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Contract With A Chinese Face: Socially Embedded Factors In The Transformation From Hierarchy To Market, 1978-1989

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This article examines how contract law came to play an important new role in the organization of the Chinese economy during the decade of reform in the People's Republic of China ("PRC"), 1978-1989. Crucial to the movement for reform was the effort to create new institutions to expand, regulate, and channel economic transactions. These institutions were designed to complement centralized planning as the basic means of allocating goods and services. They emphasized limitation and decentralization of planning decisions, the creation of economic incentives, and the increased responsibility of economic actors for the consequences of their actions. These new institutions were introduced in response to a variety of organizational problems in agriculture, industry, and commerce. Nonetheless, they shared common features: the responses in all cases emphasized notions of contract, the legal responsibility of economic actors to perform their agreements, and the value of individual autonomy in setting the terms of economic transactions and relationships.

This article is the product of seven years of joint observation by a China-born sociologist, who has interests in migration and the

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transfer of people and ideas among cultures, and a New York-born law professor with an interest in contract and trade law. With the help of Chinese friends and collaborators, we began in 1985 to focus on the growth of contract law and related institutions in Shanghai. Through the generosity of a group of lawyers, teachers, judges, scholars, and administrators, under the leadership of the Shanghai Faxue Hui (Shanghai Jurisprudence Association), we were permitted to conduct several series of interviews during 1985 and 1986 of participants in every phase of the contract law process in Shanghai. Our observations and interviews were supplemented in another large Chinese city, Tianjin, during a sabbatical leave visit in 1987.[1] We make no pretence of having a comprehensive understanding of how things are done everywhere in China, although we strongly suspect that no single system is found everywhere. Certainly we will never be able to encompass all of China in a teacup.

The roots of contract law — cooperative economic agreements, binding promises, and sanctions enforced judicially and socially on failures to perform — can be found deep in the Chinese experience.[2] Contract played a role in China's socialist economic organization before reform began in 1978. The decade of reform has transformed these aspects of the Chinese experience, however, producing something different. It is this phenomenon that deserves examination in this paper. We write this article with several distinct audiences in mind. Much of what we have to say here will be familiar to some readers. We apologize to those readers who find parts of our story too well-known or who may find our introductions to some legal concepts rather elementary. We urge these readers to move on quickly to more

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1. Although we cannot list all of the informants who over the years have contributed to our information, we are especially grateful to President Xu Panqiu and our colleagues at the Huadong Zhengfa Xueyuan [Eastern China Institute of Politics and Law], and the Shanghai Faxue Hui [Shanghai Jurisprudence Assoc.]; our colleagues at Nankai University, the Tianjin Shehui Kexue Yuan [Tianjin Academy of Social Sciences], and the Tianjin Shangye Daxue [Tianjin Business University]; Dean Zheng Duanmu and our friends at Zhongshan Daxue [Central Mountain University], Guangzhou; Xiong Jining and friends at Zhongguo Zhengfa Daxue [Law and Politics University of China] and Jingji Gaige Yanjiu Suo [Economic Reform Institute] in Beijing. We sincerely appreciate the detailed critical readings of our manuscript by our friends, Professors William Alford, Stanley Lubman, Mark Ramseyer, and Hugh Scogin. We have been heavily dependent on a superb group of research assistants and the financial and moral support of CLEEC, the UCLA Law Faculty Dean's Fund, the University of California Systemwide Pacific Rim Grant, the UCLA Law Faculty Colloquium, the UCLA Workshop on Pacific Rim Legal Studies and the Harvard Law School East Asian Law Workshop.

2. Professor Hugh Scogin traces the roots of contract in the Han Dynasty and promises in future articles to carry the story forward to the Song and later dynasties. Hugh T. Scogin, *Between Heaven and Man*, 63 S. CAL. L. REV. 1325 (1990).

interesting material; this is the price we pay for trying to present an analysis that attempts to transcend disciplinary lines.

Part One of this paper introduces the limited role of contract law in the PRC before 1978. We look at traditional Chinese social and economic organization and the institutions that served as alternatives to contract law, particularly the reliance on networks of relationships, connections, and influence outside state structures summed up in the nontranslatable Chinese term, *guanxi*.[3] We also will examine the structures of socialist economic planning and the use of contract in the service of planning prior to the period of reform.

Part Two traces the emergence of contract law in China since 1978, its motivations, and major features. Contract law depends on supporting institutions — the existence of legal rules, courts or other adjudicative agencies — and the availability of large numbers of professionals to make contracts and to deal with disputes as they arise.

Parts Three and Four turn to two central issues that we rely upon as prime examples of contract law's social embeddedness. In Part Three we look at the question of legal personality in China: who gets to make a contract with whom. In Part Four we consider the remedial dimension that distinguishes an agreement from a contract. A contract is a legally enforceable promise, and any discussion of legal enforcement must turn to the process of dispute resolution and the influences that shape it. Finally, in Part Five we sum up our views of contracts with a Chinese face and attempt to place in perspective the experience of a decade of reform.

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Beginning with agricultural reform late in the 1970s and continuing through industrial and commercial reform during the 1980s, Chinese

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3. The significance of *guanxi* or social relationships in Chinese society before the establishment of the PRC has been noted by a number of anthropologists, for example, Fei Xiaotong. *Guanxi* differs in several important respects from the social networks observable in many Western cultures, including contemporary America. *Guanxi* linkages are always dyadic and hierarchically ranked in relation to ego. Moreover, the relationship is maintained primarily by specific personal obligations based on norms of reciprocity. *See* FROM THE SOIL: FOUNDATIONS OF CHINESE SOCIETY AS VIEWED BY FEI XIAOTONG, Introduction (Gary Hamilton & Wang Zheng trans., forthcoming 1992) [hereinafter FROM THE SOIL]. In contrast, a Western network (say the familiar "old boys network") is likely to be polycentric, based on relative equality of the members, dependent on voluntaristic choice of its members for its perpetuation, and less dependent on specific and transactional reciprocity. For an excellent recent discussion of *guanxi* and its continued importance in the PRC, see Mayfair Mei-hui Yang, *The Gift Economy and State Power in China*, 31 COMP. STUD. IN SOC'Y AND HIST. 25 (1989).

leaders sought to replace one type of organization — that of transactions and enterprises based on hierarchical commands — with an organization based on agreements between somewhat equally empowered actors. The leadership also sought to provide a bigger role for local, as opposed to central or national, management and control of the economic sector involved. The tension between local and central that typifies so many aspects of Chinese life persisted, but the reformers consistently sided with the decentralization of control, attempting to replace central command with horizontal relationships said to be based on the agreement between the economic actors, rather than the command of a superior authority.

The emphasis on contractual responsibility was created by the Chinese leadership to enhance the opportunities and incentives for economic enterprise. This apparent connection between contract and production is evidenced by the reorganization of rural agricultural production in the late 1970s and factory management agreements in the mid-1980s. In the first case, the government allowed rural households, by contract with the collective or the state, to assume responsibility for the use of land and other assets, and for the attainment of production goals. In the second instance, responsibility for management of industrial enterprises devolved from supervisory governmental and Communist Party ("Party") departments to the enterprises' managers, who agreed, again by contract, to meet set production goals. The managers were given incentives to increase production and efficiency in the form of bonuses, authority to sell production in excess of quotas, and limited discretion to innovate in operations. Contract was also used to transfer unprofitable state enterprises from one governmental unit to another in order to consolidate, invigorate, or sometimes, apparently, to liquidate the underperforming enterprise.[4] The impact of these changes has been undercut by continued reliance on planning in significant sectors of the economy and by the conversion of planning administration into negotiations between officials and managers on the amount of taxes the enterprise will pay.

At the same time, the need for hard currency and advanced technology led to a new emphasis on foreign trade and investment.

4. The process of industrial reform in China has been described from a variety of disciplinary perspectives: *see, e.g.*, CHINA'S INDUSTRIAL REFORM (Gene Tidrick & Chen Jiyuan eds., 1987); THE POLITICAL ECONOMY OF REFORM IN POST-MAO CHINA (Elizabeth J. Perry & Christine Wong eds., 1985) [hereinafter POLITICAL ECONOMY OF REFORM]; TRANSFORMING CHINA'S ECONOMY IN THE EIGHTIES: VOLUME II: MANAGEMENT, INDUSTRY AND THE URBAN ECONOMY (Stephan Feuchtwang et al. eds., 1988); EZRA VOGEL, ONE STEP AHEAD IN CHINA: GUANGDONG UNDER REFORM (1989).

This in turn demanded the adoption of contract forms that would enable these transactions to be put into a framework acceptable to a foreign partner. Agreements in domestic transactions also were transformed from their limited role as administrative instruments of planning into a central role in exchange by contract.[5]

The Economic Contract Law was the product of a rapid evolution that by 1981 was ready to supplement interagency administration of transactions between state enterprises with a legal system based on contract. The allocation of resources by planning order was to some extent displaced by allocation through trade initiated by enterprise managers, rather than by administrative supervisors. These uses of contract were matched by a growing institutional framework: economic contract law; the beginnings of a civil code that would recognize the general enforceability of consensual obligations; new civil courts and innovative adaptations of other enforcing agencies; and recruitment, training, and professionalization of notaries, lawyers, and legal advisors. All of these steps to create a legal infrastructure proceeded at a rapid pace; nonetheless, the institutions remain weak. For example, courts are subservient to the local government and Party organs to which they are attached.[6] The codes are incomplete and confusing. The proportion of trained personnel remains low. Public expectations of the capacities of these institutions for objective expertise are justifiably modest.

Remarkably, these changes were introduced primarily by state command in a social and economic setting where contract law and institutions previously had been extraordinarily weak or absent. We still do not know the details of the reformers' motivations during the crucial period when power was transferred from Mao Zedong during the mid-1970s. The thoughts and internal discussions of the Chinese leadership remain quite opaque to outsiders. It is clear, however, that the specific content of Chinese economic reform in commerce and industry was dictated from the top levels of government and Party and

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5. Zhonghua Renmin Gongheguo Jingji Hetong Fa [The Economic Contract Law of the People's Republic of China] (adopted Dec. 13, 1982), arts. 17-26 [hereinafter the Economic Contract Law or ECL], 1981 ZHONGHUA RENMIN GONGHEGUO GUOWUYUAN GONGBAO [GAZETTE OF THE STATE COUNCIL OF THE PEOPLE'S REPUBLIC OF CHINA] 864 [hereinafter GUOWUYUAN GONGBAO] describes ten types of economic contracts: 1) contracts for the purchase and sales of goods; 2) construction contracts; 3) contracts for processing, manufacturing, or repairing; 4) contracts for goods transport; 5) contracts for the supply and consumption of electricity; 6) contracts for storage; 7) contracts for leasing property; 8) loan contracts; 9) property insurance contracts; 10) contracts for scientific and technical cooperation.

6. *See* Hikota Koguchi, *Some Observations About 'Judicial Independence' in Post-Mao-China*, 3 B.C. THIRD WORLD L.J. 195 (1987); Margaret Y.K. Woo, *Adjudication Supervision and Judicial Independence in the P.R.C.*, 39 AM. J. COMP. L. 95 (1991).

was not the result of public debate or popular practice. This was not some gradual blossoming of evolving social practice,[7] although such practice was not unfamiliar to the Chinese people.[8] The use of agricultural production, commercial, and managerial contracts grew in China during the reform period because the state found these forms of agreement to be effective to stimulate production, increase services, and facilitate distribution.

Reform began with conscious, specific decisions from the top that were diffused throughout the system, but the shape these changes took on in practice depended on how they were understood by persons at the periphery who had to apply and live with them. This understanding was heavily conditioned by cultural values and expectations. The movement toward contract in China took place against the background of an extraordinarily rich cultural tradition that included complex legal institutions, a long history of commerce and trade, and a number of sophisticated transactional forms for a variety of economic activities. Many elements of this tradition had been weakened and rejected during the century of unrest and decline that preceded the Communist accession to power in 1949. Others had been rooted out during the Great Leap Forward in the late 1950s and the Great Proletarian Cultural Revolution in the late 1960s. Reform during the 1979-1989 period was shaped by the often divergent pulls of models drawn from China's historical experience on the one hand, and, on the other, by models based on the experience of industrialized capitalistic nations of

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7. In contrast, the English, and then the American, common law growth of contract ideas occurred over centuries. The English experience from medieval to modern times is traced in A.W.B. SIMPSON, A HISTORY OF THE COMMON LAW OF CONTRACT: THE RISE OF THE ACTION OF ASSUMPSIT (1975). Much of this story is marked by judicial rule-making, as courts confronted specific cases in an increasingly rapidly changing economic and social environment. Morton Horwitz, *The Historical Foundations of Modern Contract*, 87 HARV. L. REV. 917 (1974). The common law story is one of gradual and often grudging response to change, and the very slow emergence of broad legal doctrine, unlike the Chinese experience described in this article, where contract law is a proactive governmental policy designed to motivate economic reorganization. There are inevitable uncertainties in identifying causes and effects, chickens and eggs, but this basic characteristic comes through clearly in the two best recent tellings of the English and American stories: PATRICK S. ATIYAH, THE RISE AND FALL OF FREEDOM OF CONTRACT (1979), and LAWRENCE FRIEDMAN, CONTRACT LAW IN AMERICA: A SOCIAL AND ECONOMIC CASE STUDY (1965).

