
Of Laws and Privileges

The nondevelopment of Chinese law along lines familiar to the West was plainly related to the nondevelopment of capitalism and an independent business class in the old China.

John King Fairbank (1983, 123)

Introduction

Law in China today serves primarily, as it has throughout Chinese history, as an instrument of state control rather than as a limit on or obligation of the state. While over the past 20 years rule of law has made strides in China, legal conditions remain difficult for firms, individuals, and foreign governments. The central government itself is concerned with the inadequacy of the existing system as a basis for important future reforms, such as clarification of ownership rights. Each of the earlier chapters has touched on legal issues; this chapter explores questions of law per se, in two categories. Under the first heading are those that concern the firm in securing predictability and ensuring compliance (mostly in its dealings with the state). Under the second are laws that make possible recourse for the firm when disputes arise over transactions or anything else (mostly with private parties). There is a good deal of overlap, as in China the state is often involved in dealings that usually concern private parties alone in the United States. The question of corruption, though undeniably relevant in an analysis of China's legal environment, is extremely difficult to categorize; it therefore is discussed separately.

A final aspect of Chinese law today requires attention. Foreign investors often enjoy superlegal privileges that benefit their operations and

profitability; for example, some have exceptional licenses giving them exclusive rights to engage in some generally prohibited activity. It is difficult to compare the privileges enjoyed by some firms with the costs borne by others as a result; only a cursory attempt is made here. However, two things are clear. First, when these privileges are taken into account, the measure of foreign enterprise power in China's seemingly chaotic marketplace changes significantly. Second, to advance economically China must withdraw many of them, putting all firms on an even footing so that they can compete efficiently. This point is well understood as pertaining to state-owned enterprises (SOEs), which depend on subsidies, allocated market shares, and exemptions from procompetitive and other laws (e.g., those protecting the environment); its application to foreign enterprises has been less widely discussed but is increasingly important. Such privileges may be as detrimental to FIEs' interests in the long run as they are helpful in the short term.

China's legal weaknesses stem in part from unavoidable problems of transition and in part from government policy. The choices that foreign-invested enterprises (FIEs) themselves make also contribute to their problems with Chinese law. There is evidence—though only recently—of FIEs successfully using the legal system to achieve their objectives. The interviews suggested not irremediable lawlessness but a fair degree of legal predictability in China. Legal norms and institutions are evolving at a reasonable pace, reinforced by a network of less formal structures that partially fill in the existing gaps.

How quickly China progresses depends significantly on whether foreign enterprises, China's window to the modern business world, choose to promote change or simply to wait for it (or, alas, to resist it). No single firm can alter China's legal regime. But important individual firms are impelling the creation of local "islands" to serve their legal needs; these include compliance offices at the local foreign direct investment (FDI) bureaus. Moreover, the FIEs collectively do have the power to force change. But there is a catch: FIEs are not a monolithic group, and their behavior is almost guaranteed not to be orchestrated—indeed, it hardly can be. These ventures have different interests in reform, according to their market power, corporate culture, risk affinity, and the like. The weight of the foreign-invested community taken together is most likely to lead to change in those areas in which the logic of the market necessarily generates the same concerns among divergent firms: one can refer to these as forced moves in commercial policy.¹

1. Firms exposed to a common external environment (i.e., a competitively ordered marketplace) over time evolve symmetrical characteristics, such as a desire for predictability and avenues of recourse. These wants are not ideological but pragmatic.

China's Legal Environment

China's legal traditions can be clearly traced to before 1000 BCE. Confucian classics drafted around 500 BCE were still central to Chinese law at the beginning of the present century, millennia later; their remnants are easily discerned in everyday Chinese language and culture today. In an analysis of the dynamics of FDI in China, Wang (n.d., 21–31) reviews the traditional characteristics of China's legal environment. It is striking how germane they appear today:²

State-centrism: The purpose of law is to serve the state, not to protect abstract civil rights.

Secularism: Little tradition of religious absolutism exists to provide a definitive higher authority; therefore “Chinese legal institutions lacked the sacred and universal quality based on divinity.”

Lack of independence: The primacy of the state precludes judicial independence or checks and balances; the main avenue of appeal is through the assistance of patrons with authority.

Rule of man: The weakness of institutions supports the primacy of powerful individuals in the legal system, who judge by analogy the many matters left uncovered by statute.

Primacy of criminal law: The court system is concerned mainly with preserving the state's omnipotence and with criminal cases; it plays little part in civil disputes (including commercial transactions), deferring them to local mediation bodies.

Inequality: The legal presumption is “legalized inequality,” as reflected in the Confucian ethic of filial obligation of son to father, and so on; a harmonious society is presumed to require unequal standing among men and women, old and young, gentry and commoners.

Secrecy: “If [the people] knew the content of the legal codes, they would find ways to go around them in order to avoid punishment”; this extraordinary logic was the basis of withholding the content of the law, thereby concentrating discretionary power to enforce the law in the hands of officials.

Informal mechanisms: As noted with regard to civil cases (including commercial transactions), the state preferred to leave noncriminal matters to resolution by local mediators, clans, guilds, and the like.

Expatriates in China today could be forgiven for presuming that this list had been distilled from present conditions in Shanghai or Chongqing. But

2. I am grateful to Hongying Wang for permission to provide this summary of her points.

these observations applied equally on the eve of the reform period, at the end of the Cultural Revolution. As Lieberthal points out,

China . . . had no legal system and no law in a western sense as of 1977. When the PRC was founded, the party declared all Guomindang [GMD] laws invalid, and during the early 1950s it began to develop new legal codes to replace the defunct GMD statutes. This effort, however, came to a halt at the beginning of the Great Leap Forward [1958–61], and it never resumed. As of 1977, therefore, China was governed by decrees, by bureaucratic regulations, and by the personal orders of various officials; it had no code of law at all. In addition, many of the decrees, regulations, and so on were kept secret. The first foreign firms that sought to invest in the PRC signed contracts subjecting their investments to all pertinent rules and regulations, even though they were not allowed to know what these strictures were! (1995, 150–51)

Thus the dominant legal institutions in 1977 were even less compatible with Western commercial norms than those that sprouted up during the Republican period (1912–49).

When China's leaders decided to reform the economy and crack open the door to foreign participation, they recognized that legal reform would be necessary. On the one hand they were under pressure from potential investors and international advisors, such as the World Bank, to fortify early economic gains with legal reform (see, e.g., Jacobson and Oksenberg 1990, 114–16). On the other hand, they were influenced with equal strength by memories of foreign extraterritoriality in China. Prior to the 20th century, Chinese rulers had granted a limited degree of self-regulation to foreign trading communities (Fairbank 1983, 167). However, starting as early as 1784 and formally after the Treaty of Nanjing in 1842, foreign powers—following Great Britain's lead—placed themselves outside Chinese legal jurisdiction. They were frustrated with the often arbitrary Chinese legal system, not only as it applied to criminal cases but also to commercial transactions. Intending to contain inequities, they imposed an imperialist system ultimately no less inequitable to China, opening and legitimizing foreign encroachment that contributed to the dismantling of the Chinese state.

When Communist authorities ventured to invite foreign enterprises back into China in the 1970s, they were therefore excruciatingly aware of their vulnerability to charges of treason should critics later emerge. Loath to risk having to tell investors to go home in order to stave off charges of pandering, a short-term measure that would inflict long-lasting damage to China's reputation, they took the initiative in legal reforms. Under Deng Xiaoping, the government promulgated a large number of laws and codes, framed a new constitution recognizably Western in form, and adopted key principles such as the separation of powers (giving power to the hitherto impotent National People's Congress)³ and rule of law (e.g.,

3. Only in the 1990s did the NPC show (halting) signs of real independence, however. See, e.g., Steve Mufson, "Chinese Congress Vote Shows Surprising Dissension," *Washington Post*, 18 March 1995, page A21; and "A Little Booing from the Audience," *Economist*, 25 March 1995, page 38.

setting term limits on high officials for the first time). From their inception through 1988 the reforms generated 73 laws, 592 State Council regulations, and over 1,000 “local congress” regulations; most of these (71 percent) related to economic matters.⁴

As economic development gathered momentum, the need for a better legal basis for resolving transactional disputes increased no less rapidly, as private property returned and economic incentives were restored. Chinese citizens once again had material things worth protecting, and with increased dynamism and mobility the old, informal modes of legal recourse were insufficient. As property ownership was reintroduced, economic performance appeared to improve,⁵ thus bolstering the consensus for even greater protection to spur growth. Growing economic success also made it more important for China to have a legal system comparable to those of foreign countries in order to facilitate foreign investment, to reduce the natural tensions that arise during trade, and to satisfy the demands of the countries on whose open markets China depended. In addition, China has come under pressure to address inadequacies in civil and human rights protections, a task that logically demands extensive revision to the legal regime. The evidence below, however, is primarily concerned with the commercial imperatives of predictability and recourse in the law.⁶

By 1997 a system of law had been more or less restored in China’s urban centers, spurred in no small part by those needs of foreign firms. Changes included a broad framework of publicly available laws and regulations, instead of the personal pronouncements of party leaders known only to bureaucrats; attention to training lawyers, judges, and legislators, instead of leaving the Communist bureaucracy to respond with dogma; and a move to sharpen rights and adjudication procedures, instead of avoiding litigation by shunting cases off into arbitration. And yet it is still very much a system in transition, neither fully serving the purposes that reformers had originally envisioned nor efficiently meeting the needs of market-oriented investors.

