

Different Legal Institutions for Different Economic Settings: Evidence from Interviews in China

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Abstract

China's rapid growth in the absence of autonomous legal institutions of the kind found in the west seems to pose a problem for theories which stress the importance of law for economic development. In this paper we draw on interviews with lawyers, entrepreneurs and financial market actors to illustrate the complexity of attitudes to law and economic growth in contemporary China. In the case of product markets, business relations are increasingly characterised by a mix of trust-based transacting and legal formality which is not fundamentally different from practice in the west. Financial markets are less like their western counterparts, thanks to the preponderant role of government in asset allocation, and a lack of transparency in market pricing. However, in both sets of markets we find evidence of a transition from inter-personal trust (*guanxi*) to impersonal transacting, and of growing demands from business and legal groups for the impartial application of legal rules and market regulations. China's experience does not suggest that law is irrelevant or unrelated to growth, but that legal and economic institutions coevolve in the transition from central planning to a market economy.

1. Introduction

What has been the contribution of institutions in general, and of the legal system in particular, to economic growth and development in China? The Chinese experience of rapid growth in recent decades appears to contradict the claim that 'law matters' for economic development (La Porta et al., 2008). It seems to be the case that China incompletely recognises the security of contract and property rights which new institutional economics identifies as having been essential to the rise of market economies in the global north (North and Thomas, 1973; North, 1990). Official discourse in China identifies a version of the rule of law 'with Chinese characteristics' which is explicitly distinct from the prevailing notion of the rule of law in the west. For many commentators, it is precisely the absence of western notions of legality in China which has been responsible for driving Chinese growth, by enabling business and government alike to act with a degree of flexibility which is not found in more developed industrial economies (Jones, 1994; Upham 1994, 2002; Allen et al., 2005, 2011; Gilson and Milhaupt, 2011).

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There are, in principle, many pathways to industrialisation (Gerschenkron, 1962), and there is no a priori reason to believe that China's route has to be the same as that of any other country. Yet, claims for Chinese exceptionalism too often rely on broad brush references to 'culture' and 'values' which remain elusive to systematic analysis. There is therefore a danger of embedding a narrative of China's development beyond the rule of law which, as some commentators (if a minority) have recognised, fails to capture the changes which have occurred in legal institutions and in attitudes to the legal system contemporaneously with the rise of a market economy since the 1980s (Pistor and Wellons, 1999; Peerenboom, 2002, 2010; Guarnieri, 2010; Liebman, 2014).

In this paper we explore the hypothesis that 'law matters' for China's economic development. To set the scene, section 2 seeks to clarify the nature of the theoretical claims at stake. We discuss a conception of the rule of law as a 'deep stable state' of a societal game (Aoki, 2015), in which it becomes the first best response of actors to align their behaviour with publicly articulated legal norms (Chen and Deakin, 2015). We compare the equilibrium properties of the 'rule of law', so conceived, with alternative modes of coordination, including the mix of interpersonal trust and clan-based relational contracting which is associated, in the Chinese context, with the practice of *guanxi*. We also discuss complementarities between *guanxi* and authoritarian political control as modes of coordination.

In section 3 we present our empirical evidence, which draws on interviews and focus groups with entrepreneurs, managers, lawyers and bankers in Beijing and the Pearl River Delta, carried out in 2013 and 2014. The interview data provide evidence that attitudes to trust and law are changing as the market economy develops and deepens, and that a transition from *guanxi*-based transacting to a more formal, legally-driven approach to contracts is taking place, although unevenly across industrial sectors and regions. We also observe differences in attitudes to law in product and financial markets, respectively. Section 4 concludes that, in the current rapidly changing environment, some aspects of the conventional picture of Chinese economic development may need to be rethought. Above all, closer attention should be paid to identifying in which respects China's trajectory is distinct from that of other countries undergoing industrialisation, and those aspects of its experience which may not be so very different after all.

2. Conceptual framework: the coevolution of institutions and markets

2.1 Formal and informal institutions

New institutional economics identifies a number of roles for institutions in underpinning processes of market exchange, from securing property rights to enforcing contractual agreements (North, 1990). Departing from the general equilibrium foundations of neoclassical economics, institutional theories maintain that the perfectly competitive market is an anomalous case, which is rarely if ever found in practice, and, to the extent that it is, depends on formal and informal rules for its operation (Coase, 1988). Particular sub-branches of the institutional literature place greater or lesser emphasis on

the role of formal rules and sanctions in creating the conditions for contract performance. The presence of informal institutions, which can generate a basis for inter-personal or inter-organisational trust in business contacting, is generally recognised to be important. According to Douglass North, too little is known about the evolution of informal institutions or of their mode of operation (North, 1990), but very much the same point can be made about more formal institutions. While neoclassical economics has provided elegant and tractable models of how a perfect market works (or would work, if it ever existed) to create a society-wide equilibrium, economics, in common with the social sciences more widely, has not yet come up with a good account of how market economies are formed in the first place (North, 2005).