8. Justin Yifu Lin, *An Economic Theory of Institutional Changes: Induced and Imposed Change*, 9 CATO J. 1 (1989); David Zweig et al., *Law, Contracts, and Economic Modernization: Lessons from the Recent Chinese Rural Reforms*, 23 STAN. J. INT'L L. 319 (1987). The agricultural responsibility system that began in the countryside and then was legitimated by officials was similar to prerevolutionary tenant farming practices. Frederick Crook, *The Baogan Daohu Incentive System: Translation and Analysis of a Model Contract*, 102 CHINA Q. 291 (1985).

the West and the newly industrialized nations of Asia.

The Chinese decade of reform appears to have entered a period of pause, if not reaction. By all indications, the current leaders of China, while fearing political and economic chaos, still want economic reform, but in a more limited and controlled way.[9] They desire to realize the economic benefits of reform while avoiding the dispersion of power that reform implies. The leadership seems to believe that economic reform can be achieved without fundamental political change, although not without some changes in legal structure. The momentum for legal reform seems to be continuing as indicated by the revision of the civil law in December 1990 to include more specific provisions on economic cases;[10] the training of county-level representatives regarding law;[11] the continued expansion of legal institutions such as notary bureaus;[12] and continued emphasis on the education of lawyers and legal workers.[13] At the same time, the reported decline in the number of economic law court cases in 1990 may suggest a lower level of interest in the legal enforcement of claims.[14]

The complex factors that fed and shaped the decade of reform present a daunting challenge to our attempts at scholarly analysis. The motivations for reform were economic and political: the desire for development, greater wealth, relief from the inefficiency of central socialist planning, and political legitimation of the regime. Understanding these motivations is helpful to explaining what reform was trying to escape. It is less helpful in explaining why a particular choice, such as the choice of contract, was made.

As we have watched contract ideas develop in China, often in unique and counterintuitive ways, we have tried to understand the choices that were made. Sometimes the contract institution that emerged was quite clearly imitative of foreign practice. In the early stages at least, Chinese draft laws seemed to draw heavily on the experience of an older generation of scholars trained in Europe and America. The marks of nineteenth century European and Japanese

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9. Communique of the Seventh Plenary Session of the 13th Central Committee of the Communist Party of China, *trans. in* BEIJING REV., Jan. 7-13, 1991, at 31-33.

10. RENMIN RIBAO — HAIWAI BAN [PEOPLE'S DAILY — INT'L ED.], Dec. 21, 1990 [hereinafter RMRB—HB].

11. RMRB—HB, Dec. 17, 1990.

12. RMRB—HB, Dec. 24, 1990.

13. RMRB—HB, Dec. 13, 1990.

14. Chang Hong, *Business Disputes Dropping*, CHINA DAILY, Feb. 2, 1991, at 1; Ren Jianxin on Work of Supreme People's Court, Foreign Broadcast Information Service—Daily Report, China [hereinafter FBIS—China], Apr. 3, 1991, at 25-26; and Ren Jianxin Addresses Meeting of Higher Courts, FBIS—China, Feb. 7, 1991, at 19-20.

codes and Common Law case influences are apparent. Ideological commitments, and a desire not to depart too radically from socialist values, suggested reliance on Soviet law ideas. Some of the choices are politically motivated in the sense that they seem designed to please the bureaucratic interests of a politically powerful constituency. Some of the choices seem almost accidental, perhaps the product of the principle of entropic dispersion, which decrees that if choices are available somebody will choose to be different. At the same time, many choices seem economically rational, motivated by a calculation of the benefits and costs of the apparent options.

In this article we will emphasize several instances where the path of reform and the growth of contract law was influenced by cultural values and established institutions and the requirements of the world capitalist system, in addition to rational choice by economic actors. We believe that these socially embedded practices channelled the course of reform in significant ways. Our exposition may interest general readers curious about the construction of a new legal system in China, and those interested in how everyday legal institutions like contract are linked to economic concerns and human values. The Chinese experience also may be of interest to American academics because it illuminates the process of choosing between both markets and hierarchies that has been masterfully described by Oliver Williamson[15] and Mark Granovetter.[16] The Chinese experience also illustrates the role of relational contract in social organization that has been the work of Ian Macneil[17] and the relation between institutional change and economic performance discussed by Douglass North.[18] Economists and sociologists have struggled in recent years to understand the process of choice typified by the alternatives of market and hierarchy. Oliver Williamson describes the "bounded rationality" within which actors make these choices. Mark Granovetter argues for greater recognition of their socially embedded character.

The tension between market and hierarchy certainly is an important theme of our work, as it will be of any analysis of modern political

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15. OLIVER E. WILLIAMSON, MARKETS AND HIERARCHIES, ANALYSIS AND ANTITRUST IMPLICATIONS (1975); OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, AND RELATIONAL CONTRACTING (1985).

16. Mark Granovetter, *Economic Action and Social Structure: The Problem of Embeddedness*, 91 AM. J. SOC. 481 (1985).

17. IAN MACNEIL, THE NEW SOCIAL CONTRACT: AN INQUIRY INTO MODERN CONTRACTUAL RELATIONS (1980).

18. DOUGLASS NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE (1990).

economy. We shall argue, however, that it should not be seen as a battle between polar opposites. It is simplistic to see the organizational changes associated with the growth of contract law as the rejection of hierarchy in favor of markets composed of autonomous actors. In Parts Three and Four we shall discuss instances where the Chinese appear to have sought solutions to their problems that will serve both interests.

It is a mistake to set up rigid dichotomies between market and hierarchy, or between cultural and economic determinants of social choice. To some extent the dichotomies are false, and the differences are more in defining vocabulary than in the underlying phenomena. Of course contract is a socially embedded institution. How could a concept so steeped in such ideas as intention, expectation, and interpretation, not draw heavily on the social context within which the parties form their agreement? Of course, economic rationality is a necessary condition for the choice of an economic practice. Over the long haul, if an economic institution does not minimize costs and mazimize benefits, it is unlikely to attract many adherents. But pointing out the economic efficiency of a solution often fails to explain why that solution, rather than other alternative choices, was adopted.

The falseness of such a dichotomy is demonstrated by the ease with which cultural determinants can be stated in economic efficiency terms. A practice's compatibility with familiar social patterns is a factor that will influence the ease of its adoption and use. The more a practice is socially embedded the lower its transaction costs should be. Social experience shapes the pool of potential institutional alternatives and innovations, and institutions affect the performance of the economy through their impact on the costs of exchange and production. In political terms, social acceptability is an aspect of building constituency alliances. The best path toward building viable coalitions for change is to choose institutions that people know and are at least willing to live with.

I. CONTRACT LAW'S LIMITED ROLE IN CHINA BEFORE 1978

A. What do you mean, Contract?

The classic American legal definition emphasizes the elements of promise and legal enforcement as the defining characteristics of

contract.[19] In the minds of most people, the term *contract* refers to a document, but in the minds of lawyers, it has a broader meaning that includes the totality of an agreement, encompassing both express, conscious terms, their implications and the unspoken assumptions that reasonably underlie them, together with a host of terms that the law imposes, by statute and through the courts, on parties, without regard to their agreement.[20] Viewed broadly, the contract includes the entire relation between two parties.[21]

However broad the sources of contract obligation may become through judicial interpretation, the emphasis in these definitions is always on finding the "intention of the parties" and the concrete legal obligations to perform or compensation that flows from such an expression of intention. This emphasis on specific obligation may not adequately capture the more positive aspects of commitment that underlie alternative visions of contract commonly encountered in both Western and Asian legal systems. A contract is likely to be more than a recital of obligations and negative sanctions for failure to perform. Beyond providing a statement of "this is what we will make you do if you fail to perform," an agreement often is a simple acknowledgement of the existence of an ongoing relationship, a commitment to the implementation of common goals, and a statement of intention to resolve whatever difficulties may be encountered by cooperative consultation.[22] This perspective on the role of contract emphasizes the extent to which people create new things by contract — individuals and enterprises use contract to structure new social relations, to create markets, and to solve problems together. Persons more at home with

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19. The RESTATEMENT (SECOND) OF CONTRACTS § 1 (1981) provides "[a] contract is a promise or a set of promises for the breach of which the law gives a remedy or the performance of which the law in some way recognizes as a duty."

20. The Uniform Commercial Code (1990) recognizes this when it defines contract in § 1-201(11) to mean "the total legal obligation which results from the parties' agreement as affected by this Act and any other applicable rules of law." Agreement, in turn, is defined in § 1-201(3) to include the "bargain of the parties in fact as found in their language or by implication from other circumstances including the course of dealing or usage of trade or course of performance."

21. The confusion can be compounded because the word "contract" is used both as a noun and as a verb (e.g., mealy bugs in the garden contract when they are touched, travellers contract infections, gangsters put out a contract on those who cross them, and some of us contract to make three no-trump).

22. Hiroshi Wagatsuma & Arthur Rosett, *Cultural Attitudes Toward Contract Law: Japan and the United States Compared*, 2 UCLA PAC. BASIN L.J. 76 (1983); Albert D. Angel, The Use of Arbitration Clauses as a Means for the Resolution of Impasses Arising in the Negotiation of, or During the Life of, Long-Term Contractual Relationships, Address at the Annual Meeting of the American Bar Association (Aug. 16, 1972) *in* BUS. LAW., Jan. 1973, at 589-92.

this perspective may be uncomfortable with the familiar American commercial contract, replete with boilerplate and detailed clauses that seek to provide in advance for every possible unhappy contingency.

The central source of difficulty with definitions of contract is that the term usually suggests more than an agreement or consensual cooperative behavior. It connotes obligation and legal enforceability, but the link between agreements and the law is persistently problematic. Most legal systems do not claim to enforce all agreements, yet the substantive earmarks of a legally enforceable promise are difficult to state simply because there is no single generally accepted basis of promise enforceability.[23] Some legal systems, such as China's, use agreements, but, until the recent events we are describing in this article, have provided no institutional framework for their enforcement. It took English Common Law many centuries until, in the seventeenth century, it arrived at an approach to the general legal enforcement of agreements. The result remains a conflicting and confusing melange of ideas.

It is also confusing to talk about contract as a legally enforceable promise because agreement is usually seen as a powerful source of the law itself, which then makes agreements binding. For millennia, Western legal cultures have understood that the legitimacy and binding power of government itself is based primarily on some notion of social compact, covenant, or contract.[24] In this sense, contract is an antecedent and a source of law, as well as its beneficiary. If American

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23. Most legal systems at some stage establish a formal contract in which compliance with the formality provides the essential marks of enforceability. E. Allan Farnsworth, *The Past of Promise: An Historical Introduction to Contract*, 69 COLUM. L. REV. 576 (1969). Such ideas live on in European use of the Notarial contract or the peculiar American insistence that some kinds of promises, to be enforceable, must be embodied in a written agreement that complies with the Statute of Frauds. Another alternative is to treat agreements dealing with particular kinds of subject matter as specially deserving of legal enforcement. Examples of this attitude can be found in the Common Law's infatuation with the bargain supported by consideration as the mark of enforceability or in the Chinese adoption of the socialist concept of economic contract.

The trouble legal systems have with enforcing promises usually does not extend to difficulties with enforcing obligations that have ripened into a debt. There is often a circular element here, for the source of the obligation forming the debt is likely to be intimately tied up with promises, particularly the promise to repay. One confusing aspect of trying to understand the history of Chinese promise enforcement is that there are clear signs that debts and loans have long been routinely enforced, but it remains unclear how important the promissory aspects of these transactions were understood to be.

24. "That to secure these rights, Governments are instituted among Men, deriving their just powers from the consent of the governed, . . ." The Declaration of Independence, para. 2 (U.S. 1776); Sturm, *American Legal Realism and the Covenantal Myth: World Visions in the Practice of Law*, 31 MERCER L. REV. 487 (1980).

law defines contract as a legally enforceable promise dependent on the law for its obligatory power, European law seems to see contract as a form of law, a private law between the parties.[25]

Finally, the emphasis on legal enforcement in the definition of contract seems strange because few contracts in fact are enforced legally and, in most legal systems, the legal remedies available for complaints of contract breach are notably weak and ineffective. Non-legal sanctions for agreements are frequently more powerful than the formal remedies provided by law. Social condemnation, reputational loss, and moral suasion are more common and often more powerful.

The costs of legal enforcement are always high and limit the usefulness of legal remedies. The law rarely enforces promises directly. What it does is award a sum of money as damages for some of the losses resulting from the breach. The definition of legally cognizable contract damages is ungenerous in every legal system we know about and usually excludes many important kinds of loss.[26] Often, contract law produces no remedy at all for the admittedly wronged promisee. As we shall see, Chinese leaders have found it very difficult to resolve the puzzles of contract remedies in the context of a socialist and poor society. This has led them to seek to create some remarkably innovative incentives to contract observance to reinforce the weak remedies of the law.