4. The Australia Department of Foreign Affairs and Trade’s East Asia Analytical Unit (1997a, 92) cites a paper by Chen Duan Hong given in Sydney in 1995 for these figures.

5. There may be a considerable difference between apparent and actual growth: see table 4.1.

6. Bette Bao Lord of New York’s Freedom House has argued that the long-term (or maybe even medium-term) predictability that FIEs desire *requires* them to attend to human rights conditions in China, as social tensions are likely to build and threaten commerce unless democratic reforms are carried out (personal communication). I agree with her both that enlightened self-interest is needed in China and that social conditions in high-growth areas may get worse before they get better. As argued in chapter 3, many foreign firms do exert a positive influence on social conditions by their very presence and interaction with Chinese employees. Whether these firms ought to direct their sales force and engineers to spend more of their time with Communist Party officials advocating for democracy is a question beyond the scope of this study.

As Child (1996, 220) observes from a management perspective, not only do FIEs in China, as in many countries, face special procedures at the border and restrictions governing establishment, but once set up they continue to be controlled by laws distinct from those applicable to purely domestic firms.⁷ When legal questions are unresolved by FIE-specific legislation, domestic law applies by default; but for most matters involving transactions and labor, separate rules are in place.⁸ Other nations have crafted special rules to govern the activities of foreign firms operating domestically in exceptional sectors (e.g., banking in the United States), but having two entirely distinct regimes is unusual, if not unique. On its face, then, this seems to demonstrate a lack of “national treatment” for FIEs in the context of investment. Or does it?

First of all, while China’s foreign investment laws might be said to deny national treatment to foreign investors by virtue of a two-track legal regime, the national treatment obligation in the World Trade Organization (General Agreement on Tariffs and Trade, Article III, paragraph 4) applies only to foreign products, not to foreign investors. In fact, extending the national treatment principle to the investment realm is a key goal of efforts by the Organization for Economic Cooperation and Development (OECD) to negotiate a Multilateral Agreement on Investment, and it was an important element supporting cross-border investment in the North American Free Trade Agreement. So if a bifurcated legal regime in China were a hindrance to foreign firms, it would nevertheless be outside the purview of WTO as presently chartered.

More important, it is not clear that the dual legal system is a hindrance. The special rules for FIEs were designed to create a regime closer to Western norms. While it is separate from domestic law, it may well be superior—at least for the purposes of market-oriented foreign firms. The rule of “no harm, no foul” may apply, as no foreign investors in their right mind would prefer to be subject to the vagaries of the system of domestic adjudication with which wholly Chinese firms must grapple. But if a private party is unlikely to challenge the two-track Chinese system within the WTO mechanism, sovereign parties may nonetheless argue that “sep-

7. Jeff Schott of the Institute for International Economics points out that other nations acceding to the GATT/WTO have also employed differential legal systems for foreign firms (e.g., Poland) (personal communication). But in those cases, he notes, the applicants’ impact on world trade and the system itself was not large and was moderated by geopolitical considerations (Cold War politics); China’s impact, in contrast, is both large and entirely conceived in terms of its economic viability.

8. Not only are FIEs subject to these two sets of law, but for contracts ancillary to the main contract setting up the venture (e.g., covering technology transfer agreements, trademark use, distribution, and supply and off-take) foreign laws (US law, most commonly) can be specified as governing. Savvy tactical reference to suitable statutes is critical. See, e.g., Charles D. Pagle’s 1998 “Contracts and Agreements in the People’s Republic of China,” at <http://www.qis.net/chinalaw>, 20 April 1998 (under “Chinese Law Explained”).

arate but equal is inherently unequal” during negotiation of China’s WTO accession package, when they can raise any issues they wish, regardless of WTO discipline.

This study has shown that the firewalls dividing FIEs and domestic firms are eroding rapidly. In a number of sectors, foreign and domestic firms are increasingly indistinguishable, and FIEs are transacting more and more business in the domestic economy. Because of the dual system, a transaction covered by FIE-oriented laws under Western contract would be adjudicated by Western norms, but one between an FIE and a Chinese state-owned enterprise might be subject to different norms. In the latter case, Child (1996, 221) points out, a contract can be abrogated as a result of the decision of a planning authority or agency. The partnerships between firms (including foreign firms) and sympathetic bureaucracies make the potential for serious abuse of this power very clear. It is such fears that lead China’s trading partners to contest the present legal regime.

The Expatriate Experience

Next to be discussed are the legal experiences and challenges reported by informants for this study. Three senior attorneys for China operations were among the respondents (##7, 14, 28). Many other interviewees had law degrees, and most had significant experience dealing with legal matters in China. Other counsels were interviewed at the US headquarters of firms.

Predictability and Compliance

Most of the FIEs studied for this book had stated corporate commitments not to violate host-country law, wherever in the world they operated. For example, one large American FIE (whose China company is headed by interviewee #36) applies the following—notably unambiguous—standard:

As part of a global organization, [we] need to respect the laws, customs, and traditions of each country in which [we] operate. At the same time, certain actions violate the Code of Conduct, even if they are legal and customary in some countries. In general, these would be actions that violate the laws of the United States or the host country [emphasis added].

This firm suggests to its employees an easy test to guarantee ethical behavior: a major newspaper should be able to report their actions without embarrassing them. The motivation for running a compliance-oriented firm, in addition to fear of exposure (and of litigation), is greater predictability and a more dynamic enterprise. The firm also distributed Paine’s *Harvard Business Review* article, “Managing for Organizational In-

tegrity” (1994), to an array of employees brought together in mid-1997 for the sole purpose of focusing on ethics. Paine’s thesis is as follows: “By supporting ethically sound behavior, managers can strengthen the relationships and reputations their companies depend on,” enabling them to better attain profitability goals.

Nevertheless, expatriates often noted that in China “the law” does not hold the same meaning that it does in OECD countries, insisting that to naively operate as though it did would only squander resources and effort. Many spoke of competitors who, either because they were from home countries with less established legal cultures or because they were smaller and less subject to scrutiny, operated without regard for legal regimes. And many firms uncomfortable with the shakiness of China’s legal environment were simultaneously the beneficiaries of the privileges and opportunities that legal ambiguities permitted. Thus their status was often paradoxical.

Deliberate ambiguity has been extremely useful to Chinese reformers. Explicit guarantees for FIEs (e.g., regarding market access) could have provided hard-liners opposed to trade liberalization with ammunition: after all, not even Chinese firms enjoyed such rights in practice. The vagueness of the regulations enabled reformers to push policy beyond the point of reversal while making possible a fair degree of foreign establishment and competition. Therefore, it would be somewhat misguided to simply deride the present faulty legal regime as inadequate, immature, and corruption prone. True, it has those characteristics, but they also served a purpose. Important domestic reform milestones have been realized; and as the still (but more slowly) growing flow of FDI demonstrates, investors have felt sufficiently protected to find China attractive. The obvious challenge now is to make changes that will serve future and not past conditions. Earlier reliance on ambiguity may make the legal reforms needed for the next phase more difficult to achieve.

Seeking Access to the Content of the Law

Clearly, investors who do not know the relevant regulations will have difficulty planning strategically for the Chinese market and elaborating a rules-based culture within the firm. Such lack of information has been a major problem for China-based FIEs in the past. China continues to restrict publication of some legal and regulatory materials, and in some industries market development is devised behind closed doors. Even the new Price Law, which only went into effect 1 May 1998, allows planners to set prices “when necessary,” for a range of goods and services. When reform began, the vast majority of economic law was secret, or *neibu* (literally, “inside”).

Greater transparency has been a consistent goal of bilateral and multi-lateral negotiations, and in fact much progress has been made in this regard. By keeping regulations secret, authorities could implement them as

flexibly or arbitrarily as they wished. Earlier investors were willing to come to China without having full access to the statutes. But as the economy has matured, policymakers have become more concerned with a diminishing FIE inclination to invest without transparency. China has had to make its rules and regulations more public as a result.

The major commercial laws, foreign investment guidelines, and preferential sectoral policies have now been published and circulated. They are readily available on the Internet and in libraries, and most expatriates interviewed were able to gain access to the laws and regulations they needed. But while instructions that govern the operation of FIEs and the designs of Chinese macroeconomic policy are available, sector-specific management rules in some cases are not. For example, in some sectors policies allocating market share are said to exist outside the reach of expatriates (#20). Furthermore, as discussed below, much in Chinese laws is not made explicit, instead being fleshed out only over time in implementing regulations and opinions that can take years to be elaborated. Therefore FIE managers must regularly return to the authorities for interpretations and clarifications—the bases of which are still often not transparent.