Attempts to fill this gap have recently been made using concepts of social evolution drawn from game theory and complexity theory. A market economy is understood to be the result of an evolutionary process which stabilises the practices which underpin the impersonal exchange of goods and services (Aoki, 2001, 2010). Stabilisation, in this sense, can be thought of as involving the coordination of actors' strategies in environments of varying degrees of uncertainty. Conventions, understood as shared information (Lewis, 1969) and norms, understood as directives or signals based on shared conceptions of legitimate or appropriate behaviour (Gintis, 2009), enable actors to align their strategies in a way which overcomes the risk of defection or non-cooperation, thereby enhancing gains from trade and creating a social surplus which reinforces those same norms and conventions.

In this approach, institutions are seen as complex systems of conventions and norms of varying degrees of formality (North, 1990; Aoki, 2001). They retain and embed information on strategies which have been more or less successful in the past, and thereby store knowledge which actors can access through interpretation and observation (Young, 1996). As individual agents are capable of updating their strategies in the light of changes to the material or social setting in which they find themselves, so the institutions of a market economy are able to adapt to shifts in patterns of trade and in the technological bases of production and exchange. This process of adaptation is, to a certain degree, contingent and path-dependent, resulting in lags in adjustment, and, in some contexts, persistently sub-optimal outcomes (Roe, 1997), but is functional up to a point, enabling institutions and market relations to achieve a degree of 'fit' or complementarity over time. Thus institutions and markets *coevolve* (Deakin, 2011).

A coevolutionary framework may help us better to understand some longstanding problems in the law and development and law and economics literatures. One of these is the role of law in contract enforcement. Empirical studies of the operation of contract law stress the role of informal, or non-state, institutions in generating contractual cooperation. Thus Stuart Macaulay's study (Macaulay, 1963) emphasised what he called the role of 'noncontractual' elements of business relations, by which he meant repeat trading, reputation and inter-personal trust, in engendering contractual cooperation. By contrast, more formal institutions of contract law, such as written agreements and court-based sanctions, seemed to play a marginal role at best in shaping the strategies and behaviour of managers Macaulay interviewed. Since Macaulay's sample consisted of business transactions in a mature industrial economy with a highly developed system of contract law and a well functioning court system, one reading of

his research is that contract law does not matter anywhere: if it is marginal in the US context, it is likely to be even more irrelevant to the practice of contracting in developing economies which lack a similarly articulated legal infrastructure.

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

The downside of this type of inter-personal trust is that it is difficult to realise economies of scale and the deep division of labour associated with large-numbers bargaining. Small-scale exchange minimises transaction costs at the expense of high production costs. A variety of informal mechanisms evolved at various points to assist the transition to impersonal trade in the west, by facilitating information flows and enabling parties to signal their trustworthiness (North and Thomas, 1973; North, 1990). Avner Greif's study of the Maghribi traders (Greif, 1993) showed how a social network based on shared religion, social ties and language helped to build long-distance trade in the Jewish Maghribi community of the late middle ages. Many of the trust-building practices of the Maghribis can be understood as incentive-compatible in the sense identified by efficiency-wage and principal-agent models. These contractual and social devices enabled trade to take place between different Maghribi groups, between which there were relatively few direct links, and were also extended to non-Maghribi traders.

The seminal studies of Macaulay and Greif describe environments in which social cooperation emerges on the basis of the iterative behaviour of agents. Informal mechanisms such as reputation, kinship, social ties and religious affiliation are used to build trust, in isolation, it seems, from formal institutions of contract enforcement. It is possible, in this perspective, to see law as actively harmful to the building of trust, since courts are removed from the context in which trading relations develop, and may insist on enforcing formal agreements at the expense of the parties' tacit understandings of their mutual commitments (Ring and Van de Ven, 1994). Yet the claim of law's irrelevance can be taken too far: otherwise, it is difficult to explain the rise of modern contract law coterminously with the market economy, which is also one of the defining features of institutional development in the global north (Ferguson, 2011).

It could be that the law is simply expressing or reflecting a deeper economic reality, but to see law in such purely 'epiphenomenal' terms may be to underplay the incentive properties of formal legal institutions (Deakin et al., 2015). Although only a tiny percentage of contractual disputes reach the stage of litigation, the possibility of a legal sanction in a contractual 'endgame' of the kind created by a transactional dispute or the bankruptcy of one of the parties can be expected to influence the 'state of play' in earlier phases of a bargaining relationship. In principle, contract law can play the role of

a ‘correlating device’ which alters the parties’ ex ante incentives and helps overcome collective action problems in situations akin to the prisoner’s dilemma or stag-hunt game (Deakin, 2011). The law may stay in the background for the most part, while still exerting an influence on the contractual environment by selecting in, as well as out, particular strategies. An equilibrium in which contractual cooperation becomes the ‘first best strategy’ of actors without recourse to litigation could in principle be just as stable (and perhaps more so) as one in which agents make regular recourse to the courts to enforce their agreements. From this point of view it is not necessarily surprising that Macaulay’s interviewees reported that they were relatively indifferent to formal agreements and only litigated as a matter of last resort. Nor can Greif’s study of the Maghribi traders’ coalition, in isolation from a consideration of the wider institutional context, justify a view that the quality of the legal system is irrelevant to contract enforcement.