When compared to competitive organizing principles for economic activity, contract offers several distinct advantages. Despite its weaknesses, legal enforceability is valued to the extent that it provides a residual remedy when social constraints fail. It also provides a more objective and rational expectation of enforcement that assists the calculation of risks, costs, and benefits at the time parties enter a transaction. This potential may be related to the preference expressed by Chinese leaders during the decade of reform for legal enforcement over other forms of social or authoritarian sanction.[27] If the aim of

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25. *See* Georges Rouhette, *The Binding Force of Contract in French Law*, *in* DONALD HARRIS & DENIS TALLON, CONTRACT LAW TODAY: ANGLO-FRENCH COMPARISONS 38, 38-67 (Oxford Univ. Press ed., 1989) [hereinafter CONTRACT LAW TODAY].

26. *See generally* G.H. TREITEL, REMEDIES FOR BREACH OF CONTRACT: A COMPARATIVE ACCOUNT (1988); JOSEPH LOOKOFSKY, CONSEQUENTIAL DAMAGES IN COMPARATIVE CONTEXT (1989).

27. The preference is expressed in the following:

> In order to safeguard people's democracy, it is imperative to strengthen the socialist legal system so that democracy is systematized and written into law in such a way as to ensure the stability, continuity and full authority of this democratic system and these laws; there must be laws for people to follow, these laws must be observed, their enforcement must be strict and law breakers must be dealt with.

the policymaker is to broaden participation in an overly centralized regime, contract supports this choice by providing a way of doing business with an expanded set of actors. If the aim of the policymaker is to create incentives for economic activity by offering rewards to those who show initiative and take an active role in entering new transactions, again contract has advantages over its competitors.

At the same time, the decision to use contract makes new demands on the legitimacy and reliability of government institutions. If people have to depend on the largesse of the official to enforce their deal, they will have less confidence in the agreement. In short, there has to be some faith that the judge or other enforcing person can be relied upon to be fair. The significance of legal contract sanctions is especially strong in a market-based economy. The effective functioning of markets depends on the presence of many competing actors and on the possibility of deals among strangers. The efficiency of such deals among strangers is likely to depend, in turn, on the possibility of legal enforcement.

Legal and non-legal sanctions for agreements are certainly not mutually exclusive. The law may not be applied often, but its presence channels and frames behavior.[28] Most disputes are resolved informally, but the settlements and negotiations take place in the shadow of the law.[29] What the law will make someone do is a powerful defining feature of what parties will informally bargain among themselves to do without invoking the law. However, the current Chinese perspective on the role of law goes beyond the idea of negative sanction or institutional constraints. The Chinese leadership now sees the law as playing a positive role for social change, supporting a commitment from the Chinese citizenry toward the implementation of common goals. New forms of economic organization are deliberately erected by contract. Less deliberate, but equally significant, are the new social relations structured through the use of contract.

Communique of the Third Plenary Session of the 11th Central Committee of the Communist Party of China, BEIJING REV., Dec. 29, 1978, at 6, 14 [hereinafter Communique of the Third Plenary Session].

28. John Haley describes the Japanese view of the law which compares the law to a rusty old sword in its scabbard that hangs on the wall, but continues to influence behaviour although rarely drawn. John Haley, *The Myth of the Reluctant Litigant*, 4 J. JAPANESE STUD. 359 (1978).

29. Robert H. Mnooken & Lewis Kornhauser, *Bargaining in the Shadow of the Law: the Case of Divorce*, 88 YALE L.J. 950 (1979). This is related to Holmes' suggestion that the law is simply what a judge will make a bad man do. OLIVER W. HOLMES, *The Path of the Law*, *in* COLLECTED LEGAL PAPERS 170 (1920).

B. *Traditional China Made Limited Use of Legal Institutions for Commercial Organization*

Contemporary attitudes toward commerce and government participation and regulation of economic activity have deep roots in the Chinese past. At the end of its long struggle with Nationalist competitors and encroaching foreigners, the Communist Party assumed power in 1949 over a society remarkably untouched by the values and institutions that were common in the West. The predecessor regime had borrowed from European legal codes and had established the foundations of a legal profession, but modern legal thought had not penetrated very deeply into the Chinese consciousness. The reformers of the late 1970s and early 1980s emphasized how important it was that their work not be slavishly imitative of Western models. They sought to capture and recreate a Chinese system of law.[30]

The Chinese approach to commercial contracts is connected to the relation between central authority and local units of community. It also reflects a hierarchical moral and social vision that assigned a low position to those who engaged in trade. The vast and diverse geography of China has helped form a territorial and family-based social structure. It also has given rise to a political regime that, while at times has been able to impose military hegemony over the whole nation, rarely has been able to exercise close political supervision over the provinces, or to foster easy trade or an active national market.[31] Moreover, suspicion of those who engage in commerce and acceptance of very broad governmental control of economic activity has its sources in the Confucian tradition.[32] These attitudes, as absorbed by Chinese elites, have been embodied for many centuries in mechanisms

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30. Vice Premier Qiao Shi called upon Chinese jurists "to forge ahead with the study and research of law with Chinese characteristics" and stressed that legal study should not blindly copy from the experience of other countries. *Legal Study Must Seek Chinese Path*, CHINA DAILY, May 22, 1986, at 1.

31. *See* G. William Skinner, *Marketing and Social Structure in Rural China* (pts. 1-3), 24 J. ASIAN STUD. 3, 195, 363 (1964), *reprinted in* Bobbs-Merrill Reprint Series, S-204, S-627, S-628; *See also* J.C.H. Fei, *The "Standard" Market of Traditional China*, *in* CHINA'S MODERN ECONOMY IN HISTORICAL PERSPECTIVE 235 (D. Perkins ed., 1975).

32. *See* ZHANG WEIAN, ZHENGZHI YU JINGJI: ZHONGGUO JINSHI LIANG GE JINGJI ZUZHI ZHI FENXI [POLITICS AND ECONOMICS: AN ANALYSIS OF TWO PREMODERN CHINESE ECONOMIC ORGANIZATIONS] Ch. VI (1990); *see also* DOROTHY SOLINGER, CHINESE BUSINESS UNDER SOCIALISM: THE POLITICS OF DOMESTIC COMMERCE, 1949-1980, at 130-35 (1984) ("Close interconnection between a primitive technology and state defined market 'corruption' meant that the technological supports for such behavior had to be transformed before the merchant's position could be truly undermined." *Id.* at 134-35).

of state control that shaped the institutions of contract in traditional China, although there always was distance between the Confucian value statements that were opposed to commerce and Chinese social practice, which was very concerned with trade.

C. *Law, The State, and Relational Communities in Traditional China*

Chinese thinkers have wrestled with the appropriate role of law in the Confucian, Taoist, and Buddhist strands of the tradition.[33] During some periods, antinomian naturalists spurned legal rules. They taught that good government depends on educating people to behave in conformity with the spirit of the great Way, the Tao. In other periods of Chinese history, legalists insisted on the need for formal rules to control people's badness.[34] From its remote beginnings, an important Confucian strand of Chinese thought has emphasized the centrality of harmonious order in the universe, in the government of societies and families, and in the behavior of every cultivated person. By organizing their lives in conformity to this order, parents and children, husbands and wives, and siblings sustained lives that were in virtuous balance. In particular, it was this harmonious virtue that reinforced the appropriate relation of the Emperor to the nation and gave legitimacy to the state.

The transcendent harmony of the natural world has inner aspects, forming a moral law felt by every sensitive human. People fulfill their highest potential when they conform their lives to that moral order and live in harmony with it. When they do so, there is no need for coercion to right behavior. People become self-regulating in an orderly and appropriate way of life that perpetuates itself.[35] Law from this

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33. *See generally* BENJAMIN SCHWARTZ, THE WORLD OF THOUGHT IN ANCIENT CHINA (1985).

34. *See* WILLIAM THEODORE DE BARY ET AL., SOURCES OF CHINESE TRADITION 100-35 (1960). De Bary provides the following translation of the Legalists' views from Han Feizi:

> When the sage rules the state, he does not count on people doing good of themselves, but employs such measures as will keep them from doing evil. If he counts on people doing good of themselves, there will not be enough such people to be numbered by the tens in the whole country. But if he employs such measures as will keep them from doing evil, then the entire state can be brought up to uniform standard. Inasmuch as the administrator has to consider the many but disregard the few, he does not busy himself with morals but with laws.

Id. at 141.

35. DERK BODDE & CLARENCE MORRIS, LAW IN IMPERIAL CHINA: EXEMPLIFIED BY 190 CH'ING DYNASTY CASES 19-29 (1967). Confucius said:

> Lead the people by laws and regulate them by penalties, and the people will try to keep out of jail, but will have no sense of shame. Lead the people by virtue and restrain them

perspective is not simply a set of specific commands and prohibitions, but instead is a set of relationships and interactions that produce order and harmony. The tasks of law and of moral education are of necessity closely linked.

A different attitude toward law among Confucian philosophers grows out of the recognition that some rules of social behavior are a necessary feature of any human society. Specific rules that are announced in law structure the functions, roles, and behavior of family members and enable the group to interact and prosper. Many legal rules are conventional and quite arbitrary in content. It really does not matter on which side of the road the law tells us to drive our automobiles, but it is very important that we all know what the rule is. Organizational rules of government often are conventional in this sense, providing useful clues on "how we do things around here," although there is little intrinsic logic behind their specific content. The Chinese creators of the state and inventors of paper fully understood the role of formal law as an aspect of government administration, through which the all-powerful Emperor could provide order and regularity to the behavior of those who served him. Law in this sense is simply the agent of constructive social order and control of people's potentially destructive instincts.

These different attitudes regarding law would present no serious problems if they could be brought together comfortably. Then the formal rules of the state and the directions of family and community would meld in a grand synthesis, joining the natural and inner moral order with the social and governmental order in mutual reinforcement. The problem, of course, is that for many great Chinese thinkers, as for many ancient and modern Western thinkers, the pieces do not fit together so easily. The moral spirit of the inner law gives life and

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by the rules of decorum, and the people will have a sense of shame, and moreover will become good.

Analects II:3, *in* DE BARY, *supra* note 34, at 32.

This attitude is also found in the Taoist view of the role of government:

A leader is best
When people barely know that he exists,
Not so good when people obey and acclaim him,
Worst when they despise him.
'Fail to honor people,
They fail to honor you;'
But of a good leader, who talks little,
When his work is done, his aim fulfilled,
They will all say,'We did this ourselves.'

LAO TZU, *in* THE WAY OF LIFE ACCORDING TO LAOTZU 34-35 (W. Bynner trans., 1944).

harmony, but emphasis on the formal logic of external rules kills that spirit and destroys the possibility of a truly virtuous human life. The rules are stultifying, lead away from moral sensitivity, and cause people to focus on how they can get away with as little commitment to the spirit behind the law as possible. Following closely in the wake of the formal law, one always finds people chiseling around the edges, looking for loopholes, and hypocrites, who are out of touch with the moral spirit of their behavior. Not far away are sure to dwell large bands of pettifogging lawyers giving tax advice, teaching people how to make black seem white, and generally justifying the failure to honor obvious obligations.[36]

Throughout all periods, the reigning imperial bureaucracy developed large bodies of legal rules to instruct officials how to discharge their functions. In his observance of the formal ceremonies of the state, the Emperor sought to instruct the people by providing a model of emulation of the harmonious order that would be appropriate for their lives.[37] The imperial hierarchy of the state was a model for the smaller clan and family hierarchies by which the lives of ordinary Chinese were supposed to be governed. Through the playing out of these divergent views of the role of law, China developed impressive bodies of public law, rules that detail the administration of the state and the behavior of officials. Substantial bodies of land law also developed, closely tied to the interests of the unitary state in taxes and bureaucratic control over the countryside. Some dynasties adopted large bodies of criminal law through which the state maintained peace and suppressed unrest. During the three centuries of the Qing Dynasty, the penal and coercive aspects of the law were especially prominent, for China was in effect an occupied nation, ruled by the Manchus, who systematically repressed and discriminated against the Chinese (Han) majority.[38]

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36. The more prohibitions there are, the more ritual avoidances, the poorer the people will be,
The more sharp weapons there are, the more pernicious contrivances will be invented;
The more laws are promulgated, the more thieves and bandits there will be.
Therefore a sage has said:
So long as I do nothing, the people will of themselves be transformed.
So long as I love quietude, the people will of themselves go straight.
So long as I act only by inactivity the people will of themselves become prosperous.
So long as I have no wants and the people will of themselves return to the state of the Uncarved Block.

LAO TSU, DAODE JING, BOOK VI ¶ 57.

37. *See* DE BARY, *supra* note 34, at 156-65.

