courts more effective. The strengthening of formal contract enforcement thus heavily depended on the available resources of given localities.

This point can be further seen from the attitude and behavior of the local governments toward building a better court system in developing the local economy in both developed and less-developed areas. To develop the local economy, the major political forces at the local levels across the country are, of course, willing to provide a better business environment. This does not mean, however, that they have tried their best to develop the courts institutionally and professionally. Major political forces may not object to establishing well-functioning courts, and they may even support the development of such courts.¹⁰² But the development of such courts is by no means their top priority. It is common knowledge that politically important officials were rarely appointed court directors. Indeed, major political forces have been the main intervening factor in the decision making of the courts. In most circumstances, a better business environment does not mean a more institutionalized court or a stricter legal enforcement. Instead, it always means more evasions of national laws, and more personal promises and preferential treatments offered by major political leaders in the region to potential investors. For foreign direct investment (FDI), for example, “‘stability and continuation of economic policies,’ and ‘local preferential policies’ originally designed for some regions,” are crucial to attract and maintain FDI inflows, while the build-up of a healthy legal system, together with a transparent administration, are still significant gaps to meet investors’ expectations.¹⁰³ Some in-depth empirical studies also suggest that the most important tactics to attract foreign investment have invariably excluded a sound legal system.¹⁰⁴ Local governments often take initiatives to circumvent the existing regulations at the central level. Unclear and, in some cases, muddy property rights provide regional

¹⁰² Clarke, *supra* note 27.

¹⁰³ Linda F. Y Ng & Chyau Tuan, *FDI Promotion Policy in China: Governance and Effectiveness*, 24 THE WORLD ECONOMY 8, 1051–1074, at 1072(2001); Linda F.Y Ng and Chyau Tuan, *Building a Favourable Investment Environment: Evidence for the Facilitation of FDI in China*, The World Economy (2002).

¹⁰⁴ See e.g., ANDREA HAMPTON, LOCAL GOVERNMENT AND INVESTMENT PROMOTION IN CHINA, working paper for Institute of Development Studies, UK, available at www2.ids.ac.uk/gdr/cfs/pdfs/AndreaHamptonFDI-WPDec06final%20.pdf. (last visited on March 6, 2008).

officials tremendous leeway in managing FDI.¹⁰⁵ The lack of a healthy legal system, again, has not really deterred investment. On the other hand, when major and significant incidents occur, the courts are often required to toe the line of major political leaders.¹⁰⁶ In this sense, the institutional development of the local court comes less from the market demand of the developed economy in urban areas than from the uniform judicial reform occurring across the country. In other words, it is more for political than economic reasons that the national judicial reform is taking place, and it is for both political and economic reasons why the courts in the developed region, and very likely only the courts in this region, have become more effective.

Therefore, while the courts in more developed areas have indeed become more effective, this change has occurred also because the local government, with a more developed local economy, has more income for itself and can consequently afford to give more financial support to the courts. In other words, the development of the local economy, or more accurately, of local financial resources, provides a precondition for the institutional building and staff professionalism of the courts. The diversified economy, which means more court users with more or less the same legal status, further provides the conditions from the demand side for the courts to handle disputes in a more neutral way. But these are necessary rather than sufficient conditions: when the economy develops, the functioning situation of the courts does not necessarily increase.

This further strengthens the point that the courts are thus far from indispensable in either lower or higher stages of economic development. If the strengthening of the judiciary is important for the ruling party, then the strengthening of the police, the supervision department, and the letter-petitioning department will be far more important. Even if economic development has some association with the improved functioning of the judiciary, the link is, at most, indirect. The courts, therefore, seem to be neither the sufficient nor the necessary condition for economic development. The judicial reform is more a response to political needs than a demand from economic development. Their development shall thus be contextualized in the historical, political, and structural conditions in China. It is not just institutional change from below, in response to social and economic forces unleashed by the development of a market economy, but also a product of revolution from “above.”

¹⁰⁵ YASHENG HUANG, FDI IN CHINA: AN ASIAN PERSPECTIVE, at 31-41 (1998).

¹⁰⁶ He, *supra* note 31.

Conclusions and Implications

Through contrasting the improved formal contract enforcement in urban China with the dire situation in rural China, this study has explored the underlying reasons for the evolution of the judiciary and local economic development. While it seems difficult to argue that effective contract enforcement is essential for China's economic development, the reverse causal link—that economic development generates more demand for mature contract enforcement—has more empirical support. In particular, the developed and diversified local economy changes the demand side of the formal contract enforcement, making it possible to be conducted in a more neutral and effective way. Given China's context, the analysis suggests that the reverse causal link is still incomplete in capturing the relationship. It is true that China's court system and formal contract enforcement in urban areas have become more mature and economic factors are important, but it largely comes from a combination of adequate financial resources and political concerns to effectively govern the country under a changed socio-economic situation. To a great extent, this development seems contingent on many elements.