Empirical research has also qualified the claim that law does not matter for contract enforcement. There is evidence to suggest that the relative indifference displayed towards contract law by business firms reported by Macaulay (1963) and other studies of common law systems (Beale and Dugdale, 1975) is specific to certain industries and sectors, and possibly to certain legal cultures. In Germany, for example, it seems that contract formality is not viewed in such negative terms, and that both formal agreements and the standard-form contracts drawn up by trade associations play a role in generating trust (Deakin, Lane and Wilkinson, 1998). Nor it is clear that indifference to the law is optimal in aggregate welfare terms: in the more legally conscious German business environment, firms were found to be less likely than they were in the UK to pursue debts through litigation, suggesting that there are deadweight costs associated with reliance on informal contracting (Arrighetti, Bachman and Deakin, 1997).

A second issue illuminated by thinking of institutions in evolutionary terms is that of corruption. Societies in which corruption is widespread are those in which field experiments and surveys report a high degree of ‘antisocial punishment’ (Gintis, 2009). This is the inverse of ‘altruistic punishment’, or the tendency of actors to withdraw cooperation from those who free ride or otherwise depart from norms of social solidarity, even where to do so incurs a private cost for the ‘cooperators’. An example of this would be refusing to give, or to accept, a bribe. In the case of antisocial punishment, those who *do not bribe or take bribes* are the ones who are punished or shunned (Cinyabuguma, Page and Putterman, 2004; Denant-Boémont, Masclet and Noussair, 2007; Nikiforakis, 2008). The empirical evidence suggests that there is a high degree of correlation between the incidence of altruistic (or conversely, the absence of antisocial) punishment in a society, and the strength of its public institutions, in particular the level of democracy it has achieved (Hermann, Thöni and Gächter, 2008).

These studies imply that the rule of law, like contractual cooperation, is an emergent phenomenon, which depends on the presence of interlocking institutions and practices: a state capable of exercising authority in a way regarded as legitimate by its citizens is the precondition, but also the result, of a social norm which regards bribery as transgressive. In the same way, societies in which corruption is the social norm are likely to generate, and be generated by, authoritarian and coercive states, which, lacking legitimacy, are required to operate through force. The issue to consider is the process by

which it becomes the ‘first best response’ of public officials to refuse bribes when they are offered, and for citizens not to offer them. As shown by numerous studies conducted by international organisations since rule of law studies became the vogue in the mid-1990s, it is not possible to make this shift by simply legislating for it. A legal norm cannot in itself bring about the practice of the rule of law. The process needs to be understood, instead, in evolutionary terms, as the emergence of a ‘deep stable state’ of societal cooperation, which develops incrementally, is not preordained, but may become self-sustaining once it reaches a certain point (Aoki, 2010). The hypothesis that the rule of law coevolves with impersonal exchange of the kind associated with a market economy is one which would merit further research using a variety of contemporary and historical sources (Chen and Deakin, 2015).

The rise of formal institutions is conventionally associated with economic development in the global north (Ferguson, 2011; Cooter and Schaefer, 2011). Most likely it is part, but only part, of a complex trajectory. The emergence of formal institutions does not rule out a continuing role for informal institutions in contract enforcement. Reputation-based mechanisms, along with interpersonal trust based on repeated trading among close-knit groups, continue to play a role in market exchange (Ellickson, 1991; Bernstein, 1992, 1996, 2001). The persistence of informal institutions can be attributed to their transaction-cost reducing functions (Bernstein, 1992; Dixit, 2004). However, informal institutions more often operate in conjunction with formal ones, than in contradiction to them. It is the interlocking of the formal rules of the legal system with the social foundations of cooperation in exchange which should be the focus of attention.

2.2 Law and finance

Since the mid 1990s, a large body of quantitative research has highlighted the potential significance of law for financial development (La Porta et al., 1998) and thereby, according to the majority view, also for economic growth (King and Levine, 1993). Many of these studies make the claim that legal protection of investor rights is a prerequisite for the growth of capital markets, while protection for secured creditors is essential for the growth of credit markets (La Porta et al., 2008; Djankov et al., 2006, 2007 and 2008).

There are various methodological problems with these studies. Many researchers, including two of the authors of the present paper, have challenged the quantitative methods used to measure the degree of legal protection provided by the law for shareholders and creditors (see Siems and Deakin 2010). Historical research on the development of capital markets in the US and the UK has also challenged the ‘law matters’ claim. In both countries, capital markets and product markets alike experienced a transition from personal exchange based on interpersonal trust to impersonal transacting. There was also a shift from informal institutions to formal ones, which was accompanied by the shift from regional capital markets to integrated national ones. Legal rules providing investor protection emerged only at a later stage, after the rise of a broadly based investor class. According to this historical evidence, it was the rise of the capital market which prompted legal reforms, contrary to the direction of causation

assumed by the law matters hypothesis (Coffee 2002; Cheffins 2008; Franks et al., 2009; Mayer, 2008).

But if the findings of La Porta et al. (1998, 2008) do not very well explain the financial development of early industrialisers such as the US and UK, the role of formal institutions protecting investors might be more relevant to newly-established capital markets in today's emerging countries. Unlike the situation in the US and the UK where stock markets evolved without direct state assistance from small regional markets into larger national exchanges, newly-established stock markets in many middle income countries are consciously designed and imposed by the state. They often have a national role from the outset, in contrast to the localised stock exchanges of nineteenth century Britain and America. Thus impersonal exchange dominates the market from the outset. Nor can it be said, in these cases, that capital market practices preceded legal and institutional reforms. Given the lack of informal substitutes for state-designed institutions, it is possible that legal protection of investors may indeed be a prerequisite to the development of stock markets in middle income countries.