38. BODDE & MORRIS, *supra* note 35, at 3-51 (1967).

Despite these impressive examples, it appears that there was little systematic promulgation of legal rules for other areas of law, including much of what we would call civil, commercial, or economic law. The ordering of group and individual commercial relations was left to clan, family, guild, customary, and local rules that were administered by elders who held no formal imperial office, although their decisions might be generally supported by imperial magistrates and other officials at the local level.[39]

At the highest levels the state claimed to be committed to inculcating values primarily by example and education, not by the enforcement of legal rights or the adjudication of personal claims. Officials are said to have discouraged litigation and imposed penalties on those who attracted official attention by presuming to bring a lawsuit. Invocation of the machinery of the state for such matters was considered a clear sign of failure by the clan and family authorities, who were supposed to teach and maintain harmonious orderliness. Some legal avenues existed by which subjects could petition the throne to correct erroneous decisions made by lower officials, but the focus in these proceedings was primarily on maintaining correct imperial administration, not upon the vindication of the rights of the subject.[40]

During the Republican Period, between 1911 and 1949, the regime sought to introduce civil law codes from Europe, borrowed through Japan and directly from Switzerland, but these codes and the ideas behind them did not penetrate very deeply into the society. Only in the commercial communities of coastal cities and in a few inland centers where foreign influence and industry had developed would one be likely to encounter such laws.[41] Even in such places, most Chinese

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39. For a good description of commercial practice and administration of magistrates in an outlying province of pre-revolutionary China, see Rosser Brockman, *Commercial Contract Law in Late Nineteenth Century Taiwan, in* ESSAYS ON CHINA'S LEGAL TRADITION 76 (Jerome Cohen et al. eds., 1980). *But see* Phillip Huang, *Lawsuits, Disputes, and Conflicts in North China Villages During the Qing and the Republic, in* CIVIL LAW IN CHINESE HISTORY (P. Huang ed., forthcoming) [hereinafter CIVIL LAW]. *See also* Scogin, *supra* note 2.

40. William Alford, *Of Arsenic and Old Laws: Looking Anew at Criminal Justice in Late Imperial China*, 72 CAL. L. REV. 1180 (1984).

41. The interaction between the law and courts brought by Westerners into Shanghai after 1849 and traditional Chinese courts and institutions is traced in Tahirih Lee, *Risky Business: Courts, Culture, and the Marketplace*, 46 U. MIAMI L. REV. — (forthcoming Dec. 1991). *See also* WILLIAM ROWE, HANKOW: COMMERCE AND SOCIETY IN A CHINESE CITY, 1796-1889, at 158-210 (1984). William Jones has described the limited extent that Western legal concepts and "rights consciousness" had penetrated traditional Asian societies during this period:

> In an ultimate sense, individuals did not have rights; they had duties to the state which pursued its own interests in accordance with its own rules. On the other hand, the state took little interest in large areas of society, notably the areas of contract and

entrepreneurs followed millennia of tradition and did not expect to enforce their claims against strangers by legal means. Instead, they pursued their enterprise along the lines established by clan and family ties or through guilds and merchants' organizations that offered their own methods of enforcement for claims and transactional security.[42]

The merchants' reliance on a network of personal ties to provide information and sanction for rules, necessarily limited the number of trade partners. Potential partners were confined to those with whom these relationships existed. When dealing with a stranger the merchant was wholly dependent on the goodwill of the officials. Only the rash would enter commerce in an unfamiliar community or without propitiating the officials. This, in turn, gave state officials greater personal power and discretion in determining who could be the players in the local market.

The hierarchical social structure expressed as a positive value the kinds of education and cultivation that led to appointment as an imperial official. Not surprisingly, those at the top of this hierarchy saw their virtues as superior to the diligence of the peasant who labored on the land, and saw both as superior to the grasping materialism of the parasitic merchant, who grew rich by buying and selling the products of others' labor. This ideology contained a puritanical dimension which supported the view that the hierarchical matrix serves as a moral harness to keep people happy and prevent them from losing their heads and hearts to Mammon. It remains unclear, however, how extensively these views were shared by those who were assigned lower positions in the hierarchy.

Structural preferences are embedded in these values as well. The emphasis on harmony leads dominant groups to prefer vertical hierarchies in which everyone has a clearly defined place. Groups at

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commercial law: sales, loans, and banking. These areas of life could be regulated, and were if any state interest became involved. The result was potential total state control over every aspect of human life. Yet, in practice, large areas were left open to private management so long as no government interest, including maintenance of the peace, was affected. This could be said to have been true of both China and Japan as of the time—circa 1880—when Japan began to introduce western institutions including law.

Of course much of the western legal appartus was quite consciously fictitious.

William Jones, *Reflections on the Modern Chinese Legal System*, 59 WASH. U. L.Q. 1221, 1226 (1982).

42. *See* FROM THE SOIL, *supra* note 3, ch. 4-12. *See also* Gary Hamilton, *Why No Capitalism in China? Negative Questions in Historical Comparative Research*, 1 J. DEVELOP. SOC. 187 (1985); Landa, *A Theory of the Ethnically Homogeneous Middleman Group: An Institutional Alternative to Contract Law*, 10 J. LEGAL STUD. 349 (1981); K.-C. Liu, *Chinese Merchant Guilds: An Historical Inquiry*, 4 PAC. HIST. REV. 1 (1988).

the top will prefer systems of communications that go up and down these long vertical chains. Persons lower down are addressed through the person at the top of their chain, and superiors thus avoid dealing directly with individual members of another unit. This simplifies dissemination of decisions by enabling a superior to give instructions to those directly under him in the hierarchy, leaving it to those lower in the chain to carry the word down. From the perspective of the superior, directions from above are preferred to horizontal communications between equals.

Yet several consequences follow from the difficulty inherent in communication up and down vertical chains of authority. The assertion of any claim by a subordinate is likely to be interpreted as disorder and an indication that superiors have failed to set a good example. The appropriate response is likely to be the punishment of both litigants and their boss. Additionally, actors lower in the chain have no convenient way to assert claims against those in other chains. Since formal communications are difficult and uncertain, it becomes vital to create informal links that facilitate horizontal communications. Personal ties and the networks upon which they are based thus create their own demands that compete with the values of the formal system and blend into corruption.

D. Contract and Socialist Planning

Westerners tend to associate contract and contract law with individualism, autonomy, and private agreement. But to a considerable extent contract is ambivalent in these respects. The link between contract law and market structure is subtle and potentially confusing. Use of contract law to structure economic transactions does not necessarily imply an open market structure in that economy. Contract law has been used in a variety of nonmarket economies, including English feudal society,[43] and even in Soviet[44] and Chinese socialist planned

43. The role of contract law in English feudal society was described as follows:
The master [Maine] who taught us that 'the movement of the progressive societies has hitherto been a movement from Status to Contract,' was quick to add that feudal society was governed by the contract. There is no paradox here. In the really feudal centuries men could do by a contract, by the formal contract of vassalage or commendation, many things that can not be done now-a-days. They could contract to stand by each other in warfare 'against all men who can live and die'; they could (as Domesday Book says) 'go with their land' to any lord whom they pleased; they could make the relation between king and subject look like the outcome of agreement; the law of contract threatened to swallow up all public law. Those were the golden days of 'free,' if 'formal,' contract. The idea that

economies.[45] Many forms of contract can be found in societies and economies that lack strong theories of individual autonomy or liberal enterprise. For example, English medieval contract forms were embodied in the ceremonies of homage and fealty that organized a military system and land tenure. Even in America and Europe today, contractual forms are used as a means of bureaucratic organization for mass transactions. An eminent legal scholar has estimated that 99% of the contracts made in America today are form contracts of adhesion that are neither negotiated nor the expression of substantial individual autonomy.[46] We sign the form on the dotted line, make the payments on the first of each month, and only the most curious or bored among us would think of reading the fine print on the back of the form. It would do us little good if we did read the gobbledegook and even miraculously could understand what the language means. There are few realistic opportunities to cross out or renegotiate the standard terms to make them more to our liking. Mass contracts are autonomous acts of voluntary will only in form.

A kind of contract served as a tool of legal organization in Stalinist Russia and appeared in post-1949 China. Russian contract law, as well as the system that prevailed in China during the first generation after 1949, used the forms of contract to embody written planning orders. The contracts were largely unnegotiated and in no substantial sense reflected choices on the part of the enterprises that were bound to deal together by the contract order. In this sense, "contract" can be adopted to serve a socialist system of central planning almost as readily as it can be used to support a capitalist system of free

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men can fix their rights and duties by agreement is in its early days an unruly, anarchical idea. If there is to be any law at all, contract must be taught to know its place.

2 FREDERICK POLLOCK & FREDERIC W. MAITLAND, THE HISTORY OF ENGLISH LAW 232-33 (S.F.C. Milsom ed., 1968) (2d ed. 1898).

44. OLIMPIAD IOFFE & MARK JANIS, SOVIET LAW AND ECONOMY 15-22 (1986); Jacek Kurczewski & Kazimierz Frieske, *Some Problems in the Legal Regulation of the Activities of Economic Institutions*, 11 LAW & SOC'Y REV. 489 (1977); Dietrich Loeber, *Plan and Contract Performance in Soviet Law*, *in* LAW IN SOVIET SOCIETY 128 (Wayne LaFave ed., 1965).

45. *See* SOLINGER, *supra* note 32, at 206-42. Contract use in socialist planning:

In Capitalist societies, it is not important whether a contract is performed, the real purpose is whether people can make money by performing the contract. But in China, contract performance is of the utmost importance, because it is tightly related to socialist planning, the way to guarantee supply of necessities.

ZHU XIAOQIANG, QIYEJIA YU GONGSHANG XINGZHENG GUANLI [ENTREPRENEURS AND THE MANAGEMENT OF INDUSTRY AND COMMERCE ADMINISTRATION] 189 (1986).

46. David Slawson, *Standard Form Contracts and Democratic Control of Law Making Power*, 84 HARV. L. REV. 529, 529 (1971).

enterprise. At the very least, contract techniques make it easier to decentralize the planning process by allowing the parties at the operating ends of the system to create a binding form of obligation, the contract order. Although the central planner may remain in control of the operation, everything does not have to stand still and wait for the issuance of detailed commands from the center before the plan is translated into specific transactions.

Subsidiary units of the state can deal with each other in a system of socialist planning through the forms of contract, but contract implies economic liability for the consequences of nonperformance, and this undermines the apparent monolithic solidarity of the socialist state. A major aim of recent Chinese reform has been to devise a system that will operate in a self-correcting way, reducing the reliance on the heavy hand of administrative regulation to keep the economy going. One aspect of Chinese reform has been to separate the government planner and Party official from the operation of specific transactions, and thereby to free and expand such transactions. Contract law can operate this way by imposing liability on nonperformers and motivating performance of agreements. But it is hard to see how you can have market-based price and production decisions, in distinction to hierarchical command or planned transactions, unless economic actors are free to agree to enter or stay out of transactions and to rely on the agreements of others in making their own commitments.

1. Socialist Planning Before 1978[47]

During the early years following the consolidation of power in 1950, the new regime was confronted with tremendous economic troubles inherited from a century of war, imperialistic exploitation, dynastic decay, invasion, and revolution. Pursuant to its socialist commitment, the new regime confiscated land and other major economic assets from their capitalist owners. A system of socialist

47. This section is based on a number of impressive studies that have attempted to trace the tangled story of Chinese economic management after 1949. *See, e.g.*, AUDREY DONNITHORNE, CHINA'S ECONOMIC SYSTEM, 176-218, 457-95 (1967); DWIGHT PERKINS, MARKET CONTROL AND PLANNING IN COMMUNIST CHINA (1966); BARRY RICHMAN, A FIRSTHAND STUDY OF INDUSTRIAL MANAGEMENT IN COMMUNIST CHINA (1967); CARL RISKIN, CHINA'S POLITICAL ECONOMY: THE QUEST FOR DEVELOPMENT SINCE 1949 (1987); Thomas Rawski, *China's Industrial System, in* JOINT ECON. COMM., 94TH CONG., 1ST SESS., CHINA: A REASSESSMENT OF THE ECONOMY 175 (Joint Comm. Print 1975); Peter Schran, *Economic Management, in* CHINA: MANAGEMENT OF A REVOLUTIONARY SOCIETY 193 (John Lindbeck ed., 1971) [hereinafter REVOLUTIONARY SOCIETY].

accounting was established, and gradually a planning and allocation system for the production and distribution of goods was put into place. The system that emerged was one marked by socialist ownership of all significant means of production and an economy managed primarily by state planning of economic inputs and outputs. State ownership and management of the economy was extensive, and most sizable enterprises became units of the state.

The system of planning that emerged was based on the expectation that each economic unit in society would create a plan for its future activity, coordinated at each level of government to provide resources (i.e., materials, labor, and capital) to accomplish the goals of the plan and the outlets through which the product will be distributed. In this way, the creators of the new regime expected that allocative decisions would not be made selfishly, on the basis of the wealth and power of economic actors, but through rational social choices regarding the wisest use of scarce resources.