Transparency is clearly a prerequisite for predictability and compliance. Although relationships with high-powered leaders may temporarily substitute for the predictability provided by a sound, transparent legal regime, in the long term these leaders will be gone and a new generation of regulators will take their place. History suggests that such relationships, implicit deals, and bargains will not be honored by those who follow, and the most senior leaders are aware of the instability of this system.

Bridging Gaps in the Law

China has passed a huge number of laws in recent years, but many areas of commercial concern remain uncovered. New laws and implementing regulations must still be promulgated in areas. Until that happens, firms must fill in the gaps. Either they extrapolate by analogy with existing regulations, get an administrative ruling or opinion from a policymaker, or shop around for a jurisdiction that has a track record satisfactory to the firm. When gaps in the FIE-specific laws exist, domestic law generally applies by default. As noted above, this can be problematic when domestic law fails to provide an adequate market-oriented device to resolve disagreements. Other regulatory issues are covered neither by FIE laws nor by domestic laws.

Such lacks increase the risks perceived by investors. For example, because the regulations are incomplete, firms must repeatedly return to approval authorities for clarifications, which can bring other problems. As a Hong Kong-based senior attorney noted:

The alternative to a litigious system is constantly going back to approval authorities, which opens so much opportunity for corruption. Getting a *legal*, fully vetted

transfer of land [for example] is a very difficult task. So you get local approval, and hope there is not a “rectification campaign.” All that worrying significantly raises the costs, and many Americans just pull out. (#14)

Surely the wrong way to bridge gaps in Chinese law is simply to ignore them: foreigners sometimes delude themselves into assuming that what is not there can do them no harm. The lawyer quoted above recalled a prominent American advisor’s glee at hearing from the governor of Guangdong that his business associates could “do everything they wanted, in accordance with Chinese law.” The trouble is that “People just do not hear the qualifier: ‘in accordance with Chinese law.’ People suffer from ‘Sino-narcosis,’” he explained.

Barring self-delusion about how holes in the law will be filled, FIEs still cannot predict with certainty how policy will unfold. A large US conglomerate developed layers of distribution and service provision offices only to discover that these operations were in conflict with the policies later enunciated to regulate such activities (see chapter 5). This firm is currently considering whether to push for special treatment under a “grandfather clause” or simply to comply with the new regulations, restructuring from scratch (#7). While those at the conglomerate say they were lulled into thinking that legislation would validate the course of action it took, other legal experts (#54) insist that such firms took their chances and knowingly overstepped the guidance that central authorities had offered about the policies to come. The potential costs of misjudging future regulation is significant, but so is the cost of not moving aggressively in the Chinese market and being boxed out by competitors.

Interpreting the Law to Advantage

That the scope of Chinese legal coverage is widening does not by itself answer all commercial policy questions. For a number of reasons, statutes are often vague or intentionally ambiguous, full of room for interpretation. Early on in reforms, decision makers in China realized that they lacked the competence to legislate effectively, but that loosely written policies could be reinterpreted with experience (exemplified by the expression “crossing the stream by feeling the rocks”). Ambiguity also helps to reconcile residual ideological requirements (e.g., that the state must be the primary economic shareholder on behalf of the people) with practical necessities (e.g., that state enterprises must be privatized to meet economic growth targets in the medium term and beyond). A certain lack of clarity is thus essential to maintaining the image of Communist officials as relevant and potent.

As a result of this ambiguity, foreign and domestic firms try—both defensively and offensively—to shape the circulars and decisions that affect them. Beijing pushes decision-making responsibility down to lower levels of government, with admonitions of “don’t ask, don’t tell.” A firm seek-

ing permission to undertake a certain activity will be told just to do it without asking for formal approval (#52). Firms, likewise, push responsibility down to the lawyers and, increasingly, to compradors, all the while preparing contingency plans to deal with regulatory trouble if it should arise. "Right from the start, you need to build a defense against the possibility that [some authority] may challenge your 'approvals' later," said one senior counsel (#28). She went on:

There is a lot of interpretation. Asking the right person for an interpretation is key. If you get unclear or conflicting interpretations, what do you do then? And if you ask for a written ruling, for someone to put their word on the line, it is nearly impossible. Often, what you end up with is merely a memo to yourself; maybe you can get someone to "chop" it [i.e., to put their personal stamp on the document, indicating it had been seen by them]. The lawyers [for the FIE] are conceivably the ones who will hang, though the chance of getting [sanctioned by the government] is infinitesimal. . . . An American-style lawyer who demands a paper trail for everything will only bring the business to a halt.

One tactic for dealing with the authorization problem is to send authorities notice of a legal position, which is then presumed to be legal unless sent back marked to the contrary (#36). Thus, most of the time it is the task of the legal staff to find a way to justify what has already been done or decided. "Are we 100 percent ethical?" asked one senior respondent. "Within the Chinese system, we are 99 percent pure from the US standard and 110 percent pure from the Chinese standard. Lawyers *are* where the buck stops, but that's their job" (#37).

With experience, foreign firms are more successful at the art of interpreting the permissible, which is one of the reasons why a local presence is essential to having goods consumed in China. Despite restrictions on distribution and service-sector activities, for example, most firms involved in this study were interpreting their way forward into these areas with tacit central approval (not with explicit blessings). As the general manager of a large American chemical company's China operations noted:

Getting the laws is doable; interpreting the law is what is difficult. It is hard to get [the authorities] on the record. As an American firm we cannot do anything that is not lawful; but taking advantage of the provisional implementation [of a regulation] is the key to success. Being able to interpret your way through this gray area is the key. At first there may be trial and error, but you need to find the way forward. (#15)

Building Bureaucratic Capacity

The legal professionals involved in this study were in agreement that to become compatible with modern corporate legal norms, the Chinese government requires more and better legal professionals and training. One interviewee (#28) had written papers and held seminars for Ministry of Foreign Trade and Economic Cooperation (MOFTEC) officials on the role

of an in-house corporate counsel. Only in 1984 had the State Council decreed that firms were permitted to have corporate lawyers, a fact that reflects the prior focus on rule *by* law, as opposed to rule *of* law.⁹ Despite such basic steps, authorities continue to abrogate (or bend) laws and regulations in particular cases with such frequency that the process of building legal competence is compromised.

Only 66 percent of China's judges have a college education, by one estimate (although that is up from 17 percent in 1987);¹⁰ a large percentage have no legal background at all, coming rather from careers with the People's Liberation Army (PLA) or the People's Armed Police. Some may well have strong ties with special interests in the economy, interests that the party bureaucracy is not willing to oppose during China's critical time of social transition. Similarly, *China Daily* reported on 20 June 1998 that only 25 percent of China's 100,000 lawyers had undergraduate degrees. Clearly, specific legal training throughout the gargantuan Chinese bureaucracy will fall short for some time, presenting a major problem for Western firms that want to anchor their operations in solid law.

This has obvious implications for FIE compliance efforts, because investors cannot predict whether the commercial logic of ensuring legal enforcement will prevail or if interlocking relationships will instead prove decisive. China has risked major international embarrassment by abrogating contracts in order to satisfy special interests (in one well-known case, a McDonald's in Beijing was forced to move despite its lease). Yet Chinese leaders are aware that a better legal environment is needed to keep economic development on track, especially in the aftermath of the cronyism-induced Asian financial crisis. While an estimated 60,000 Chinese students are presently enrolled at 300 domestic law schools ("Vital for Market Economy: Lawyer's Education Advancing," *China Daily*, 20 June 1998, page 3), these numbers will only begin to supply China's needs.

Meeting Environmental and Labor Standards

Foreign enterprises in China also have legal liabilities related to environmental and labor obligations. Through the 1980s China promulgated and revised environmental protection laws, and as of 1998 a solid regulatory framework had been elaborated.¹¹ The problem is not promulgation but implementation. For many Chinese firms under the protection of local governmental entities (or, it is said, in partnership with the PLA), compliance with these seemingly noncommercial objectives is absurdly low, and remedial steps are taken only when cost-neutral (if then). FIEs are more

9. *Zhongguo Lushi* (China lawyers), no. 11 (1994), 35–37; cited in Wang (n.d., 45).

10. Stanley Lubman, remarks to the Asia Society (19 April 1997); Lubman (1997, 13–14).

11. In early 1998 the National Environmental Protection Agency (NEPA) was formally upgraded to ministerial status as well.

likely to be held to standards, they are by nature less likely to be coddled by authorities, and they are generally better positioned to afford environmental protection than are domestic firms.