Account should also be taken of differences between product markets and capital markets. Except as in the case of certain former socialist countries, it is very rare to see the product market being entirely monopolized, even by the state. Private actors can generally find some way to get around rules designed to suppress market-based exchange. Thus one feature of centrally planned economies in the middle decades of the twentieth century was the coexistence, with the state-owned sector, of a sizable informal economy, which provided flexibility lacking in the formal sector, and came to be tolerated or even encouraged as a result. Thus, while in socialist systems the conventional function of contracts was to control, not to enable, individual behaviour and the economy (Zhang, 2006: 47-50 for China), market-based exchange did develop outside the formal sector, thereby compensating for the lack of a legal underpinning to contract enforcement in product markets. The de facto coexistence of the formal and informal sectors under the socialist system meant that there was an experience of private exchange (albeit semi-official) which could be drawn on.

Any such continuity is lacking in the case of newly-established capital markets. The supply of financial products is often still monopolized by state-owned enterprises and leaves little option for private actors, who must take or leave what is on offer. The mandatory nature of securities laws and the modern electronic transaction systems in many emerging markets further reduces the room for private contracting, particularly for retail investors. Where legal rules are ineffective or are sub-optimally designed, the inability of private parties to contract around the legal framework poses a problem for the development of the capital market (Chen, 2013a).

In this type of environment there is no guarantee that rules will be made and implemented in a manner that adequately protects the interests of investors. In states with a minimal or still emergent rule of law, where constitutional rules curbing the power of the executive branch are lacking and the legislature and judiciary are subject to executive control, the legal system is almost certain to be captured by elite groups and to serve their interests (Shirley, 2010). Rules protecting investors are unlikely to emerge or, if they are formally adopted, to be incompletely observed and enforced (Pistor and

Xu, 2003). Information asymmetries make capital markets particularly prone to types of abuse such as ‘tunnelling’ which are designed to transfer wealth from public investors to governmental elites (Chen, 2013b). Thus the law and finance literature creates a paradox: systems most in need of investor protection are the least likely to adopt them.

2.3. The Chinese case

China provides an opportunity to test these arguments (see, for some recent contributions, Yueh, 2013; Kennedy and Stiglitz, 2013; Xu, 2014; Yu 2014). Since 1978, China has managed to maintain an economic growth rate which averages out at 8-9 per cent per annum over the past three decades. Its legal system had to be rebuilt practically from scratch after the Cultural Revolution. The professionalism of judges has been increasing and there is evidence that judicial independence has also been enhanced, with a bifurcation between high-profile political cases, which are still subject to executive interventions, and the large majority of routine cases, in which judges are unlikely to come under political pressure (Yulin and Preenboom, 2010; Guarnieri, 2010). At the same time, there is evidence of regional differences, with judicial professionalism most in evidence in Shanghai and the cities of the Pearl River Delta, along with other centres of commercial activity (Pei et al., 2010; Henderson, 2010). In addition, individual judges remain subject to hierarchical controls which limit the progress made towards merit-based recruitment and promotion systems (Guarnieri, 2010).

The limited effectiveness of the Chinese legal system in the aftermath of the Cultural Revolution was, however, compensated for by the continuing influence of the Confucian tradition which stresses the importance of interpersonal relationships and social networks as the basis for commercial and wider societal coordination (*guanxi*) (Li, 2013; Zhou and Siems, 2015). As in the early stages of the industrial revolution in the west, it was the informal institution of *guanxi* which underpinned exchange. The rapid expansion of product markets and China’s emergence as ‘the World’s factory’ would not otherwise have been possible. What is much disputed is whether China’s reliance on *guanxi* represents a relationship-based path to economic growth which departs from the law-based path of western industrial development. It could be a characteristic of a given stage of industrialisation, which will diminish over time. Another possibility is that, as we have argued above, formal and informal institutions will continue to coexist as they have done in the economies of the global north, albeit in ways which reflect China’s developmental path.

In relation to the capital market, China established its two stock exchanges, the Shanghai Stock Exchange (SHSE) and the Shenzhen Stock Exchange (SZSE) in 1990 and 1991 respectively. By the end of 2008, in terms of market capitalization, China already ranked second in Asia, next only to Japan, and fourth in the world. However, stock market capitalisation does not necessarily indicate a productive role for the capital market, as most of the equity capital raised on the Shanghai and Shenzhen exchanges flowed into SOEs rather than private business firms. During this period the Chinese government promoted the growth of equity finance to help SOEs overcome financial difficulties after the recession of the mid-1990s, when large parts of the financial sector were technically bankrupt because of widespread non-performing loans. To this day, the

stock market continues to be dominated by companies which are directly or indirectly owned by the state. Where private companies are listed in one or other of the domestic markets it is often because they are better connected rather than superior in efficiency terms. Thus it is far from clear that Chinese stock markets are adequately servicing the macroeconomy (Walter and Howie, 2003; Green, 2004; Wu, 2005; Ren, 2004; Chen, 2013a).