Commitment to socialist planning thus is founded on the belief that officials can rationally plan the economic activity of workers and managers and can control uncertainties by reason. The process also depends upon the belief that there is some rational way to balance and accommodate conflicting economic preferences within society. For example, we may have the labor and materials to build only one railroad this year, but there are four interprovincial railroads that are proposed to improve the economic situations of those four regions. The faith of the planner is that there is a logical way to make a social decision concerning which railroad is to be built. Every government in the world engages in some forms of planning to allocate scarce public goods. At the very least, the leadership makes decisions regarding the construction of public roads, school buildings, post offices, and the like. In most places such decisions are marginally rational, with the contending interests fought out in a political forum. Frequently, achieving agreement on priorities proves elusive and paralysis results. Nongovernmental economic managers also engage in extensive planning. The Ford Motor Company is already hard at work deciding how many of what kinds of automobiles it will build five years from now. It must plan the construction of factories, the purchase of machinery, and the hiring and training of workers far in advance. Such decisions are grounded on its expectations regarding the national economy five years hence, how much money how many people will have to purchase automobiles, and what their preferences for automobiles are likely to be.

Planning, therefore, is not the exclusive property of socialist

economic systems. What is different is the degree of reliance upon and the centralization required by the plan. The essential characteristic of the Soviet model of planned economy, imitated in China, is that the planning process is so coherent and all-encompassing that it can claim to control economic activity in a complex society.

On a national level, a long-term (five or seven years) plan is developed that will include, for example, the decision that a railroad is needed to connect two provinces. The task of the planners is to find and allocate the needed labor, materials, and capital to build the railroad. The locomotive factory must be given an order to deliver eight locomotives four years hence, when the railroad will be built. The steel mill must be ordered to produce three years from now special steel for roller bearings that can be delivered in time to the locomotive factory so it can build the locomotives and deliver them to the railroad. If the system worked as advertised, the result of all this planning would be that every economic actor works in a coherent and rational manner to achieve social goals.

It is this all-encompassing coherence of the state plan that enables it to claim to provide an alternative to capitalistic markets. Only because it is said to possess this capacity to supplant profit-driven markets can planning claim to fulfill the communist promise of providing an escape from the exploitation and alienation of workers. Indeed, unless planning is complete enough to displace the power of competitive market forces, it is hard to see how a socialist regime can fulfill its ideological promises to return the dominance of the economy, and of society in general, to the workers and producers. Only by these means can the system's supporters claim that the exploitation of selfish profit-seekers has been avoided.

Discussion of the planning process in China is complicated by our uncertainty whether the system was ever put firmly in place. A strong indicator that the system did not work as designed is furnished by the small number of products for which input-output allocation categories were established. To return to our locomotive example, for the system to work the plan must allocate to the factory the materials it needs to build the locomotive. These materials are likely to fall into a large number of nonsubstitutable categories. To most people it may look as though the locomotive is made primarily of steel, but someone who knows about locomotives will tell you that there are many kinds of steel, that you can't use cold rolled sheeting to build locomotive wheels that require high carbon alloys. At the height of the era of Soviet planning there were tens of thousands of categories of materials, each of which was separately provided for in terms of production and

allocation under the plan. Yet available information indicates that the Chinese planning process never progressed beyond roughly 600 categories.[48] Other commodities were distributed administratively or through rudimentary markets.

As the example suggests, the process of planning goes on at many levels. The national government has a plan on transportation which includes a section on new construction. This plan is developed in consultation with the provinces, local governments, and with the ministries who need the transportation to accomplish their goals. It must also be drawn in consultation with those units that provide the resources used in the planned activity, and with those who are to receive the output. The planning process may produce a document that is designed to present a picture of some aspect of the plan at a given moment (e.g., a National Five Year Plan or The Construction Plan for Hebei Province, 1992-1993), but the process is a constantly developing one. Each time a new priority for a project is established, planning decisions must be made to accomplish that goal.

Planning decisions at the highest governmental level are coordinated through the State Planning Commission (*Guojia Jiwei*). The plans developed by the ministries will be more detailed, with specificity increasing in the local and enterprise plans. Goals must be set, needs identified, priorities established, resources identified and allocated, and finally the plan must be translated into economic transactions. Since planning and management are two aspects of a single process, the planner at each level occupies a central position, making or at least recording the decisions and priorities, discovering and allocating the resources, and monitoring the ultimate compliance. Enterprises are seen as subjects of the plan and must limit their activities to those that are planned. Little decisional discretion is given the enterprise manager to do things his or her way, since planned activity must be coordinated and subordinate to the dictates of the plan. It is the planner who is primarily responsible for matching needs and resources and introducing suppliers to consumers, and distributors to manufacturers.

When an economy is in crisis, markets will not work well, and the needs for social control of economic activity will be compelling. Revolutionary regimes and those at a very primitive economic stage

48. Xue Muqiao, *A Study in the Planned Management of the Socialist Economy*, BEIJING REV., Oct. 26, 1979, at 14, 15; Barry Naughton, Economic Reforms and Decentralization: China's Problematic Materials Allocation System 5 (1984) (unpublished paper); Gordon White, The Role of the State in China's Socialist Industrialization 213 (1985) (unpublished manuscript, on file with authors).

are likely to start with the expectation that there will be a high level of government intervention in the economy. They will also be confronting a crisis in which relatively simple allocative decisions will appear to vastly improve the situation. As the crisis is successfully surmounted and economic development proceeds, the planning decisions become increasingly complex, interrelated, and less clear-cut. The capacity to communicate, upon which the system rests, becomes clogged and the capacity to encompass the whole, upon which rational choice depends, becomes flooded. Decisions become slower and less certain. Putting it crudely, if half the nation is starving, the appropriate economic goal will seem clear: feed the hungry, prevent little children from starving. It may be difficult to accomplish that goal, but that will appear to be a detail of management.

Success will complicate the picture. Once everyone is fed and housed, epidemic disease has been controlled, and the disastrous summer floods have been contained by dams, to what degree should we direct our efforts next year toward giving every household a color television set? Perhaps we should invest less in that direction, leaving most homes with a black and white set while we invest more heavily in urban parks, art museums, and sports stadiums. It was easy to plan cotton cloth production so that every citizen received a new dark blue set of clothes each year, but now that we are richer, how many cotton, wool, and silk dresses should we plan for next year? What colors should they be and how long should the skirts be, how wide should we make the lapels? On what basis do we decide how much scarce investment funds we should take away from other uses for this purpose? In short, the kind of planning process that may produce dramatic short-term improvements in a crisis becomes too crude to manage a more affluent and diverse society.

2. Contract in the Service of Planning

The leadership of the PRC in the 1950s needed a technique to make planning decisions concrete and specific. The aim of the system was to make allocative decisions and distribute goods by plan, not by price. Yet, inevitably, planning was not expected to be perfect and all-encompassing. It was anticipated that some minor routine purchases would be made outside the plan and in emergencies some exchanges would have to be made while the plan was being adjusted to reflect the new circumstances. In practice, it appears that these off-plan transactions remained substantial, although the official view was that they were relatively insignificant. Within the scope of the plan, the

assumption was that the planning and the supervising agencies would allocate the materials necessary to enable the enterprise to fulfill its production quota. Planning directives ordered suppliers to provide materials; similar directives dictated where the enterprise was to deliver its production. Procurement outside the planning mechanism when there was input-output planning effect was viewed as serious deviance and was severely punished.

To make planning decisions concrete and specific, the planners drew upon the Soviet experience and created a kind of contract law in the service of the plan.[49] Under this system, ministries and supervising agencies sponsored periodic meetings, sometimes referred to as "goods-ordering conferences," to which were invited all those who were to produce and deliver products under the plan. At these meetings, suppliers for materials would be matched with consumers of those materials, and specific delivery plans would be negotiated. The results of these meetings were embodied in written documents that were referred to as contracts, but which essentially were written planning orders to the enterprises. "Dancing partners" were assigned by the relevant ministry to ensure that there was a supplier for every requirement and an outlet for every product. The terms of these contracts were determined by the orders of the supervising agencies, not by the negotiations of the parties to the transactions.

Most significantly, these contracts were understood to create obligations in the parties who signed them, but few meaningful rights. If the goods that were subject to the contract failed to arrive or were below grade, the problem would be adjusted by the buyer's manager, who would ask the supervising agency to complain to the breaching party's superior in an effort to require performance. Since the supervising agency is likely to be unable to achieve this result, the consequence of the failure to deliver is that the disappointed enterprise's plan will have to be adjusted to reflect its inability to produce and deliver the product planned.

A ripple effect follows as every failure to perform is likely to trigger a loss of production downstream in the course of economic distribution. This effect is an inevitable consequence of the monopoly created by the plan. Since there is no market and the goods can be obtained only from the sources identified by the plan, there are few opportunities for substituted performance. If the nuts and bolts are not

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49. *See* RICHARD PFEFFER, UNDERSTANDING BUSINESS CONTRACTS IN CHINA, 1949-1963, at 10-28, (1973); Gene Hsiao, *The Role of Economic Contracts in Communist China*, 53 CAL. L. REV. 1029, 1042-49 (1965).

delivered, assembly of the goods must stop until they come. There is no way to go to a hardware supplier, buy other nuts and bolts, and then make the supplier who failed to deliver pay the difference in price as damages. This feeds an economy built on scarcity as each enterprise hoards the goods it has since it cannot find substitutes if they are lost. An enterprise that is disappointed by the failure of its supplier to deliver cannot pay a premium to persuade another enterprise which has goods of this kind but no immediate need for them, to surrender them for a price. Shortages persist while goods sit in warehouses. The system does not encourage the flow of goods toward those uses in which they would be most valuable.[50]

E. Socialist Economic Organization Before 1978

The organizational tasks of building a socialist economy were immense and were accomplished in stages, each of which was also marked by severe political struggles, new slogans, and new heros. Given the magnitude of these problems, the enormous size and diversity of the nation, and the tendency for political programs to shift radically every few years, it is not surprising that the administrative structures and processes that emerged were not always systematic and coherent. Throughout the history of the PRC and up to the present, substantial variation can be observed in the treatment of different regions, between cities and countryside, between provinces and the special administrative regions for the three largest cities (Beijing, Shanghai, and Tianjin), and in other special zones. Nonetheless, at the risk of great oversimplification, we can describe the overall governmental structure within which most substantial economic activity was organized in a way that will enable the reader to understand the impetus they provided reform after 1978.

50. *See* JANOS KORNAI, THE ECONOMICS OF SHORTAGE (1980). *See also* Christine Wong, *The Economics of Shortage and Problems of Reform in Chinese Industry*, 10 J. COMP. ECON. 363 (1986).

1. Center and Locality[51]

Since 1949 the PRC has been run by a small group, consisting at any given time of about 25-35 persons, who form the leadership of the Government and the Party. These people can be identified by their physical location at the Zhongnanhai compound at the edge of the Forbidden City in Beijing, or in their personal location in a relational network around the "Paramount Leader" (Mao Zedong from 1949 to 1976; Deng Xiaoping from 1978 to the present). Formal office titles are a sign of membership in the group, but can be misleading. Some who bear important sounding titles are fronts or out-of-favor has-beens. Some officials who bear an obscure title, such as deputy director, may in fact be in charge. The *sine qua non* of power is participation in a network of contacts that connects important forces in Chinese society outside Zhongnanhai to the Paramount Leader within.

Authority moves to and from this group of leaders through at least three sets of structures: the national government, the Communist Party, and local governments. It seems likely that there are other important structures controlled from the center, such as the military, police and state security, etc., but they stand outside this description. Life and process inside the center are essentially opaque mysteries to all foreigners and to all but a few Chinese. One point is clear: This small group is the central link in all chains of authority and the source of all claims to legitimate power.

The central institution of national state power is the State Council (*Guowuyuan*) under which a large number of ministries, state committees and departments exercise authority on a national level.[52] Some of these State Council organizations operate directly throughout the nation, but many are replicated by provincial, municipal, and local agencies that report for some purposes to their national counterpart, but are responsible for other purposes to the municipal mayor or provincial government. The result is parallel but intersecting chains of hierarchical

51. The tensions between a highly unified central authority and diverse and far-flung local societies that make up China is a persistent and crucial theme. *See, e.g.*, DAVID GOODMAN, CENTRE AND PROVINCE IN THE PEOPLE'S REPUBLIC OF CHINA: SICHUAN AND GUIZHOU 1955-1965 (1986); SUSAN MANN, LOCAL MERCHANTS AND THE CHINESE BUREAUCRACY, 1750-1950 (1987); RISKIN, *supra* note 47; VIVIENNE SHUE, THE REACH OF THE STATE: SKETCHES OF THE CHINESE BODY POLITIC (1988); Frederick Teiwes, *Provincial Politics in China: Themes and Variations*, *in* REVOLUTIONARY SOCIETY, *supra* note 47, at 116.

52. This description draws heavily on KENNETH LIEBERTHAL & MICHEL OKSENBERG, BUREAUCRATIC POLITICS AND CHINESE ENERGY DEVELOPMENT (1986), as supplemented by informants.

organization that extend from the center of power down to a local enterprise or organization. One chain of command extends from national government to local government to enterprise; the other chain extends a bureau's jurisdiction from the national level to subordinate agencies. Our impression is that the tangled structure is puzzling to participants, as it certainly is to outsiders.