For FIEs with large investments in advanced economic areas, basic environmental standards are today fairly well enforced, and environmental impact assessments are taken seriously in the planning stages (though rarely made grounds for rejecting a project). But otherwise—for many smaller FIEs and outside a handful of localities—enforcement remains lax. Those firms in strictest compliance are likely to have their own reasons for operating to high environmental standards. Some firms from home markets such as the United States and Europe have fears about bad publicity that skirting these obligations in China might bring. And managers at some firms can imagine a time in the future when China will develop a “superfund”-style effort of its own to clean up its environment, complete with “joint and several” liability—a corporate nightmare.

Chinese partners sometimes pressure the joint ventures to avoid the expense of obeying environmental laws and to make other decisions that sap their effectiveness. Once again, the question of who controls the firm becomes crucial, affecting management’s ability to make decisions on remediation spending, to process investments, and to choose subcontractors to deal with waste streams, one of the trickiest problems facing foreign firms in China today. Firms interviewed for this study claimed to maintain the same standards in China that they would apply anywhere in the world; but in most parts of China the infrastructure such standards require simply does not yet exist. One supposedly “certified” hazardous waste disposal site sits atop the water table a few miles upstream from populous villages.¹² In practice, conscientious FIEs are simply warehousing toxic wastes that they cannot process themselves, while continuing to search for responsible methods of disposal. That course, though laudable, is quite costly; and one expects that relatively few firms say no to the services of officially approved but incompetent waste disposal agents.

Similarly, FIEs are not always in compliance with Chinese labor regulations, which—like environmental laws—often go underenforced. The manager of a US-owned factory in Shenzhen explained,

[We] are sticklers for law. The government of Shenzhen says to us, “As long as you have a deal with your [workforce], we don’t care whether you are in compliance with official regulations.” But we want compliance by the book. I am trying to manage between these two positions. (#19)

Despite his determination to comply with regulations, his factory workforce regularly exceeded overtime limits (see table 3.3). Management is working to bring those numbers down, but mostly for reasons of cost and of work-

12. This example was reported by policy analysts at the US Council for International Business, who are helping firms to better grapple with environmental policy issues in China.

place safety, not out of concern for violating Chinese regulations (as indeed they are). No one expects that Shenzhen labor authorities will enforce the labor laws locally, absent any pressure on them to do so. Conditions of non-compliance are, however, a lever that can be used against FIEs on other matters, such as technology transfer or subcontracting arrangements.

As with environmental problems, the greatest threat in the labor area may be aspects of the operation outside the foreign manager's control. FIEs that rely on subcontractors may have little idea of conditions up and down the value chain. Under Chinese law they would be unlikely to face any sanction for the behavior of a subcontractor. However, in the eyes of Western business ethicists those subcontractors' practices may be a foreign investor's responsibility as well. Moreover, their initial negotiated contract may have left foreign firms with limited management power; and ethicists certainly hold them accountable for conditions within their own ventures, even if they claim a lack of complete venture control—especially of labor.

Two difficult questions confront FIEs on labor policies. First, how much diligence should be expected of them in discovering abusive practices? And second, how far ought FIEs to go in promoting social policies to aid the workers in their sphere of influence? Like tracing waste streams, monitoring and enforcing compliance with labor standards among subcontractors can be difficult in practice. The sourcing of intermediate inputs can be highly decentralized, making full audits next to impossible. Clothing company Levi Strauss, which withdrew from China on labor rights grounds in the early 1990s and has since returned, sent auditors to inspect 700 contractors worldwide once it decided to commit itself seriously to social activism (Santoro 1998, 39). But this action is extraordinary and costly; and it represents an investment in image that is more clearly justified on commercial grounds for brand names such as Levi's than for the great majority of manufacturers. Codes of conduct regarding employees vary widely in ambition. No consensus exists on this question, even among labor advocates; it seems reasonable to permit FIEs some latitude in deciding how intimately involved with their workers social lives to become.

In general, as FIEs plan for legal compliance with environmental and labor regulations, the threats to predictability come either from the long-term changes that will alter domestic enforcement or from non-Chinese auditors and activists seeking to pressure investors to act in particular ways. The dearth of active Chinese enforcement in these areas has made the work of these activists assume greater relative importance, creating a conflict of interest for firms that would prefer to uphold standards but that must cope with intense competition and low margins in the Chinese market. Some firms in that developing country are reluctant to embrace symbolic gestures that embody the sensibilities of the advanced industrial nations but have no impact in China (beyond antagonizing leaders). Despite the obvious temptation to cut corners, the majority of firms exam-

ined chose to comply with higher environmental and labor standards, at higher cost—mostly, it seemed, out of (first world) habit.

Pursuing Recourse

Disputes between firms and buyers, suppliers, and service providers over contracts and payment are very common in China, as elsewhere. Intellectual property protection issues and conflicts between firms and their employees also arise regularly. By far the most common solutions to these problems are administrative or informal remedies, which rely on local brokers and authorities to use their relationships to resolve disputes. But the number of cases brought to more formal proceedings is increasing in part because FIEs are writing precise instructions on arbitration or litigation venues into their contracts. Thanks to such drafting, the China International Economic and Trade Arbitration Commission (CIETAC) now claims to have the second heaviest caseload in the world, while official yearbook statistics show civil and economic cases resolved legally in China to run into the millions (see *China Statistical Yearbook, 1997*, 741–43). Regardless of the quality of resolution in court cases—which still often leaves much to be desired—their sheer volume is significant and demonstrates a clear trend.

Structuring Contracts

Interviewees stressed the importance of both the contract establishing the venture and contracts governing individual transactions; such emphasis contradicts the position that the legal system does not really matter or deserve much attention. FIE establishment has been discussed at various points in this study, and poorly negotiated contracts have often diminished opportunities for recourse later on. They can interfere with the venture's decisions on staffing, incentives, dividend allotment, sourcing, and technology use. Interviewees identified haste, poor information, ignorance, and fatigue as reasons for accepting contracts that were not well designed to protect the foreign investor. Not least, some had assumed that the legal regimes in China were not worth wasting energy on (an attitude particularly common among Japanese respondents).

There is increasing evidence that the structure of the contract does matter. Several factory managers (e.g., ##20, 26) expressed regrets about not having pursued specific goals in the contract, particularly influence over employee salaries and better control over their Chinese partner's access to sensitive technological data. Legal practitioners have stressed the growing utility of properly structured contracts (see Lubman 1998, 38–44). Setting aside the obvious question of securing managerial control (which would in fact obviate some of the need for legal recourse), instructions for procedures to resolve disputes seem to be particularly important.

Expatriates identified four elements to this task. First, disputes must be referred to the appropriate forum; for example, certain of the arbitration boards set up in China (as discussed below) have reputations for greater fairness than others. Second, it is crucial that they be referred to the most effective body of governing laws. For many ancillary contract matters, though not for the establishment of the venture itself, foreign legal codes (including US codes) can be specified. Third, reasonable time limits must be specified for each stage of resolution prior to litigation. Without such limits, it was observed, Chinese parties were known to keep disputes at the conciliation stage indefinitely. And fourth, interviewees noted that investors must be aware that even well-structured contracts can be abrogated by powerful special interests.

Conflict Resolution Prior to Litigation

Interviewees discussed five types of disputes:

- intrafirm management disputes,
- firm-employee problems,
- firm-firm disputes between commercial parties,
- firm-consumer problems, and
- conflicts between the firm and authorities at various levels.

The case studies suggest that problems currently amenable to legal methods of recourse are mostly those between firm and employee, between firm and firm over intellectual property and payments, and to a lesser extent between firm and consumer over product liability. Relying on the legal system to settle intrafirm disputes among partners or disputes with authorities is generally avoided, as local partners and authorities can influence adjudicators and can potentially damage vital relationships. Foreign investment bureaus increasingly try to resolve firm-authority altercations, but their efforts almost always involve the alternative to legal recourse: administrative remedy (i.e., settling a problem in the proverbial smoke-filled back room).

Foreign firms have two legal remedies (short of litigation): consultation and conciliation (mediation) or arbitration. The first, which is less formal, requires the express consent of all parties to the dispute. The second, once agreed to in the contract terms, is supposed to be compulsory and binding.

Mediation services have sprung up in many commercial areas where FIEs gather, particularly in the special economic zones and in provincial capital cities. For example, Jilin Province with national guidance has developed a conciliation center (see their website at <http://www.jl.org/ccpit/center>). Mediation of this sort is either stipulated in the contract or

agreed to by all parties after a dispute arises. Conciliators grapple with the same broad slate of commercial disputes that arbitrators do. In Jilin, the directors of the conciliation center are also heads of the local FDI bureau, the People's Courts at several levels, and other trade bodies. Interviewees (e.g., #7) reported that following a number of successful arbitration and litigation proceedings, conciliation and mediation services were being taken more seriously as an attractive alternative to more formal recourse. For now though, conciliation is usually only the first step in the process of resolving disputes, as it results in decisions that are not binding.