3. Empirical findings

3.1. Underlying project and empirical approach

The present article is part of a wider research project on Law, Finance and Finance in Rising Powers based at the Centre for Business Research of the University of Cambridge. The overall aim of this project is to analyze how far the quality of legal and other formal institutions has affected financial development and economic growth in Brazil, Russia, India and China (the so-called BRICs). It also aims to address the institutional barriers to growth in emerging markets, in particular how far informal institutions may pose an obstacle to their future growth.

This project is based on a multi-methods approach (Nielsen, 2010; Poteete et al., 2010), combining quantitative analysis of the extent and nature of correlations between legal and financial development, with qualitative, fieldwork-based research aimed at building up a detailed, micro-institutional account of the perceptions and strategies of actors involved in legal and financial reforms. The fieldwork research aims to analyze how firms in the BRICs meet their financing needs, how governments aim to support or restrict forms of bank and/or capital market finance, and how those factors relate to the general role of law and law enforcement. Interviews are being conducted with entrepreneurs, lenders, lawyers, business consultants, policy-makers and legal officials in order to identify the salient features of legal, contractual and financial environments in the four countries.

In this paper we report the results of interviews and focus groups conducted in Beijing and Guangdong province between September 2013 and November 2014. Altogether we spoke to 74 respondents, 26 in individual interviews and the rest in a total of nine focus groups (see Table 1). The majority of the interviewees were practising lawyers; others were entrepreneurs, bankers and legal scholars who also have practical experience of the workings of courts and financial markets. The interviews were conducted on a non-attributable basis. Given the sensitive nature of the material, and in order to ensure that respondents gave as full an account as possible of their experiences, the interviews were not recorded, but notes were taken during the meetings and typed up afterwards. The questions were based on a semi-structured questionnaire which was distributed to the interviewees in advance to the interviews. Some of the questions were factual ones. We also asked questions about the interviewees' perceptions of the operation of legal institutions and financial mechanisms and their interpretation of changes in the legal and financial environment over time.

Table 1 here

The subsequent text reports and interprets our main findings, starting with the role of law in China in general and then addressing its specific relevance for product and financial markets. As far as appropriate, we will provide direct quotations indicating the type of interviewee in question.

3.2. The role of law in China in general

Many of the interviewees mentioned that there had been a steady increase in the volume of legislation in recent decades, in particular on commercial issues. However, a widespread view was that these new laws did not necessarily provide legal certainty. In particular, problems of interpretation of the Chinese Company Law 2005 were noted; many of its provisions were seen as having been drafted in an excessively general fashion. It was therefore seen to be crucial to supplement legislation by taking into account the judicial interpretation provided by the Supreme People's Court (SPC), in particular its 500-page annotated commentary on the Company Law, as well as the rules promulgated by the securities commission (CSRC) for companies issuing securities to the public. Even so, some of the interviewees were sceptical about the functioning of company law: a common view, responding to a question about the adequacy of shareholder protection, was that 'on paper the law is fine; in practice not but things are progressing' (lawyer and entrepreneur, Beijing, November 2014).

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

Another interviewee expressed the view that, over the previous decade, Chinese law-makers had also aimed to address the shortcomings of the market economy reforms, by addressing social issues through labour law reform and changes to the social insurance system. But some of the other interviewees were more sceptical of this view, suggesting that law-makers showed a stronger interest in economic matters than in matters of distribution. As one interviewee put it, today in China 'Hayek is more important than Marx' (lawyer and academic, Beijing, October 2013). And another one expressed the position this way:

'Inequality is a problem. The view was once, we must make the cake grow before we can start dividing it up. Some still think that but others

say, the cake is big enough now. Another issue is the environment. This is beginning to impact on quality of life.’ (entrepreneur, Guangzhou, September 2014)

An explanation for this business bias is, we were told, the close links between economic and political elites (similar Peerenboom, 2010). One interviewee also mentioned a ‘race to the bottom’ in terms of environmental requirements since regional and local authorities are keen to attract business investments which led to some reluctance to monitor full compliance with environmental laws.

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

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

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

The relationship between law and the economy also became apparent in responses that referred to differences within China, in particular in the interviews we conducted in Foshan in Guangdong province. Here, some of the interviewees referred to the promotion of a policy of ‘legalisation’ which referred to a programme to encourage the use of law to resolve disputes and limit social unrest and disorder. Better law enforcement was part of this. This programme is seen as important because of Guangdong’s status as one of the economically outward looking provinces of China. The interviewees also mentioned how far Guangdong’s experience was different from those of other parts of China, with respondents comparing the low number of registered lawyers in Hunan as compared to the Pearl River Delta (2,000 and 20,000). Mention was also made of the tendency of people in Guangdong to try to ‘find a lawyer’ in contrasts to the approach in less commercially developed cities and regions where there was still a strong Confucian tradition, which revealed itself in a preference for family and network-based dispute resolution.