On the surface, the development of Chinese courts seems to have followed the roadmap designed by many economists. They suggest that in transition countries, the law in written form should be introduced in the first place, because the cost of so doing is low and affordable. Institutional building and staff professionalism should be introduced only after the economy has been developed, because they are so costly that they become affordable only at this stage.¹⁰⁷ This study is, by and large, sympathetic to this suggestion, but this is not to suggest that this study agrees with the assumptions and processes designed by economists. On the contrary, primarily focusing on the costs in legal transplant and law and development is not adequate: they have neglected the more decisive political and contextual factors, such as political concerns, court finance structure, and the state's strategic development priority in economic development.¹⁰⁸ Through a detailed empirical examination of the mechanism of how politics, economic development, and legal institutions interact with each other in China, the study demonstrates that contextual factors, especially politics, still play crucial roles in the

¹⁰⁷ Richard Posner, *Creating a Legal Framework for Economic Development*, 13 WORLD BANK RESEARCH OBSERVER 1 (1998).

¹⁰⁸ C.f., RANDALL PEERENBOOM, CHINA MODERNIZES: THREAT TO THE WEST OR MODEL FOR THE REST? at 217-224(2007).

relationship between law and economic development.¹⁰⁹ The dynamics of institutional change shall be located in terms more of state actions than of pressures from below. Once again, it suggests that the relationship between law and economic development is not simply a function of rights protection. It is intertwined with how the state uses the law and legal institutions as an instrument to meet its own ends in a given historical period. An institution, legal or not, will develop only when it in some way caters to the needs of a local political and economic elite; the process of legal transplant from legally developed countries has been widely proven to be closely related to political forces and their interactions.¹¹⁰ A more realistic and meaningful research agenda in the revived law and development movement shall then incorporate politics into the analysis: what roles do political forces and other contextual factors play in the dynamics of various areas of substance in law, legal institutions, and development?

If the past is any clue to the future, then a more specific implication of this research is: will rural areas in China grow their way out of the problem, which seems to be the case in urban areas? If China's effort toward developing its western regions is successful, this is likely because the development and diversification of the local economy seems a crucial demand factor in the current improvement in coastal areas. When the reforms toward institutional building and professionalism flounder in the rural areas, the crucial element responsible for such a failure is a lack of funding. While it is very risky to forecast the trajectory of China's legal development, there is a strong correlation between wealth and social governance, including rule of law, as proven in many other countries.¹¹¹ But this change could take a rather long period; in the short run, the difficulty in rural areas might persist. It would also be interesting to see if the dynamics between formal contract enforcement and economic development are also true in other areas of law and legal institutions, such as property rights and corporate governance.

This analysis may also allow us to reflect on an old debate in the literature. For a long time, scholars have debated whether or not China can sustain its development

¹⁰⁹ LAW, CAPITALISM AND POWER IN ASIA: THE RULE OF LAW AND LEGAL INSTITUTIONS (Kanishka Jayasuriya ed.)(1999).

¹¹⁰ See Upham, *supra* note 7. Yves Dezelay and Bryant G. Garth, THE INTERNATIONALIZATION OF PALACE WARS (2002); Daniel Kaufmann, *Rethinking Governance: Empirical Lessons Challenge Orthodoxy*, available at http://www.worldbank.org/wbi/governance/pdf/rethink_gov_stanford.pdf (last visited on April 29, 2007).

¹¹¹ PEERENBOOM, *supra* note .

without a healthy and formal legal system.¹¹² But this debate may have getting a direction different from the real trajectory of China's legal development. If, as suggested in this study, China's legal institutions will be developed anyway along with its more developed economy, what we shall pay attention to are the interaction and dynamics among law, legal institutions, politics, and economic development in their context.

¹¹² Carol Jones, *Capitalism, Globalism, and the Rule of Law: An Alternative Trajectory of Legal Change in China*, 3 Social & Legal Studies 195-221(1994); Upham *supra* note 7 (1994); Jane Kauffman Winn, *Relational Practices and the Marginalization of Law: Informal Financial Practices of Small Businesses in Taiwan*, 28 LAW AND SOCIETY REV. 193-232(1994); Peerenboom, *supra* note 83; Dam, *supra* note 2.