Arbitration is largely the purview of the China International Economic and Trade Arbitration Commission (CIETAC), a quasi-official body that serves to resolve commercial disputes with an international aspect.¹³ Though when it was first resurrected in the 1980s after a 30-year holiday it was derided for its partiality, CIETAC is regarded as more objective today. It has units in Beijing, Shanghai, and Shenzhen, and prominent Chinese and non-Chinese sit on its panels. The commission's Shanghai branch has addressed joint venture and cooperation contracts, international purchase and sales contracts, machinery import contracts, and construction deals gone bad.¹⁴ Firms foreign and domestic both make use of the commission's services. Parties to a contract either stipulate in that contract to resolve conflicts at CIETAC or jointly submit in writing to the commission after a dispute arises. Findings are binding and—in theory—cannot be appealed by either side. As China is a party to the 1958 New York Convention on International Arbitration, CIETAC decisions involving non-Chinese firms can be registered for enforcement in 80 countries worldwide.

While CIETAC is useful and operates in a recognizably Western style,¹⁵ it has no power of *enforcement*; for that, plaintiffs must apply to the intermediate People's Court in the jurisdiction of the losing party. Whether the court will accept the application or not is another question, one that can start the dispute all over again and dilute the effectiveness of CIETAC's decisions. While a People's Court is not supposed to obstruct the findings of the commission, innumerable delaying tactics can be employed to serve a special interest. Moreover, there is evidence that Chinese courts

13. Paglee (1998) points out that arbitration of contracts governed by Chinese law does not have to take place in China any longer; they can be referred to almost any national jurisdiction. However, if such recourse is in the establishment contract then it must obviously be approved by examining authorities, who might object at the behest of a Chinese partner.

14. See the Shanghai Commission's website at <http://www.china-collection.com/shanghai/ccpit/cietac.htm>.

15. Though unlike its Western equivalents, CIETAC has powers of investigative discovery, or at least can make independent inquiries. See "Arbitration—Refusal to Enforce CIETAC Award in Hong Kong," *Asian Maritime and Trade Newsletter*, April 1997, at <http://www.cliffordchance.com/library> (under "Newsletters").

can reject CIETAC decisions. Paglee (1998) reports cases of Chinese judges finding “fraud” in original venture contract terms that CIETAC did not identify and on that basis reversing decisions, even fining a foreign firm that had prevailed before CIETAC. Similarly, one interviewee (#23) reported the mayor of a major city stepping in and voiding the monetary compensation that a firm had been awarded.

Overall, the interviewees were guardedly optimistic that arbitration was improving, but they believed it imprudent to use arbitration when powerful parties were involved or when the case would attract a lot of attention. These are important reminders that legal institutions for recourse have not fully taken hold and that cronyism can still trump quasi-judicial processes. The most successful cases reported involved disputes with individual employees over contract terms and disagreements with other firms over payments due. In order to make these mechanisms more effective still, Chinese authorities must strengthen the link between CIETAC findings and People’s Court enforcement, and reduce the tendency for arbitrated cases to be effectively reopened by courts or by individual power holders.

Such capriciousness implicitly adds to the transaction costs of operating in China, making necessary more hedging against legal uncertainties, higher rates of return, shorter time horizons for payment, and shorter credit terms. Local authorities perceive clearly the gains from diluting resolution procedures on a case-by-case basis; the invisible costs borne by the system at large are harder to conceive. The central leadership must take responsibility for this waste, just as it must show initiative in stripping special interests of the subsidies they demand from society in the form of tariffs and exemption from social obligations (e.g., not to pollute).

Litigation

Some firms studied had attempted to resolve problems through litigation (##7, 22, 23, 28). The interviewees described cases involving delinquent payments, disputes with employees, consumer complaints, and piracy of intellectual property. Even firms that had succeeded in litigating stressed that they would not attempt to resolve a first-order problem, such as non-fulfillment of contract obligations by the Chinese venture partner, through the courts, seeking instead an administrative remedy in those cases. The cost of litigation in terms of damaged relationships can overwhelm the value of winning a case. Thus a US commercial attaché advised, “You are an idiot if you go to court with a problem. . . . [I]t is a Pyrrhic victory at best” (#45).

The weaknesses of litigation in China are several. One problem is cultural; China does not have a tradition of civil adjudication, and people generally assume that state judgments are rendered based on personal affiliations, not on the case’s objective merits. And as already noted, the

court system suffers from the capacity problems that hobble much of the bureaucracy. Moreover, there is a tendency in the court system to avoid strong positions. Judges rely on a heavy consultative process; rather than deciding cases themselves, they confer with senior colleagues. Lower courts consult with higher courts even in advance of hearing cases. “Judges would rather mediate than adjudicate,” Lubman notes, “because they do not want to risk being overturned. It is a ‘face’ type problem” (remarks to the Asia Society, 19 April 1997). Not surprisingly, litigation proceedings were often characterized as corrupt or arbitrary. Even if one wins a case, decisions can be administratively overturned. And even without a formal reversal, getting the decision against the loser enforced, as in arbitration, is a separate challenge.

In sum, litigation has been of limited utility to FIEs so far, but there already exist islands of legal quality on which investors are trying to build. This is likely to increase in the future as competition to secure higher-value-added investment prompts localities to match the legal steps taken elsewhere in China and around the region. The number and quality of lawyers, judges, and statutes must increase accordingly, and superlegal intervention by agents of state power must be limited. Firms themselves (foreign and domestic) must focus on securing legal recourse instead of concentrating on administrative remedies. All this will take time, but progress is already being made. For example, in a highly publicized case Eli Lilly plans to appeal to China’s Supreme Court to protect its intellectual property rights over the antidepressant Prozac, and other firms will be watching the outcome closely.

Intellectual Property Rights (IPR) Protection

Protecting intellectual property rights involves both legal obligations to the state and legal agreements with private parties. Transfers of foreign technology have been essential to China’s economic reform and development since 1979. Leaders have implicitly and explicitly aimed at promoting technology acquisition as they invited foreign participation in the economy. As discussed, the foreign role has gradually shifted from “cooperate inside, compete outside,” to “compete everywhere.” Firms have cooperated by sharing managerial and process know-how, hard technology, and intangible property such as trademarks. FIEs are still eager to bring technology to China, but more than ever they intend to use it to compete domestically, not just to barter their way to a designated local niche and access to cheap Chinese labor. If Chinese intellectual property and technology protection practices do not keep up with FIE needs, they risk discouraging instead of facilitating FDI.

Management control over the venture is essential to secure control over technology transfer. The Guidelines on foreign investment explicitly state the preferences to be extended to firms that transfer higher technology,

indicating China's degree of willingness by sector to cede independence to the potential FIE in order to assuage concerns about piracy. Once again, pressure can be applied on foreigners not only during the process of establishing the venture but also when a firm seeks new approvals down the road—to recapitalize the venture, for example. The rise in applications for the use of wholly owned foreign enterprise (WFOE) investment structures in recent years reflects—in part—foreign investors' awareness that good intentions are no match for proprietary control. Chinese central authorities are aware that permitting WOFEs is the price to be paid for encouraging the transfer of more sophisticated technology.

Chapter 2 described in detail the trade-offs and characteristics of the establishment negotiation. The point was made that usually the first priority of a potential investor can be achieved by compromising on other goals; thus if control over management, including technology policy, were the first priority of a potential investor, then other goals could be compromised in order to achieve it.

Expatriates also report, however, that China's technology regimes are not always strictly enforced. The definition of a "high-technology firm" that qualifies for certain incentives such as preferential tax rates is often liberally interpreted (especially by local authorities, but also by central authorities when a powerful patron intercedes on a venture's behalf). A related point is that the "substantial transformation" of imports needed for them to be considered domestic manufactures often involves lower levels of technology than strictly required. Generally, technology transfer obligations are negotiable.

Bureaucratic pressure to transfer technology is less critical in a firm's overall decision to employ sophisticated machinery in China than is sometimes thought; sometimes more important is the need to raise productivity by raising the level of technology, as discussed in chapters 4 and 5. Effective use of higher technology also requires transfers of soft technology as well as increased capacity to train the labor force that will employ the new machinery. Such innovations require time, and tensions remain widespread between authorities intent on compelling the introduction of higher-tech goods and expatriate managers attuned to the limits of Chinese firms and workers not yet able to put them to effective use. Chinese partners and authorities, often suspecting that foreign firms seek to utilize outdated technologies in China, automatically press for increased transfers as a matter of course, without clearly understanding what they are asking for. As a result, FIE managers observe that technology sometimes goes underused, misapplied and mismatched to China's level of development and thus to the country's needs.

When there is not effective foreign control over the venture, the Chinese partners often share foreign technologies with research institutes designed for reverse engineering. In many firms, this seems to be accepted as the trade-off for access to the domestic market. Some interviewees con-

fided they understood well before the transfer that their technology would be effectively pirated as a result of their bringing it to China. Thus they simply avoided bringing “the crown jewels” to China (#22). Others reported that those responsible for negotiating the technology transfer contract had no idea what they were doing (#20), failing to secure control over technology. Several interviewees (at the factory level) therefore held their firms to blame for many subsequent IPR problems. Another error cited was not checking the backgrounds of Chinese staff with access to sensitive materials. In some cases, other overseas units of the same firm were selling sensitive materials of great use to Chinese competitors directly into China, with no controls, even while the FIE in China was trying to protect the same technology (e.g., the JV manufacturing telecommunications equipment that was discussed in chapter 4).