So, overall, the perceived relationship between law and economic change is that law tends to lag behind developments in the economy and has to catch up. However, interviewees mentioned the need for more and better law and law enforcement. This suggest some shift of emphasis, which the view gaining hold that law can have a

positive effect on the economy as well as society as a whole. To explore this theme further, the following sections will address whether it is necessary to distinguish, for example, between areas of law and between forms of economic activity and market settings, with particular reference to the distinction between production and finance.

3.3 The product market: *guanxi*, contracts, and courts

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

The view that in China informal institutions, such as *guanxi*, replace formal ones is a well-known position expressed by numerous legal scholars, economists and sociologists (see section 2, above). In our interviews some responses also emphasized the importance of non-legal factors, for example, as interviewees told us that 'personal contacts are still important in business' (entrepreneur, Guangzhou, September 2014), that 'you have to know your business partners' (law firm partner, Foshan, September 2014), and that the 'importance of personal trust goes back to Confucius and is deeply embedded' (manager, Foshan, September 2014).

However, the interviews also suggest that a transition is going on, from relationship-based to rule-based transactions in product markets. This transition is in part attributable to economic growth. A larger market creates demand for legal certainty and reduces the importance of personal relationships in transactions. In this vein, interviewees also mentioned the role of technology, making information more easily accessible and facilitating the interaction with new business partners where written contracts become a necessity. Cultural factors, while recognized, do not seem to constitute a major obstacle to this process. One factor going against the use of informal agreements, referred to by interviewees, is the practice of the Chinese courts in not accepting oral evidence of transactions.

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

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

This statement also indicates that there is some variation in practice according to the identity of the contractual partner in question. Along the same line are other comments, indicating the varying detail of contracts, ranging from simple receipts or invoices – just indicating time of delivery and mode of payment – to contracts with basic clauses in some cases and more complex contractual documents in others. There were also suggestions of further differentiations according to the size of firms, and to different industries and regions.

Standard form contracts are said to be increasingly used. But it also needs to be distinguished as we were told that:

‘they are of three types: first, standard terms issued by government departments. For example, property contracts, construction contracts, labour contracts. These standard forms tend to be complete and detailed. Second, standard form contracts issued by large firms such as SOEs. These are usually simpler. They are basically imposed on the other party and serve the interests of the SOEs. Third, standard form contracts supplied by law firms and legal counsel who upload them on to the web. These are often simple, not much used by experts, but they are used by people in more everyday transactions.’ (lawyer, Beijing, November 2014)

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

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

Thus, regarding the duration of contracts, the situation may be described as somehow mixed: short-term contracts are important. For medium-term relationships there may or may not be a contract, but even in the former instance trust is also important. Finally, long-term relationships are frequently not based on a formal contract; thus, here *guanxi* is still the decisive factor.

The future development of contractual drafting is likely to be influenced by the growing influence of contracts with trading partners from other legal systems (other countries as well as Hong Kong). But this will not necessarily lead to full convergence of the practices of contractual drafting given that there is a good deal of variation even within the countries of the developed world. For example, the relatively short-term contracts

found in China seem to be in line with its association with the civil law origins of its legal system as research has found that in Britain and the US contracts tend to be lengthier than in continental Europe due to the tendency toward literal interpretation of terms in common law courts and due to the role of default rules in civil law countries (see Siems, 2014: 136).

Compliance and enforcement of contractual provisions was also frequently discussed in the interviews. Several interviewees referred to the role of interpersonal trust and viewed it as important. In the words of one of the interviewees, the presence of interpersonal trust may bring about a situation where ‘even when the parties agree a formal contract, they often don’t use it’ (lawyer, Foshan, September 2014). In other contexts, interviewees said that they would refer to contract terms during the course of negotiations. This would suggest that contract terms may play a complementary role to trust, in framing negotiation-based dispute resolution.

The role of courts, by contrast, was seen as more limited, at the point of resolving disputes. According to one of the interviewees ‘litigation is a last resort and you would only use it if the relationship was ending’ (lawyer, Foshan, September 2014). Another entrepreneur explained that he had not used courts in order to enforce claims, adding that:

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

Such scepticism about the role of formal contracts and judicial enforcement is not at all unique to China. As we have seen (section 2, above), Macaulay (1963) reports similar statements of US entrepreneurs according to which ‘disputes are frequently settled without reference to the contract or potential or actual legal sanctions’ and that ‘you can settle any dispute if you keep the lawyers ... out of it [because] they just do not understand the give-and-take needed in business’. As we noted above, these comments do not necessarily imply the absence of equilibrium selection effects of the legal system. In the Chinese case, however, the likelihood of any such effect could be conditioned by the variable institutional quality of the court system.

On this point, our interviews suggest a mixed picture. Some interviewees indicated that courts have improved, in particular in the economically most advanced regions of China (such as Guangdong), that the majority of cases are decided on an objective basis, and that judicial independence is respected in ordinary cases. Reference was also made to the strengthened qualification requirements for judicial appointments, the growing sophistication and length of judgments, and the recent requirement to publish courts’ decisions online. A trend towards litigation is also confirmed by quantitative data. A former judge from Shenzhen indicated to us that between 1999 and 2008 the case load per judge rose from around 100 to more than 300 cases per year. Other research has also found that judicial enforcement is playing a more pronounced role than has been the case in the past (Clarke et al., 2008; Zhou and Siems, 2015).