The national government, local governments, and the Party display substantial organizational similarities. Each has a formal structure that is constitutionally defined, and at the top of each structure is a ceremonial body with little real power (the National People's Congress and the National Party Congress). Real power is concentrated in a much smaller body (the State Council or the Party Central Committee Political Bureau).

A large number of subordinate agencies, falling into three main categories, report to this smaller body. First, there are a number of ministries that are agencies of sectoral competence (e.g., Ministry of Water and Electricity, Ministry of Chemical Industries). In the Party structure, departments serve roughly comparable functions (e.g., propaganda, organization of personnel, relations to foreign Socialist parties). The ministry is at the upper end of what is likely to be a long chain of supervisory authority and professional responsibility that, with intermediate links, extends to the local cell, unit, enterprise, or factory.

The work of the ministries in key problem areas that are confronted by all ministries (e.g., Planning, Management, Science and Technology) is coordinated by a commission, that in some respects is equal in rank to ministries, but possesses power of supervision over ministries within the commission's area of special competence. Thus, the State Planning Commission is charged with developing the plan by coordinating and supervising the planning activities of the national ministries, as well as the planning organs of provincial and municipal governments. Some of these organizations are given special status for bureaucratic convenience. For example, many ministries and local governments operate educational institutions in China. To coordinate education at the national level, the Education Commission has a special status that enables it to supervise and issue directives to ministries and provinces. Its chief carries the prestigious rank of Vice-Premier. Similarly, the National Science Academy and the Academy of Social Sciences operate directly under the State Council. Special agencies for inspection and audit of other agencies also enjoy this special status.

In addition to these commissions and special groups, the members of the top leadership often create small agencies to coordinate their

personal responsibilities or to tackle ad hoc problems. Some of these groups are described as research institutes. As long as the leader holds power, these personal organizations may possess remarkable influence and power. The rapid eclipse of several of these bodies after the fall of Zhao Ziyang in 1989 testifies to the fragile nature of life at the top in this system.

Viewed from the outside, China at first appears to be a very authoritarian and centralized state, with a heavily systematic and rule-oriented approach to the problems of government. Yet each of these features is inevitably limited by powerful practical necessities. The central authorities can extend their control to vast reaches of the nation only by making alliances with the leadership of the regional communities and the countryside. These alliances are mutually necessary and are important sources of political power for both central officials and local authorities. The practical limits of remote rule from the center, the poor state of transportation and communications, and the tremendous variation in the material circumstances in different parts of the nation demand a balance between central and local authority. The result is an apparently contradictory emphasis on local self-reliance within a unitary state. What appears initially to be a very systematic and rule-oriented system is, in fact, dependent on a particularistic and very personal style of administration, emphasizing the crucial role of the alliances, connections, and influence of individual officials.

2. Relations Among the Parts—The Grid

Any substantial activity in China can be located as a point in a three-dimensional grid of supervisory control. One dimension of this control is Party leadership. Some Party unit is always responsible for a given activity and has authority over it. The relevant Party unit can make all matters its concern, but in practice it is most notably involved with ideological issues and the appointment of important personnel. The activity also can be located at the intersection of two distinct chains of governmental authority. One system of line authority connects the relevant central ministry under the State Council to the subordinate unit (e.g., every chemical factory ultimately reports to the National Ministry of Chemical Industry). The second dimension of the grid is based on physical locality (i.e., every factory reports, for at least some purposes, to the county, municipal, or provincial government in which it is located). The result is a pattern of crossing vertical and horizontal lines of authority that run to the central government and to local agencies. This pattern is replicated at the

provincial, municipal, and county levels. This system is highly concentrated at the top, but confronts the unit at the end of the chain with a large number of potentially competing supervisors. Tension and opportunities for conflict among the intermediate officials are numerous.

Authority and responsibility are fragmented because any unit always reports to more than one superior. A factory, for example, will have a leadership relation to one agency and have a different professional or business relation to another. The factory may "belong" to the city or province that created and built it, but produce goods that are the concern of a national ministry. Other factories nearby may have been built at the instance of the ministry or its subordinate agencies and look to the ministry for both leadership and professional business supervision.

Relations among intermediate officials are further complicated by the vertical character of the bureaucratic hierarchy. Power is highly centralized at the top, but then is divided into competing chains of authority, operating largely independent of each other. Since all power emanates along a number of chains of command from a single center, an official at an intermediate position in the chain looks to the boss above him for direction, and looks to those beneath him for absolute obedience. There are strong channels of communication and command up and down the chains, but there are likely to be few official links between agencies below the center. Communication, and the ability to coordinate among officials at about the same level in different chains, is weak. Since internal operations within each organizational chain are considered confidential, they are largely outside the ken of officials in other organizations. Links do form at these intermediate levels between agencies with frequently overlapping concerns, but these links depend heavily on the personal relations between the individuals who may share a relation with a patron, have gone to school together, or who have worked together before, since they tend to remain at these posts for many years. One can trace the roots of this organizational structure to the tenth century, when Chinese government was first organized with these competing functional bureaus balancing each other out and also balancing a parallel set of local-based military and magistrates that by their conflicting pressures upon each other ensured the Emperor's central authority.[53]

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53. ZHONGHUA FAWAN SIQIAN NIAN [FOUR THOUSAND YEARS OF CHINESE LAW] 132-52 (Ni Zhengmao ed., 1987) [hereinafter ZHONGHUA FAWAN].

At first glance this system may resemble the familiar system of checks and balances between levels of state and national government and among coordinate branches of government that underlies American constitutional law. Both systems are designed to keep each agency moving in the right direction by creating a degree of cross-checking on each agency's operations and a certain competitiveness among agencies. Both systems also suffer from a tendency for the checks and balances to become absolute vetoes, complicating coordinated action and inducing paralysis. Despite these apparent similarities, the motivation and effect of the two are quite different. The Chinese system divides power and makes subordinate officials compete in order to maintain the supremacy of the power concentrated at the center. For subordinate officials it is of supreme importance to maintain both access to and approval from the center. The American system is divided for a diametrically opposite reason — to disperse power and to prevent its concentration in any single, central authority.

3. The View From the Top

Viewed from the perspective of the supervisory agency, there is a pressing need to coordinate planning and management activities between the competing sets of authorities described above. At the national level, this is the work of the State Planning Commission, an agency whose function is replicated at each level of local government and within the ministries. The planning agencies serve as conduits through which information on resource priorities and needs are collected, policy choices are formed and embodied in plans, and allocations of resources and requisitions of production are communicated back down to the production units.

The plan is constantly being revised and modified to meet circumstances. The process of planning thus often is indistinguishable from the process of management. Before 1980, there was a sharp organizational line drawn between planning and management, with the latter being assigned to another special commission, the Economic Commission (*Jingwei*). Under that structure, the Planning Commission was the major economic policymaker and the Economic Commission was the Chief Executive Officer. The function of the Economic Commission was to coordinate the activities of the industrial ministries and local government supervisory agencies. It monitored performance of the plan, made and administered budgets, evaluated management performance, and served as general manager of the economy. In some cases it dealt directly with specific enterprises in allocating money for

special purposes, such as machinery acquisition among industrial ministries.

The State Council articulates broad national policies. The Planning Commission then supervises the transformation of these policies into plans and the Economic Commission manages the plan; through its supervision of budgets, the Economic Commission ensures that subordinate agencies and enterprises execute the program. The industrial ministries specialize in the particular concerns of an individual industry and direct the enterprises within the ambit of their expertise. Most enterprises are under the direct supervision of local government planning and economic bureaus that supervise the specifics of their planning and management. Parallel networks of Party organizations maintain revolutionary values and oversee the whole operation, paying particular attention to the selection, promotion, and discipline of leadership personnel.

The Economic Commission's Economic Regulation Bureau was a major rulemaking body, drafting economic laws and regulations for state-owned enterprises. It also possessed power to review and coordinate the regulations created by the industrial ministries. The National Economic Commission, like the National Planning Commission, occupied a professional supervisory role over local economic commissions and planning commissions, but local agencies were primarily under the leadership of the local government, rather than the national commission.

In 1980, the Economic Commission lost many of its functions at the national level, the aim being to eliminate excess agencies and officials and to combine functions as part of economic reform. Some of the Economic Commission's functions were transferred to the Planning Commission; others were transferred to industrial ministries and enterprises to remove one level of supervision. However, Premier Li Peng is reported to support rebuilding the Economic Commission, in part to serve as a competitive power balance to the Planning Commission. As is to be expected, the line between planning and management is hazy at best, and planners and managers often compete over the large penumbral areas of concern. The Paramount Leaders find it politically useful to maintain both in a state of tension, preventing either from becoming too powerful.

From the point of view of those at the center, this structure has distinct advantages. It reflects and supports longstanding Chinese attitudes regarding appropriate social hierarchies and relationships. Rulers have found it useful to have their subordinates and viceroys in the provinces competing with each other and dependent on the central

government. The multiple lines of authority radiating from the center create incentives for competition among the subordinate groups, increasing the likelihood that those at the center will be alerted by the others to the failings of any subordinate.

The system creates the appearance of a very stable, even static, monolithic authority. The system also lends itself to the creation of networks of influence and informal ties that cross lines. Those who know how to manipulate the monolithic structures and rigid borders of authority possess a valuable and flexible asset for personal advancement. Those in a lower position in such a network can borrow authority from possessors of bureaucratic competence that is likely to exceed their formal authority in the system. A strong and sophisticated leader within such a structure can quickly mobilize his or her subordinates and allies to move in a new direction. Some of the most impressive accomplishments of the PRC regime exemplify this remarkable capacity to mount what looks from the outside like a mass movement that rapidly changes direction to attain a clearly defined and specific goal.

4. The View From the Operating Level

From the perspective of an enterprise manager, the system used before 1978 was quite constraining. Within the factory, the manager's authority was substantially limited by the power of the Party secretary, who had the final say on all important personnel decisions and was the crucial voice on most other important decisions as well. Production goals and targets came down from the planning agencies through the responsible business authorities. Materials were supplied under the plan, prices were set by the Bureau of Price Management, and labor was allocated by the Bureau of Labor and Wages. Capital construction was determined by the Central Capital Construction Commission, while budgets were fixed by the Economic Commission and capital was allocated by the State Bank.

The very structure of the system complicates horizontal communication and coordination. Agencies and officials have ranks and positions, but their real power relations depends on authority they borrow from the leadership in whose network they operate. Official titles prove to be an unreliable source of guidance; the only source of information regarding the official with whom you are dealing is likely to be the official himself. Bureaucrats at intermediate levels are often uncomfortable dealing with officials in other chains of command because they have limited information about them and cannot be sure

whether they are superior or inferior.

The common response to these problems has been to avoid the formal paths of communication, decision, and control by developing informal personal connections that enable an enterprise manager to make direct contact with officials in other organizational chains. These connections provide an alternative that lubricates the rigidities of the formal structure, allowing it to work. The personal career patterns of officials create opportunities for other kinds of networks to form. Like many Western social and governmental bureaucracies, the top levels of Chinese officials change positions relatively often with political change, but the middle levels tend to stay in the same position for long periods of time. These middle level officials are the permanent civil servants that the political ministers must rely upon for expertise in doing their job.

Middle level officials tend to form connections and networks with their counterparts in other agencies with whom they deal frequently over the years. This form of personal influence is relatively innocuous; the ties are collegial and not inevitably corrupt (although they may be confirmed by an occasional banquet or other goody). Such connections are a potent source of power for the middle level officials who control reliable and effective communications links among agencies that must do business together. This form of connection is intimately related to the personal political networks and coalitions that hold the whole system together. The connecting factor may be a relationship to a mentor or former supervisor who has now moved up to a higher position. That official depends on his contacts with his former subordinates who now serve as his eyes and ears at the operating level. The subordinates depend on the protection of the mentor, the borrowed authority of his position, and the usefulness of their links to each other. As the network grows and becomes more influential, it promotes the position of the mentor and of the subordinates. At the highest levels of the system, it becomes a major source of the power behind those who become the paramount leaders.

The use of connections to short-circuit the system is known as "using the back door" (*houmen*). Those adept in its operation possess power that enables the rigid formal system to operate, but which at the same time corrodes the capacity of the formal state structure to rule. Use of the back door is not itself corrupt, although it is deviant from announced norms. As in all societies, it is alright to do a favor for a friend out of friendship or out of confidence that the friend is capable and deserves the boon. It is not corrupt to do a favor for someone, reciprocating with kindness past favors or hoping for future reciprocity.

There is a line between favors done by one organization for the other, and favors that benefit the officials, rather than the organization. Even in a puritanical regime it is not seen as serious corruption to take your opposite number in another organization out to dinner once in a while. This is a slippery slope, however, and China has always been marked by favors that soon become bribes, that in turn often are obtained by extortion. Matters of degree become differences in kind. At some point the alternative connection is not simply lubricative and facilitative; it becomes competitive and corrupting.