In their attempts to protect IPR, several firms had explored the utility of formal legal remedies, but most still rely somewhat more heavily on administrative solutions—that is, getting Chinese friends in power to threaten the offenders. The cases described involved trademark and trade name infringement, patent infringement, and wholesale misappropriation of proprietary registered technology by Chinese state companies via technical institutes. Other technology-related problems included trade secrets, industrial designs, and copyright.

Legal recourse was described as a last resort, though it is increasingly tried. Typically, authorities encourage FIEs to approach violators directly and try to negotiate a settlement: for example, by licensing them or making them subcontractors. This appears to be one function of the conciliation and mediation services described in the previous section. FIEs are reluctant to cut deals on these terms; after all, in their view the offender’s actions were criminal. Furthermore, a real, contract-oriented commercial disagreement suitable for arbitration seems rarely at issue. Most reported cases involved unrelated parties simply pirating tangible or intangible FIE property. After exhausting mediation avenues (undertaken earnestly or halfheartedly), FIEs have been able with great effort to compel some governmental responses. In some cases, such as the 1995 confrontation over recording products, foreign government pressure has been directly enlisted to force action.¹⁶

Several interviewees maintained that when an FIE is willing to commit itself to making enforcement a first priority, the firm has a good chance of getting satisfaction. FIEs cannot count on regimes to protect them in the absence of strong external pressure on local enforcement authorities, from allies in central and provincial government, and from local power bases. Trademark and trade name infringement and local smear cam-

16. The China head of one large American chemicals company made the point that he would never ask the US government for help with a trademark problem. He believed that Chinese resentment and American clumsiness would lead to more harm than good (#16).

paigns received significant attention from interviewees—more, generally speaking, than “hard” technology issues. For several firms, the rare instances in which they had employed the legal system involved trademark infringement. An illustrative case involved a Chinese start-up firm imitating the trademark of a major US household durables manufacturer. The FIE went through MOFTEC’s Business Administration Bureau to stop the infringement and have the pirate’s license revoked. The most telling comment came from the FIE’s Asia Pacific director: “We don’t care about the technology. The barriers to entry in this industry are next to nothing. It was the use of *our name* that irked us” (#25). Reputation can be forever. Trademarks must be defended not because a fly-by-night firm can make money by using an FIE’s name for a short while but because as shoddy knockoffs circulate in a market, that name will be damaged.

Thus, the issue of the scope of business arises again. Marketing, sales, and service at the end of the distribution process are points at which IPR violations can be identified, and they are all functions from which FIEs are formally and informally barred—which is clearly frustrating. Several firms complained about Chinese staff breaking away from the venture to establish service businesses offering maintenance of the FIE’s products under its name, but not its management, at cut-rate prices. Though FIEs do often participate in after-sales markets through a not illegal but not clearly endorsed organizational stratagem, the ambiguity of their position can leave them at a disadvantage should they wish to contest infringements. Ultimately, only by participating fully in these business activities will firms be able to protect their IPR.

Corruption

“Corruption” is a generic term for a wide array of issues dealt with by foreign enterprises in developing markets such as China. It might encompass bribery, theft, bid rigging, intellectual piracy, and coercive collection engaged in by private parties, public officials at any level, or expatriate businessmen and firms. The universe of the *possibly* corrupt ranges from the clearly corrupt (bribes to get customs duties lowered) to the likely corrupt (“rep fees” to facilitate large government procurement contracts) to the murky (gift giving and extravagant entertainment for official customers or children of high-level officials). FIEs vary tremendously in their attitudes about the ethicality of corrupt practices in developing China. There is no question, however, that many common practices would be judged illegal in Europe or the United States; indeed, many would be so judged in China were the country’s own law better enforced.

The greatest share of comments on this subject concerned bribery and bribery-related activities affecting sales and approvals. A significant num-

ber of managers bemoaned “consultancies” used as avenues for FIEs to make payments that would be difficult to justify openly; in other words, they sanitized bribes. A case in Wuhan involved purported tax problems discovered with an FIE’s value-added tax (VAT) documentation. The problem could be resolved by a consultant paid a fee of 20,000 RMB and put on the firm’s staff at 6,000 RMB per year to ensure the firm “doesn’t make similar mistakes in the future” (#26). The alternative was a potential fine for tax fraud of up to 3 million RMB. The manager of this venture remarked that he generally tried to resist such demands, which are common, but would negotiate this one down to a onetime 6,000 RMB payment to avoid trouble.¹⁷ During an afternoon meeting at the Wuhan Foreign Direct Investment Administration, ostensibly an ally of FIEs in such disputes, the director promised to find out whether the case “had merit.” Such attempts at extortion arise constantly, however, and cannot be aired out with high-level contacts every time. Expatriates save administrative recourse for the more important cases, and either pay up or take their chances ignoring the smaller ones.

Another interviewee complained that the firm’s competitors funneled bribes through “nongovernment organizations” to influence bidding—never openly and directly to officials (#4). Yet another noted that as he attempted to get his product onto the official list of merchandise that hospitals were permitted to purchase, he was pressured to buy help from advisors to a provincial Ministry of Health (#7). A factory manager in Shenzhen reported paying \$145 a kilogram for an imported input instead of \$85 (his estimation of the correct cost including duty) because the Customs Administration was miscategorizing it into a higher tariff class. For the time being, he was paying so that his production line might keep running. The solution proposed to him: a consulting report on whether the rate ought to be lower, to be drafted by friends of the customs authorities (#19). Another interviewee, in Shanghai, who had to purchase “fire-testing equipment” from friends of the fire inspectors, complained that “every watchdog authority has its own consulting firm” (#33).

The manager of a major telecommunications joint venture in southern China explained the nuances of properly funneling money to a customer after the purchase (“a perfectly legal rebate”) versus a payment before the purchase (“a bribe, illegal”) (#20). Such ambiguity is the *modus operandi* among FIEs today: the key is to legitimize practices that would be considered plainly corrupt at home, because otherwise it would be impossible to operate in China at all. In this case the “rebates” were 3 percent of

17. The business literature is full of these stories. For example, the EIU’s *Business China* (4 August 1997, 2) recounts the tale of a Shanghai office building constructed by foreign investors. They were compelled to buy 24 fire doors for their facility from a subsidiary of the Shanghai Fire Department. They proceeded to throw these away and purchase another set from a reputable foreign manufacturer.

the sales price—a not inconsiderable expense in an industry in which overcapacity has already cut profit margins to a minimum; but managers act as though there is little alternative.

Rep fees are widespread. Payments are generally made through “black accounts” that are not registered to the FIEs, and local partners or compradors handle these transactions. American firms in particular are well versed in skirting legality, as violation of the Foreign Corrupt Practices Act (FCPA) can cause them trouble at home. The president of Asia Pacific operations for a big American manufacturer stated:

Any formal sales reps must sign our FCPA documentation. There are very few of those, though, usually only attached to a big deal. Dealers [who handle most sales and service] are independent businessmen. We don't have control over their business behavior. We try to explain to them the long-term value of the FCPA, but we are not convinced that China is going to have the same ethics and values as us. Plus, we don't see much risk from exposure [of these practices] here. (#25)

Overall, the managers interviewed seemed more concerned about avoiding a reputation as a firm that could be easily shaken down for payoffs than about compliance with home-country anticorruption statutes such as the FCPA. A regime imposed from abroad and aimed at bribery is likely to have little effect over and above the inherent logic among firms to avoid corruption. In fact, several American managers even pointed to the FCPA as a useful excuse to promote anticorruption objectives within their firms, though they did not perceive it as a serious compliance threat.

Some interviewees tempered the general indictment of corruption in China, making two main points. First, some suggested that the corruption problems were more payee driven than official (#4). “Foreigners are often the worst,” this executive reported, noting that most of the bribery he hears about comes from competitors trying to sway the bidding for large projects. The other main contrarian argument posits a valuable role for illegality. “There is corruption here, but that needs to be defined in clearer terms. It can be an implicit pricing mechanism; sometimes corruption is useful” (#5). In this view, the market remains so distorted in China (in terms of prices, waiting times for approvals, salaries, and the like) that including corruption brings the costs closer to the real value of goods and services than would otherwise be the case. This is an intriguing possibility and certainly there is evidence for it, such as the movement of exchange rates toward the black-market precursor to the “swap rate” in 1994. Basu and Li (1994) have argued that corruption can serve to “buy out” entrenched bureaucracies that would otherwise impede progress, for example.