Interviewees also reported concerns that judges might not be fully impartial. In this context, many respondents saw *guanxi* in a negative light. According to one of the interviewees, for example, '*guanxi* is a problem; both parties may go looking for it, they will try to influence the judge' (lawyer and entrepreneur, Beijing, November 2014). In particular, *guanxi* was seen as a problem where judges had close ties to one of the parties or their lawyers. Some references were also made to executive or political interference in judicial proceedings.

The interviews suggest that arbitration is not being much used as an alternative to judicial dispute resolution. In one of the interviews, a part-time arbitrator presented a positive picture: arbitration was, he suggested, quicker than the multi-layered court system, and commercial arbitrators were seen as having more business expertise than most judges. These advantages were seen as applying in particular to contracts with an international dimension. He also thought that arbitration had the potential to play a growing role in purely domestic disputes (lawyer, Beijing, October 2013). But this was a relatively isolated view; according to other respondents, 'arbitration hardly ever works [because] there are not enough arbitrators and many parties don't know about it' (lawyer and entrepreneur, Beijing, November 2014), and 'arbitration is very rarely used' (In-house counsel, Foshan, September 2014). Thus, for the time being, it would seem that informal negotiation is generally preferred to arbitration as an alternative to judicial proceedings.

3.4 The financial market: state monopoly, inefficient rules and coping strategies

Compared with the product market where government allows the rapid expansion of market mechanisms, much of China's financial sector still operates under a highly regulated environment shaped by the centrally planned system (Tam, 2002). In the pre-reform period from 1957 to 1978, China's financial system consisted of a few institutions integrated within the vertical command chains: the People's Bank of China (PBOC), directed by the State Council handling industrial and commercial credit, deposits and currency issuance; the People's Construction Bank of China, led by the Finance Ministry, managing infrastructure investment funding; and the People's Insurance Company of China, later streamlined into the insurance department of PBOC, providing insurance services for foreign transaction (Heffernan, 2005; Xi, 2010). Between 1979 and 1984 four commercial banks, namely Agriculture Bank of China (ABC), Bank of China (BOC), China Construction Bank (CCB), and Industrial and Commercial Bank of China (ICBC), were set up by separating these entities from PBOC and other line ministries, and providing for them to take over their commercial operations. Independent in their own operations but under PBOC's supervision, these banks remained wholly state-owned until 2005 when they started launching IPOs in overseas and later domestic stock markets. While institutional and retail investors were introduced leading to a diversification of shareholdings, ownership remains highly concentrated given the controlling stake still held by the Chinese state. From the late 1980s, China allowed joint stock commercial banks and other forms of cooperative banks to operate in both urban and rural areas, of which the controllers are largely SOEs and government-affiliated entities. While the establishment of Pingan Insurance (1988) and Minsheng Bank (1996) signalled the disruption of the state monopoly in the

mainland financial sector, it remains dominated by state-controlled banks (SCBs) which still absorb the vast majority of household savings.

Since 1995, fiscal appropriation as the main source of SOE financing had been gradually replaced by bank loans (Wu, 2005). Credit allocation and dispute resolution remained subject to administrative interventions, reducing the role of formal laws and regulations. The result, as one interviewee put it, is that ‘in the area of commercial banking, it is a problem that there are few laws and that there are significant gaps. The law is lagging behind the practices’ (lawyer, Beijing, November 2013). State ownership also enables direct bureaucratic inference in SCBs’ lending and decision making (Lardy, 1998; Cull and Xu, 2000). Thus it is no surprise to observe the continued lending bias towards the state sector, while private firms, in particular the SMEs, face limited credit access. Almost all the SME entrepreneurs we interviewed referred to difficulties in accessing bank loans, either because of a perceived ‘lack of collateral’ (entrepreneur, Beijing, November 2014) or simply because ‘the banks are not interested in SMEs’ (entrepreneur, Beijing, November 2014).

Can private actors overcome the inefficiencies of a state-dominated credit market? Allen et al. (2005) claim that this could be done by informal financing, that is, personal lending based on personal relationships and social networks. Consistently with this view, most private entrepreneurs we spoke to confirmed that their firms were self-financed or had borrowed from families and friends. However, this coping strategy can be costly:

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

As much of the lending over course of the 1990s turned into non-performing loans (NPLs) (Lardy, 1998; Cull and Xu, 2003), government subsidies to loss-making SOEs reached untenable levels. In response the mainland stock markets were built up, more or less from scratch, to serve primarily as an alternative capital-raising source for the financially distressed enterprises (Wu, 2005; Green, 2004). In the USA and UK, stock markets were established by market participants in order to facilitate transactions among. The early rules governing stock exchanges were entirely private, and were made and enforced by self-regulatory bodies, mostly the stock exchanges themselves. Stock exchange rules did not initially reflect the interests of minority shareholders, but over time market competition forced some regional exchanges to adopt rules protective of minority investors, since doing so served their own interests in generating higher

volumes of share trading (Coffee, 2001). These rules were later absorbed into formal codes and statutes and in some cases came to be enforced by the state.