More importantly, safety for all officials lies in pleasing the superiors in their own line of command. There are few incentives for being creative or venturesome in ways that will produce agreements across agencies that superiors in either agency may disfavor. Such agreements certainly are necessary, but when viewed from above they represent a short circuit that implicitly threatens the absolute authority of the official who is bypassed.

In such a structure, the safest course for everyone is to insist that everything is always operating just as it is supposed to. Those who inform superiors on the shortcomings of others are likely to find similar reports being made about their own activities. Those who store up favors due from others are likely to find that others will forebear from exposing them. Neither the Center nor the Periphery are equipped for direct confrontations and neither has strong incentives to address directly the inconsistencies between conflicting norms or the divergence between norm and practice. Instead, the safer course is to exercise great care in dealing with those outside the familiar chain of command, and to insist loudly on the amazing virtues of the boss' abstractly stated policies, principles, and theories. In this way, expressions of loyalty to the leaders can be maximized, while confrontation with problematic operational specifics can be minimized.

Managers and officials at the operating level work out problems that arise every day among themselves, but they are likely to cut the center out of the communications loop and to insist that they have been following directions at all times, when in fact they were not. In such a system, disclosure of a practical administrative solution of a problem is likely to be perceived as deviance. Locals are bound by a conspiracy of silence or hypocrisy. One deleterious effect is that there are few opportunities for superiors to become educated on the needs for practical adjustment or for policy to improve.

This structure imposes heavy costs on long-term enterprise management. When confronted with a problem in dealing with another unit or enterprise, it can be difficult just to pick up the telephone and

resolve the disagreement with an official at a comparable level in the parallel organization. The two officials are likely to be in coordinate organizations, neither of which has general authority to order the other one about. Communication between the two officials depends less on their personal rank or organizational position than upon the relative status of their organizations in the informal power network. In many cases neither official will possess confident knowledge of the other's status.

The correct, formal way to deal with conflict between two agencies is to refer the problem upwards in the organizational chain until it reaches an official who forms a common link between the two agencies. This official should resolve the matter and then pass directions down the two chains of command to the operating officials who are having the problem. Resolution of disputes by this method is likely to be slow, uncertain, and distorted by the process of communication itself. Since the system is built on competing long lines of command, a dispute is likely to have to travel through a number of levels to find a common link between organizations. Often the lowest common superior will be the State Council. As the problem and the decision move up and down the chains they become the concern of officials increasingly removed from the specific information and practical experience with the situation. Movement slows as officials are called upon to deal with situations they know nothing about and find it more convenient to let the file sit on their desks while they deal with more interesting matters. Communication is repeated at each level up and down the chain and at each level the file becomes thicker. The issue is likely to appear more complex and to be distorted by the interests and limits of intermediary officials. The situation may resemble the party game in which members of a team pass a message by repeating it to the next person in line. Usually the message that reaches the end of the line is significantly changed by the process. As the problem moves within the bureaucracy the agency position is reinforced, commitments to a particular policy are strengthened, and deviance from the view first expressed is likely to be perceived at least as "backing down" and more likely as institutional disloyalty. It is hard to resolve conflict that way.[54]

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54. In addition to the use of connections and the "back door", two other approaches have been taken to deal with the limitations of this form of communication and problem solving.

a. *Build a Local System.* If the chains of decision and communication become onerously long, higher officials may simply cut them by creating a new local system that replicates the gridiron pattern at the local level and permits freer communication within the new, smaller,

II. THE EMERGENCE OF CONTRACT SINCE 1978

A. *Motivations for Change in the Contract System*

Few would deny that a primary motivation leading to the reform, which began in 1978, was the fact that, despite its impressive triumphs in many areas, China's economic performance compared unfavorably with that of its neighbors. Japan, Taiwan, Singapore, South Korea, Hong Kong and even India — they all were doing much better. One consequence of the "opening" of China during the 1970s was that as the West began to learn about China, the Chinese people became aware that inexorably they were becoming poorer while everyone around them was becoming much richer. The ruling elites of the regime, like those of Taiwan and South Korea, sought to legitimate their rule through economic reform. Some way had to be found to feed the large population and increase their material well-being as the vision of a prosperous and egalitarian society threatened to fade into oblivion. As part of the process of reform, the contract system was expanded in three ways to deal with the inadequacies of socialist planning and traditional institutions of economic exchange in industry and commerce:

> a) through contract exchanges, markets would be created and incentives expanded to improve and increase the volume of goods;

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gridiron. This is one way to understand the tendency for provincial, municipal, and county governments to replicate the general pattern of the national regime. If an enterprise in a county or large city has a problem with a unit across the street it is no longer necessary to go up the chain of command to Beijing to find a common link. Instead the enterprise reports to the local Economic Commission which deals with the other unit with few intermediate steps.

b. *Build your own Society.* This strategy avoids long chains of communications to decrease reliance on strangers. Each unit tends to build its own little society. The manager places a high premium on finding ways to control supplies and outlets within a single unit's own resources or with related units. This is what American managers and antitrust lawyers refer to as vertical integration. A cement factory ensures its materials by developing its own quarries for sand and gravel, it builds schools, hospitals, and housing for its workers, it guarantees its markets by purchasing trucks and establishing its own distribution system for its products. This assures the manager that problems can be dealt with inside the organization. This strategy also is likely to prove inefficient economically and to result in substantial inequalities in access to public services between those lucky enough to be part of a large rich unit and those who are stuck with the low level of governmental services generally available.

When the strategy works, it is praised as a model of self-reliant development. For varying reasons Imperial China, Republican China, and Maoist China all emphasized the importance of freestanding local economies that live on their own resources and engage in commerce only as a sideline. In many ways self-reliance often means bare subsistence, a life without the benefits of variety or the efficiency produced by commerce and comparative advantage.

b) through contract exchanges, Chinese economic activity would be brought in closer linkage with the world system, increasing foreign trade and Chinese access to capital and technology; and
c) through contract exchanges and the creation of markets to supplement central state planning, the efficiency of economic activities would be enhanced and allocative decisions would be rationalized.

1. Contract As a Means To Increase Production by Providing Rewards For Producers

The first tentative changes in the organization of the work lives of the 800 million Chinese who live in the countryside occurred in 1978-80, when collective units of agricultural production were replaced by a system of household responsibility contracts. Major production decisions were returned to the family that worked the land. By most accounts this reform succeeded in dramatically increasing the production and availability of food. A visitor to China who recalls how things looked in the early 1980s would be struck with a strong visual impression of how much better off many Chinese appeared in the streets of large cities and towns soon after this reform. Better nutrition, more abundant and stylish clothing, and other consumer goods became available to a substantial portion of the population. A foreign traveller to those parts of the countryside open to visitors would observe similar signs of higher living standards: fuller faces, better clothed bodies, numerous locally-run brick kilns producing the materials for the newly constructed houses that were visible everywhere. Even in the far reaches of Western China the peasants' traditional homes were likely to be topped by the ubiquitous television antenna. In some places reliable electrical supplies had not yet arrived, but the silent TV set proudly displayed on the central table was an eloquent statement of confidence in the inevitability of the march of material progress.

In 1977, Chairman Hua Guofeng announced a new national Party program that committed the nation to the "Four Modernizations," including massive long-term investments to develop agriculture, industry, defense, science and technology. But only with further changes in leadership did the content of the new program take shape. In late December 1978, the Central Committee of the Communist Party Congress issued a communique setting the framework for the changes to come. The three central features of this program were the reorganization of agricultural production and rural land tenure; the opening of

China to trade with the rest of the world, particularly increased export of manufactures and greater imports of foreign technology; and the restructuring of domestic industrial and commercial enterprises to increase the share of consumption in national income. Each of these programs was to have a substantial legal and contractual dimension.

a. Agricultural Reform

During the immediate post-revolutionary period, land had been confiscated from landlords and wide scale redistribution to producer peasants occurred. By 1955-56, however, agricultural producers' cooperatives had been formed throughout China with an average size of about 200 families. Further waves of collectivization during the late 1950s resulted in the creation of large communes consisting of perhaps 5,000 families. Production was organized on a collective basis and individuals received as compensation work points based on their time, effort, skill, and political attitude. Farmers were permitted to maintain private plots on about 5% of the land and the production of these plots could be sold on an open market at prices above that received for state quotas on collectivized land. By 1962, after several disastrous years during which millions starved, the system had reverted to essentially its earlier form. The communes remained in existence as administrative units of local government, but the basic unit for organizing labor and determining the value of peasants' work points became a subunit known as the production team, consisting of only 20 to 30 families. About 7% of arable land was left for private plots and limited open markets were permitted for some commodities.[55]

The net result of all these changes — and the political campaigns and purges that accompanied them — was stagnant food production, tied to serious disorganization and weakened work incentives for agricultural producers. Wide scale local rationing of food was introduced in many cities in the mid-1970s for the first time in more than a decade. Despite technological changes, including the introduction of new high yield dwarf rice in 80% of the fields, and infrastructure investments in irrigation and roads, China was importing more than one third of its grain for urban consumption.

The rural reforms between 1978 and 1983 had two major features. First, markets for most agricultural commodities were opened and

55. Elizabeth J. Perry & Christine Wong, *The Political Economy of Reform in Post-Mao China: Causes, Content and Consequences*, *in* POLITICAL ECONOMY OF REFORM, *supra* note 4, at 1, 11.

farmers were permitted to sell their production beyond state quotas more freely on these markets. Second, the collective work point system was largely replaced by a "contract responsibility" system that amounted to household farming. The commune and production team disappeared as land was allocated to household units under long term agreements that provided for crop deliveries to the state under a quota, with state-fixed prices and tax payments. Compensation for state crop deliveries was raised, but these payments were maintained at a level lower than the market value of the produce. Beyond this basic production, the household unit was free to make production decisions and to sell its product on the newly opened markets.

Food production increased dramatically in the years following these reforms and the wealth of the countryside visibly increased in many fertile areas. Prices for above-quota market grain actually fell for several years and the abundance of grain enabled the State to repeatedly reduce grain delivery quotas to farmers, thus increasing the share of total production that was distributed on the market. Production of meat, poultry and other commodities increased dramatically during the early years of reform. Income soared in the countryside, at least in those areas with good land and resources. It has been estimated that between 1978 and 1981 real per capita rural income grew at an annual rate of 11.4 percent.[56] New houses, consumer goods, and clothing were seen everywhere and, as cash income accumulated, the countryside became a major site for new enterprises started by peasant investors.[57]

The picture was not one of unmixed joy, however, for the changes had several adverse effects.[58] New competing opportunities for cash income made it more difficult for local leaders to mobilize labor for socially necessary, but non-cash producing, activities. Less attention was paid to maintaining community irrigation, roads, public health, and education. Teachers quit for better paying jobs, irrigation channels

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56. *Id.*

57. Dwight H. Perkins, *Reforming China's Economic System*, 26 J. ECON. LIT. 601, 607-13 (1988).

58. *See* JUDITH BANISTER, U.S. BUREAU OF CENSUS, CENTER FOR INTERNATIONAL RESEARCH, STAFF PAPER NO. 23, CHINA: RECENT TRENDS IN HEALTH AND MORTALITY (1986); MICHAEL CHOSSUDOVSKY, TOWARD CAPITALIST RESTORATION? CHINESE SOCIALISM AFTER MAO (1986); William Hinton, *A Trip to Fengyang County: Investigating China's New Family Contract System*, MONTHLY REV., Nov. 1983, at 1; Richard Latham, *The Implications of Rural Reforms for Grass-Roots Cadres*, *in* POLITICAL ECONOMY OF REFORM, *supra* note 4, at 157. For an economic analysis of the gains and social costs associated with this innovation, see Justin Y. Lin, *The Household Responsibility System Reform in China: A Peasant's Institutional Choice*, 69 AM. J. AGRIC. ECON. 410 (1987).

clogged, and standards of infant health apparently declined. The reforms exaggerated the disparities in the endowments available to different households, communities, regions, and provinces. The lucky and the well-endowed grew rich, emphasizing the unhappy lot of those less fortunate. The countryside's transformation to the new system involved a social revolution that was completed with amazing speed and ease considering the size of the operation. It remains unclear how so mammoth a transfer of land to particular families could be conducted without serious unrest.

The legal structure through which these profound changes in land use and social organization occurred is said to be contractual. The success of these changes was a significant source of support for contract as a cornerstone of economic reform. The land continues to belong to the State, but the use of the land is transferred to a household by a responsibility contract. These contracts have very important legal consequences, including limited power to transfer the right to the land to other family members upon death and transfers to other persons by subleases.

In many respects, however, these agreements do not resemble familiar commercial contractual arrangements. In some places land apparently was divided into plots of approximately equal value and then lots were cast to decide which family received what piece of land. Whatever the process used, there were few serious opportunities to negotiate the terms; the households took what they were given. In this respect the responsibility contracts are more akin to status documents, giving the household a legal claim to use the land. Apparently the draftsmen of these documents relied heavily on the tenant farming and sharecropping lease agreements they remembered from pre-revolutionary days.[59] There are reported cases in which households have successfully asserted their legal rights under these agreements when local officials have sought to take their land away or deprive them of its benefits. The contract dimensions of these agreements have grown slowly, and there are few reported court decisions that have applied principles of contract law to them.[60] Indeed, it is reported that in

59. The comparison is traced in Crook, *supra* note 8. *See also* Y.Y. Kueh, *The Economics of the "Second Land Reform" in China*, 101 CHINA Q. 122 (1985).