Kim Elliott's *Corruption and the Global Economy* (1997) brought together diverse essays on the corruption phenomenon. Several suggest that despite the obvious severity of corrupt practices in a market such as China's, there are several reasons to temper efforts to make this issue a concern of multilateral economic forums such as the WTO. As Rodrik (1997a) notes,

first, the corporate use of campaign contributions in many industrialized nations to gain access to key leaders in a position to help companies secure contracts and licenses is too similar to some corrupt developing-world practices to permit comfortable finger-pointing. Second, Rodrik observes that corruption problems affect domestic firms no less than foreign ones, thereby undercutting the argument that corruption denies FIEs the spirit of national treatment (the letter of the principle, to date, applies only to traded products, not investment). Third, he fears that admission of corruption as a legitimate area for multilateral intercession would naturally lead to activism on issues such as (for example) labor standards, which share the deep social roots of corruption problems and which in China would prove equally intractable at this juncture.

Rauch (1997), in a companion paper, explores corruption's roots in bureaucratic processes. His evidence suggests a relationship between bureaucratic structure and outcomes in bureaucratic performance. The argument complements the present study, which identifies transitional factors that are less amenable to foreign policy pressure and thus should not be targeted in negotiations with Chinese leaders. China is rife with influence peddling by officials below the national level who are embedded in a structure that nurtures corruption; thus, only political reforms from within China, not foreign pressure, can accelerate anticorruption reforms. As FIEs act increasingly like "Chinese" companies, they will have a bigger role in fostering change. The commercial logic of avoiding corruption should eventually translate into pressure for stronger anticorruption strategies domestically.

Superlegal Privileges

Inseparable from a discussion of rights and obligations in China's legal system are the privileges and perks conferred outside the law. Most foreign enterprises support efforts to promote the rule of law in China, in a manner that will secure their business and investment. Few if any, however, are keen to see withdrawn the special incentives, advantages, exemptions, and entitlements that they have won. Such patronage is the major currency of politics in China today, as it has been historically. In fact, often expatriates describe with pride the friendships and special dispensations they have secured for their firms in China. Few see the irony in bragging about connections right after railing against corruption and cronyism.

Four kinds of superlegal privilege, examined below, emerged from the interviews: failure to enforce laws, deliberate failure to reform laws, patron-client protection, and market share allocation. Because these privileges are informal and nontransparent, they can be withdrawn arbitrarily—a possibility that must be figured into an estimation of their value; but on balance they greatly enhance an FIE's standing.

The most frequently described upside of China's incomplete legal environment was spotty or absent enforcement of laws and regulations, as frequently shown in earlier chapters. One cannot simply take the letter of the law as a guide to the fortunes of foreign firms. Failing to enforce laws is not the same thing as rescinding onerous or discriminatory regulations. Hazards abound when firms must rely on the favor of authorities who look the other way.

Since reforms began in 1979, Chinese law has been refashioned and upgraded in bits and pieces. Along the way, many foreign firms managed to secure rights that exceeded those available by law or those enjoyed by other firms. Some foreign retailers, for example, have been able to open operations that regulations seem to ban; and many incumbent firms operate for years while their competitors fail to secure licenses.

Incumbent firms often have an incentive to counteract the reforming instincts of the central authorities, and their incumbency usually provides the flow of cash needed to express their preference. While reform might lead to regulations applied uniformly—making administration more efficient and equitable and expanding competition to enhance aggregate economic welfare—existing firms may prefer the status quo. Perhaps they seek special provisions grandfathering in their privileges, or perhaps they wish to block the changes altogether. In either case, the result is at odds with reform. As the treasury liaison to Beijing from one OECD trading partner sympathetically noted:

The incumbents see enforcement of the law as unfair. But it's understandable that China's leaders should try to tighten [compliance]. They need to build up infrastructure, and that will take [better tax collection efficiency], and that will mean cracking down on loosely treated firms. (#50)

The overseeing authority to which a firm is responsible can be a powerful ally in China. Interviewees reported gaining major increases in production quotas (#32, helped by certain development zone authorities), favorable changes in duty rates (#26, assisted by an office in interior China promoting foreign investment),¹⁸ suppression of local rent seeking (#13), acceleration of payments (#15), and allocation of market share (##20, 33). A very important service that patrons provide is directing investors toward viable commercial opportunities, for they know where the sale is not already tacitly earmarked for someone else's favorite. In this way, they save the FIE "immeasurable time" (#25). Patrons can help see to it

18. Naughton (1996a, table 3) calculated that during the first half of 1996 the rate of imports coming in under concessionary terms exceeded 61 percent: i.e., only 39 percent of all imports ended up paying any duty at all. Moreover, the value of customs duties actually collected as a percentage of the value of imports (which does not include smuggled imports, surely a not insignificant addition) had sunk to 4 percent (table 4). The spread between these numbers raises many questions. Clearly, however, patrons play a very important role in getting clients exempted from import duties.

that the “right” interpretations of the law or implementing regulations are made (#28). In short, “You are bound to have nontransparency if you don’t have relationships” (#36).

Several interviewees felt that finding the right patron (or patrons, as both central and local connections are important) was the single most critical determinant of the success of the venture. Not surprisingly, then, several market entry consultants had some advice on the art of picking a patron wisely: consider as a joint venture partner an entity related to the People’s Liberation Army (#88). In exchange for a share of profits and perhaps other fees, such a high-status silent partner might be an excellent aid to getting approvals, moving products through customs quickly, and collecting accounts due. While one applauds the creativity of entrepreneurs who cut through red tape, the potential for effective immunity of large segments of the economy from central regulatory authority is troubling, both for commercial and for national security reasons. In addition, patrons ask for as much as they provide, a truth that has somehow surprised many FIEs in recent years. More study needs to be done on how a patron-client relationship that can so boost the FIE’s legal standing in early years evolves over time, and on whether there is such a thing as graduating to independence from under the patron’s wing.

The habit of doling out favors or enticing special investors with allocated market shares threatens to distort market structure and thus diminish the competitiveness of an economy. It is the antithesis of the culture of fair competition that reformers are advocating. While its extreme form consists of direct, nontransparent assignment of sales volumes, markets can also be allocated by discriminating among firms in terms of the rights they are granted to expand their scope or scale of operations.

Analysis

Some Observations

Several conclusions flow from this discussion. First, it must be acknowledged that to date, the volume of foreign investment flowing into China has been so significant that it seems to put in question certain presumptions about advanced legal regimes being essential. Either the flows of FDI into China are not typical of what is expected, or the investment environment in China is not as chaotic as sometimes suggested—or both, which in fact is the case. The biggest contributors to China’s FDI have been ethnic Chinese with close ties to China and a strong, patriotic desire to contribute to the mainland’s development. Increasingly, however, investors from dissimilar cultures whose profit-maximizing intentions have little personal basis have invested in China; thus the nature of the money flowing into the country is becoming less exceptional. In addition, this

chapter has described numerous ways in which FIEs pursue predictability for their investment and seek recourse when they have problems. China's reputation for capriciousness somewhat exceeds the reality.¹⁹

Thus the vitality of commerce in the People's Republic and the volume of FDI flowing in indicate that China's legal system deficiencies do not fatally impede investment. Nor is it clear that better legal regimes would lead to still more commerce; the prodigious rush to invest in China is due in part to foreigners' fear—discussed here and in chapter 2—that the inadequate legal system could permit those who enter early to secure unassailable positions in the Chinese market. The extent of superlegal privileges lends credence to those concerns. The presence of a Western-style legal system might have inclined FIEs to pace their entrance to China more carefully. Such a system probably also would have afforded greater opportunities for entrenched domestic interests to launch temporary restraints against new competition.

While the effects of China's inadequate legal regime on FDI volume are thus murky, its effects on transaction costs are clear: they are higher wherever predictability and redress are absent. Shang-Jin Wei (1997) calculates that an increase in corruption from the level existing in Singapore to that common in Mexico implies an added "tax" of over 20 percent and that such costs are just as detrimental to East Asian economies such as China's. One example is the opportunity cost of constant schmoozing to secure the relationships needed to guard one's business. Inadequate legal regimes mean less efficient markets than otherwise might exist, as the pricing needed to cover transactional problems adds costs for all consumers (just as a surge in car insurance fraud in the United States adds marginally to everyone's insurance bill).

Second, the legal tactics that FIEs employ in China—even if they approximate Western regimes in the predictability they offer—remain an exotic variant on OECD-nurtured norms. As such, they raise ethical and commercial questions. They make it difficult to integrate China-based operations with global units (and thus to rotate talent through China to build an international corps). That the local marketplace functions in this exceptional manner will also hamper indigenous businesses as they expand abroad, as well as regulators who seek to participate more actively in international economic rule-making forums.

The third conclusion runs counter to the second: a renaissance of jurisprudence is taking place in China, and the trend is convergence toward international standards. The capacity of and interest in the mediation, arbitration, and litigation systems have grown considerably over a rela-

19. A significant share of total FDI into China is either money that is funneled out and then back into the country to qualify for incentives and letters of credit or earnings that are retained and reinvested by FIEs in China, in part because they fear being seen to "extract" too much from China's developing marketplace.

tively short period of time. Foreign (and domestic) enterprises are testing these new avenues with increasing boldness. Some are finding that the threat of such proceedings alone is sufficient to compel settlement of cases out of court. It is possible that a functioning legal system will be in place in just a few more years.²⁰ While providing the training and building the capacity needed are huge tasks, many foreign firms are already leading the way.