By contrast, China's stock exchanges were created by the government (Walter and Howie, 2003; Chen 2013a). Regulations regarding securities market operation and corporate governance have often been designed and enforced in a manner intended to prioritize the government interests, in particular to channel funding for SOE restructuring. This was particularly so under the quota system whereby scrutinisation and approval of IOP applications were heavily influenced by local bureaucracies. Under these circumstances, there were virtually no market pressures to meet private firms' financing needs, not to mention to safeguard the interests of minority shareholders.

The abolition of the quota system in 2001, together with the opening of the Nasdaq-type ChiNext board in the Stock Exchange (SZSE), together extended Chinese private companies' access to capital markets. In 2011, the number of listed private companies exceeded 1,000 (All-China Federation of Industry and Commerce, 2011). An official from the policy and research department of SZSE told us in 2014:

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

However, private companies with needs for external finance may still be deterred by the process of IPO approval. Interviews with private entrepreneurs, who had considered going public, reported that 'listing is difficult' and there is 'too much control over listing' (entrepreneurs, Beijing, November, 2014). This problem has been further exacerbated since the 2007-2008 global financial crisis given the regulators' concern that 'issuance of new shares is likely to dilute current share prices, thereby exerting negative impact on (domestic) stock market stability' (official, Shenzhen, September 2014). In this case, private companies often opt for 'buying a public shell' and overseas listing as alternatives to a domestic IPO (entrepreneur, Beijing, November 2014; official, Shenzhen, September 2014; fund manager, Shenzhen, September 2014). In the case of acquisition of public shells, we weret old:

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

Meanwhile, the Hong Kong Stock Exchange (HKSE) came to be perceived as one of the favoured hubs for overseas listings (lawyer, Beijing, October 2013). One interviewee described his plan of listing in the HKSE in a few years' time. As HKSE mandate that at least one of the originators should be non-Chinese, Chinese entrepreneurs often register their companies overseas or acquire nationalities from foreign jurisdictions, such as the British Virgin Islands.

Another way of overcoming limited capital access for private companies, in particular those in such emerging industries as the IT sector, is to access venture capital ‘which is dominated by overseas investors’ (entrepreneur, Beijing, November 2014). An interviewee who had recently received financing from a venture capital comments that ‘over the past decade VC has become well accepted; it’s not difficult’ (lawyer and entrepreneur, Beijing, November 2014).

With respect to company law, lawyers and investors we spoke to pointed to the limited minority shareholder protection despite an increase in volume of legislation. There was recognition that ‘a great progress has been made, in particular over the last decade, in securities laws, M&A’ (lawyer, Beijing, November 2013). However, some respondents commented that the laws are not well-drafted, as already noted (see section 3.2, above). Some cases even reported the perverse incentives caused by the laws:

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

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

‘Enforcement is the key problem. The CSRC rules require companies to disclose a lot of substantive information so that investors can take a long-term view of a company. The disclosure rules are tougher, formally, than their American counterparts. On paper this should work but in practice the law is not really obeyed.’ (lawyer, Beijing, November 2013).

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

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

There is also a widespread view that the mainland stock markets offer ample opportunities for rent seeking by corporate insiders. Several respondents mentioned the risk of expropriation by insiders during the IPO stage, which led many retail investors to cash out their holdings following IPOs (lawyer, Beijing, October 2013).

At the same time, a number of our interviews took the view that capital market transparency was increasing as a result of growing liquidity and higher trading volumes. Some thought that the price setting process was becoming more impersonal and less

susceptible to political and bureaucratic influence. As in the case of some of our product market interviews, respondents saw a decreasing role for personal relations in financial market dealings, and contrasted *guanxi* with marketisation:

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

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

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

Overall, with respect to financial markets the following picture emerges: in China, development of credit and stock markets remain highly regulated and policy-driven. While it is sometimes possible to avoid restrictions, for example, through an overseas listing or by way of searching for alternative forms of credit, the law is not seen as supportive in this area. As far as there are protective rules, those often do not work adequately. Shareholders of Chinese companies may enjoy similar level of protection to those in other countries in terms of written laws (see comparison in Katelouzou and Siems 2015) but do not regard themselves as well protected in practice. Reflecting on the ‘law and finance’ view, it can therefore not (yet) be said that law is a main determinant of financial market development in China.

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

4. Conclusion

In this paper we have reported findings from interviews with entrepreneurs, managers, lawyers and bankers in China, carried out in the 12 months from November 2013, on the theme of law and trust in contractual dealings, and on the relationship between the

legal system and finance. Our findings shed light on the relationship between economic growth and the development of a rule of law state in contemporary China.

Contrary to some recent studies, our interviews suggest that there are costs attached to the use of inter-personal trust, or *guanxi*, as the basis of contractual relations in China. For business actors in emerging sectors such as IT, *guanxi* has negative connotations associated with clan or network relations, which can tip over into corruption. The deadweight costs of *guanxi* are being lessened to the extent that more formal market relations, based on impersonal trade, are becoming established. This is likely, however, to be a slow process, which is conditional upon the capacity of the courts to operate independently from the executive power. Nevertheless, to the extent that practices embodied in the idea of the rule of law are endogenous to economic development, there is reason to believe that China, because of its recent growth path, is well placed to make the transition to impersonal exchange in contractual relations in the near future.

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

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Table 1. List of meetings.

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