Fourth, while some foreign governments (especially the United States) have ceaselessly called for the rule of law in their negotiations with China, foreign firms cultivate special relationships and deals with government entities at all levels. A conflict will remain for some time between the desire of foreign governments to support the short-term needs of their firms, even if that means embracing superlegal privileges, and the need to support rollback of these privileges so that a reliance on impersonal law can emerge over the long term.

One final observation is that rising prosperity is connected to broad societal change, including legal reform. A number of interviewees stressed that they did not expect significant legal changes until China grows wealthier. More wealth creates more transactions among firms, individuals, and governments. The need to resolve natural conflicts over transactions leads to greater interest in rule of law; thus the WTO will be needed to mediate the conflicts between China and its trading partners as the volume of trade continues to swell. Similarly, as people acquire greater material security and property, they become more concerned with protecting it; insulated from a primary preoccupation with shelter and food, they are able to focus on more abstract goods, such as “fairness.”

As per capita GDP exceeds about \$5,000, environmental pollution tends to fall off: unbridled growth appears less desirable than cleaner air and water (Grossman and Krueger 1993). Change is also driven by economic forces in the legal sphere, as a senior banker in Hong Kong pointed out: no matter how the Chinese government officials feel about a more or a less liberal legal system, the imperatives of commerce will leave them with no choice. “The legal system needs to be more efficient at serving business. That is a practical matter, not an ideological one” (#51).

Some political scientists point out that this progression need not *necessarily* take place. For example, Pearson (1997) presents evidence that new middle classes in Latin America and in East Asia have tended not to build democracy or rule of law. Rather, they often support authoritarian rulers who keep labor docile and emphasize stability that makes possible further economic growth. Pearson finds similarities between China and these nations. The newly rich urban Chinese may be more interested in

20. That is, a legal system offering commercial predictability and recourse. Reforming laws and legal structures to provide *civil rights* 27

traditional clientism and collusion with ruling officials than in legal and democratic reforms.

But growing per capita income in China undoubtedly is helping to bring faster legal and political reform; indeed, it is widely believed by expatriates to be sufficient for effecting such changes. This view has become the standard wisdom among US policymakers as well. For example, in her testimony to the Senate Finance Committee on China's most favored nation (MFN) status (10 June 1997), Secretary of State Madeleine Albright argued that

economic openness can create conditions that brave men and women dedicated to freedom can take advantage of to seek change. It diminishes the arbitrary power of the state over the day to day lives of its people. It strengthens the demand for the rule of law. It raises popular expectations. And it exposes millions of people to the simple, powerful idea that a better way of life is possible.

Such logic has been central to the decision to extend MFN to China despite ongoing value-laden disagreements on matters such as human rights and intellectual property. Prosperity, the US Congress has concluded consistently, is the best way to transplant values. For European and Japanese foreign policymakers, this truth has been self-evident; they find no need for grueling and divisive annual debates on the matter.

Transitional and Self-Imposed Factors in Legal Regimes

There is an important transitional aspect to the general evolution of China's legal system. As the country grows richer and market transactions become more prevalent, the need for a more mature legal regime will grow as well. Six of the eleven themes discussed in this chapter possessed a transitional aspect: securing predictability and ensuring compliance, bridging gaps in the law, interpreting ambiguous laws and regulations, contributing to capacity building, and dealing with corruption (see table 6.1). While these issues are shaped by policy, no amount of good governance could have averted them entirely. In fact, given the near total absence of a legal framework at the start of reforms, the achievements thus far—though incomplete—are fairly impressive. If further progress is made at the same pace, investors will not be disappointed.

The evolution of dispute resolution and litigation mechanisms is in part a transitional matter as well. Recruiting, training, overseeing, and managing the armies of civil servants required to meet China's need to provide legal recourse will take many decades. The enormity of this task—the size of the market to be managed and the rapid pace of change—also limits the ability of the Chinese leadership to address corruption. Of course, Chinese authorities are ultimately responsible for the nation's regular position at the bottom of qualitative indices of commercial environ-

Table 6.1 Roundup of issues: law

Issue	Category	If policy . . .	
		Level	Priority
Access to content of laws	Policy	Central, provincial, local	Low-medium
Bridging gaps in the law	Transitional, policy	Central, provincial	Medium
Interpreting the law to advantage	Transitional, policy, self	Central, provincial, local	High
Building bureaucratic capacity	Transitional, self		
Environmental and labor compliance	Policy, self	Central, provincial, local	Low-medium
Structuring contracts	Policy, self	Central, provincial, local	Medium
Conflict resolution	Policy, self, transitional	Central, provincial, local	Low
Litigation	Policy, self, transitional	Central, provincial, local	Low
Protecting intellectual property	Policy, self	Central, provincial, local	Medium
Moderating corruption concerns	Policy, self, Transitional	Central, provincial, local	Medium
Securing superlegal privileges	Policy, self, market structure	Central, provincial, local	Medium-high

ment; but any regime would find it difficult to deal with these issues during a period of reform.

In the legal realm, as elsewhere, FIEs are not powerless and passive units merely acted on by forces beyond their control; their own choices affect their experiences in important ways. As they interpret laws to legitimate activities, build bureaucratic capacity, and devise strategies for managing compliance with volatile regulatory areas (especially environment and labor issues), foreign investors make their own beds. Each of the recourse-oriented factors considered here—structuring contracts; using mediation, arbitration, and litigation; and protecting intellectual property rights—is partially attributable to choices that firms make about how litigious to be. Conversely, firms are willing, even eager, to embrace superlegal privileges in order to secure the recourse and predictability (not to mention commercial advantages) that they require. Such willingness undercuts efforts to strengthen the rule of law in China, as firms with informal sources of protection grow reluctant to trade them for the promise of formal reforms to come. Their reluctance is ultimately short-sighted, however; as previous chapters have shown, the decision to sacrifice latitude

for administrative comity is returning to haunt many firms now keen to expand the scope of their operations, often years after they initiated their partnerships.

That there is a self-imposed element to FIEs' corruption concerns may be the most controversial observation of this study, at least from the perspective of the firms that took part. Some managers vehemently insist that any active role of European or American firms is dwarfed in importance by the indigenous factors. If one views the marketplace as a whole, they are largely correct, if for no other reason than the still-small size of foreign involvement in China in absolute terms. However, focusing on the limited regions where FIEs still spend most of their energies, one finds that foreign investors have an important impact. They must daily either consent to or reject corrupt practices, petty or grave—and they display a range of possible responses. While not automatically passing judgment on practices that would be condemned in a developed economy, one must note that FIEs have choices to make and that some of these choices can contribute to the cloud of corruption often observed to hang over China's commercial environment.

Policy and Market Structure Factors

Aside from the area of building bureaucratic capacity, in which FIEs take a proactive role, every issue in this chapter is shaped by Chinese government policy. From the most general issues such as passing new laws and enabling a soft political landing through gradual legal liberalization to detailed management of the use of arbitration boards, the plans of leaders, national to local, shape the legal environment. But just as important, in all cases but one policy variables are not alone in determining the legal problems that FIEs confront. The areas of highest concern for most firms appear to involve interpreting the law most advantageously and securing the superlegal privileges that undergird their operations: these do not exactly constitute a rousing call for help from foreign governments to push for the rule of law in China.

The influence of Chinese policy on the legal dimension of commercial activities in China differs in character for FIEs and for domestic firms on its face. Yet these conditions are not necessarily more onerous for foreign firms than for domestic ones. In fact, the foreign sector generally enjoys superior protection in terms of contract enforceability and other elements of commercial law, presenting an interesting case for future WTO consideration. The huge flows of FDI into China in recent years must also be taken into account: apparently, firms are satisfied with the level of predictability and recourse they can secure, despite the lack of formal legal rights.

This view of the policy dimension may temper attacks on the quality of reforms of Chinese commercial law, but the tendency to base the system on superlegal privileges implies market structure problems that cannot be

taken lightly. Governments at all levels in China have relied heavily on incentives to attract foreign investors, offering a basket of privileges that directly or indirectly provide preferential access to markets, or even allocate market shares. By design or by accident (and inefficiency), segmented markets are generally far from airtight; that is, there is generally a level of competition in China not characteristic of tightly controlled marketplaces, though fair contestability is clearly not the norm either. With each year that privilege rather than real legal reform is relied on, however, the picture stands to deteriorate: anticompetitive rights will tend to be bought by firms, and consumers and others who will suffer from collusive or monopolistic behavior will be unable to appeal through a legal system. Contemplating that possibility, China's seniormost leaders, Western officials, and expatriates alike may find it advantageous to make common cause.