60. Phyllis Chang reports that these disputes were first accepted by courts in 1982 and by 1985 accounted for over 10% of all economic disputes in the courts, or between 20 to 30 thousand disputes per year. She goes on to note that court intervention remains the exception rather than the rule in such disputes and that Party policy rather than law has largely shaped these proceedings. Phyllis Chang, *Deciding Disputes: Factors That Guide Chinese Courts in the Adjudication of Rural Responsibility Contract Disputes*, 52 LAW & CONTEMP. PROBS. 101, 102

1987 alone there were more than ten million such disputes between village committees and farmers. In a legal circular, dated April 14, 1986, the Supreme People's Court decreed that disagreements over the performance of these agreements are not cognizable in lawsuits in the People's Courts, but are to be resolved as administrative matters through the village committees. One of the issues that confronted the National People's Congress in 1989 in adopting an Administrative Procedure Law was whether decisions of local agencies in disputes involving rural responsibility contracts would be subject to review by the Administrative Courts to be created under the new law.[61] The fear was expressed that inclusion of these disputes, which approach ten million per year, would overwhelm the new administrative court system; they were therefore excluded.

2. Contract As a Means to Foster and Enlarge Markets

The geographic and cultural diversity of China complicates communications and transportion and leads scholars to debate whether China ever formed a national economy.[62] To this day, trade between enterprises in different provinces often presents features we are likely to associate with trade between foreign nations.[63] A high proportion

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& n.6, 113-14, 115-30 (1989). The ambiguities presented by reported rural disputes arise on several levels: whether the dispute arises out of the household responsibility contract or under a distinct but related purchasing agreement for the agricultural products produced on the land; whether the dispute is resolved by the court as a "lawsuit" or by less formal mediatory intervention; whether the court resolves the dispute on the law or under non-legal Party policies; and whether the resolution is an imposed decision or a compromise settlement. These ambiguities are presented and explored in the context of six cases in Zweig, *supra* note 8, at 340-55. Lester Ross' more recent study of a county in Shandong places little emphasis on the role of court litigation or on agricultural responsibility contracts themselves. Lester Ross, *The Changing Profile of Dispute Resolution in Rural China: The Case of Zouping County, Shandong*, 26 STAN. J. INT'L L. 15, 37-42 (1989).

61. There is some uncertainty whether such village committees, which are understood to be one of the parties to the agricultural responsibility contracts, are administrative units of the state under the Administrative Litigation Law adopted in 1989. *Deputies Interviewed on Litigation Law*, FBIS—China, Mar. 31, 1989, at 17-18. Edward Epstein, *Administration Litigation Law: Citizens Can Sue the State But Not the Party*, CHINA NEWS ANALYSIS, June 1, 1989, at 1.

62. *See* Skinner, *supra* note 31.

63. A leading economic reform journal reports editorially on situations where county officials restrict "imports" of bicycles, radios, shoes and about one hundred other items. Some places put advertisements in the newspaper falsely identifying goods from other communities as "shoddy goods". *Tear Down the Wattled Wall and Setting Up the Big Market*, 1990 ZHONGGUO JINGJI TIZHI GAIGE [CHINA'S ECON. STRUCTURE REFORM] No. 8, at 6. Heilongjiang province is reported to have imposed an absolute ban on 20-30 categories of goods and limits on the entry of more than one hundred other products. *Beggar Thy Neighbor*, FAR E. ECON.

of commerce follows major river systems, while road and rail networks remain weak. Traditionally, central state penetration into the lives of local communities has been limited, and within communities a heavy price was exacted from those who were strangers.[64] Although state penetration of the local community has been more extensive in the PRC, the stranger still is more vulnerable because laws and policies are enforced by local officials, who have to be concerned about ongoing social relations. State revenues continue to rely heavily on income from monopolies and practices that resemble tax farming.

In this setting, commerce, like many other aspects of civil society, has come to be organized on the basis of specific personal connections between economic actors. Family, clan, guilds, and locality remain central sources of connection for economic actors who are unable to rely upon the state and the law to support and enforce their expectations. Connections and relationship provide the only secure basis for entering commercial transactions that pose the risks of time and space.

Contract law provides additional sanctions for performance and compliance through legal enforcement that offers strangers greater hope of being able to enforce obligations. To the extent that contract law can deliver on this hope, it supports transactions between strangers and thus encourages the expansion of markets. There will always be advantages to playing on one's home turf, just as there will be costs associated with straying far from home. Nonetheless, the potential of legal enforcement, designed to provide compensation for disappointed expectations through institutions that can put money for damages in the injured party's pocket, can reduce the "home court advantage".[65]

REV., Oct. 18, 1990, at 89. Sometimes the limitations are on exporting food to other provinces, rather than the import of manufactures. In 1988 farmers in Guanxi and Hunan were reported to have engaged in daily confrontations with local officials who were trying to prevent the farmers from taking advantage of higher produce prices in richer Guangdong. *Business As Usual*, FAR E. ECON. REV., Dec. 8, 1988, at 61.

64. *See* HSIAO KUNG-CHUAN, RURAL CHINA: IMPERIAL CONTROL IN THE NINETEENTH CENTURY (1960).

65. Two Chinese judges detail the evils of "local protectionisim" in the courts and attribute many of the problems to unlawful administrative interference by local authorities:

> A small number of party or government leaders at the county or district level rudely interfere with the law-enforcement activites of courts, without considering the overall situation and for the sake of the narrow interests of their localities. Some leaders openly declare that the local court is not allowed to accept entrustments from another court and to grant local property to a nonlocal litigant through legal action. If the local court reaches a decision to the advantage of a nonlocal litigant through legal action . . . it will be criticized as "disobedient" in less serious cases or censured as "living off the locality while helping other places" in serious ones. This may lead to a cut in office expenditure and, more seriously, removal from office, dismissal, or transfer from the court of relevant

The programs of economic reform since 1979 have created incentives for actors to use contract forms drafted by the government in their transactions. In the beginning contract certainly operated as a formality, providing transactional structure in a society where the expectation is that every activity somehow must be regulated by the state. The underlying organizations of control over the substance of the transactions by the state and the Party remained in place, although great energy was expended in teaching literally millions of people how to use the forms of contract. In some of the books published early in reform it almost looks as though making a contract is essentially a matter of filling in the blanks correctly.[66]

In time, however, there have been clear signs that the availability of contract has supported expansion of the number and kinds of potential economic actors by making it safer to deal with strangers. Contract can turn outsiders into insiders and vice versa. When the mechanisms that sanction contract performance are credible, it becomes possible to do business with and ultimately to trust strangers. The objective external relationships created by contract slowly begin to displace economic ties based on personal networks and influence.

Both planning and personal networks have trouble pairing new partners and expanding the number of players in a market, but this expansion is precisely what development requires. Contract suggests a safer way to do business between strangers, who, lacking authority or relational sanctions for performance and security, depend heavily on the legal sanctions provided by contract law. Legal enforcement of

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personnel.

Yuan Yongliang & Wu Chingbao, *Analysis Views Local Protectionism*, JINGJI CANKAO [ECONOMIC REFERENCE], Apr. 1, 1990, at 4, *trans. in* FBIS—China, May 3, 1990, at 27.

66. Professor Hugh Scogin, to the authors, states that the interest in government-provided contract forms goes back to the Northern Song and is a continuous feature of Chinese state involvement with commerical transactions. The tension appears to be between those officials who are attracted to a scholarly and somewhat abstract set of contract law principles that must be judiciously applied in particular cases and those administrators who are attracted to the promulgation of forms that fix the content and legal impact of agreement. It certainly is true that ministries appear attracted to contract forms and promulgate a number of such forms for specific types of transactions, while courts and other legally oriented officials prefer legislatively stated general contract norms.

Although it is not common to collect or publish judicial opinions in cases, during our study we encountered a number of interesting collections of contract case decisions that appear designed as teaching materials. *See, e.g.*, JINGJI HETONG JIUFEN ANLI XUANBIAN [SELECTED CASES OF ECONOMIC CONTRACT DISPUTES] (1982); JINGJI HETONG ANLI FENXI [ANALYSIS OF ECONOMIC CONTRACT CASES] (Qiu Guotang & Chen Gan eds., 1984); Wuxi Municipality, Gongshang Xingzheng Guanli Ju [State Administration of Industry and Commerce], ANLI FENXI [ANALYSIS OF CASES] (fourteen unpublished manuscripts collected between Oct. 1983 and May 1984).

contracts provides shape to the new socialist order, establishing a new kind of control and avoiding the chaos of an unregulated market. It is unclear whether all reformers believed that they were building socialism through this program. It is clear, however, that this perspective created an acceptable style of political discourse for reform that could claim consistency with basic socialist principles. Socialism may not be the ideology that guides Chinese development policies, but it continues to be the shared vision of the ruling elites. Over the decade of reform, contract has moved from being merely a formal technique to being a significant supplement to planning in the service of socialism. It became increasingly apparent that contract had the potential to support the establishment of markets, expand the cast of characters, and convert hierarchical and network relations into legal relations.

3. Contract To Promote Participation In the World System

Another central strand motivating change since 1978 has been the desire to open China to broader contact with foreign nations, including the major Western trading powers of Europe, America and North Asia. Previously, China and these nations had perceived each other as dangerous enemies and excluded each other from trade. Now, however, government policy contemplates a pattern of export-driven development, in which foreign capital and technology are key ingredients. Coastal cities and provinces and special zones have been opened to foreign contact, trade, and investment. China has joined a number of international economic and commercial organizations and seeks to become a significant player in the world economic and trade system.[67]

During the first generation of the People's Republic, China had followed a fiercely independent and self-reliant path. After the breakdown in relations with the Soviet Union late in the 1950's, the nation was without major political or economic allies. The reform movement and the adoption of contract transactions reflected the leadership's recognition that rapid economic development in other nations had been supported by their participation in a global economic system. The government wanted to attract foreign capital to fuel its development; it hoped for access to foreign markets that would enable it to earn capital through an export-driven development strategy of the

67. ROBERT KLEINBERG, CHINA'S "OPENING" TO THE OUTSIDE WORLD: THE EXPERIMENT WITH FOREIGN CAPITALISM (1990); NICHOLAS LARDY, CHINA'S ENTRY INTO THE WORLD ECONOMY: IMPLICATIONS FOR NORTHEAST ASIA AND THE UNITED STATES (1987).

kind that was working so well for its neighbors. The success of this policy is indicated by the tremendous growth in foreign trade from $14.8 billion in 1977 to $73.8 billion in 1986. Direct foreign investment also jumped from $649 million in 1982 to $2.15 billion in 1986.[68]

To do business in the world system, one must do business the way everyone else does. Since the mid-nineteenth century, a powerful driver for legal development in Asia had been the necessity to use internationally-recognized transactional forms to ensure that foreign businesspersons felt secure and comfortable. To secure this comfort, imperialistic commercial interests had subjected China's major centers to the indignity of foreign courts and concessions. Courts and codes had been adopted in Japan so that foreign governments would agree to rescind treaties that had granted extraterritoriality to foreign nationals. China had resisted these pressures as best it could, and when legal codes were adopted during the Republican era, social hostility limited their penetration into Chinese life. During the second half of the twentieth century the legal rules and procedures of world commerce and investment have been largely internationalized and harmonized to the degree that it is difficult to find major substantive differences from nation to nation. China stood as an exception, outside the world system and its legal aspects, which were predominantly built on treaties and conventions that emphasized the autonomy of contract-based transactions.

To join the world and gain foreign exchange for development, China needed to make its legal system consistent with world standards. To trade with foreigners and to attract their investments, China has had to reassure potential partners that it will provide the familiar security of a legal regime. To communicate with foreigners, it has had to talk the special language that is universally used in world trade, a language closely connected with the legal requirements of the world system.

The Chinese government would prefer to limit the adoption of this vocabulary to foreign trade. One strategy to this end has been to attempt to separate domestic contract transactions from international transactions and to adopt distinct legal regimes for the two. There is an inevitable tension between these two systems.[69] As China joins the

68. LARDY, *supra* note 67, at 4, 37.

69. In a helpful comment to an earlier draft of this article, Stanley Lubman reminded the authors that the interplay between Chinese and world trade practice moves both ways:

> [N]ot only is there a question of allowing domestic transactions to be influenced by internationally recognized legal concepts, but in practice there is also the danger that

world system, it is increasingly confronted with the indivisibility of that system and with the infeasibility of selectively choosing to adopt some aspects of that system and to reject others. The world system turns out to be composed of interconnected parts, it provides valuable opportunities for a developing country, while at the same time threatens that country's sense that it is the autonomous master of its own policy choices. Whereas Mao Zedong opted for autonomy, Deng Xiaoping seized the opportunity.[70]

4. Contract As a Means of Rationalizing Allocative Decisions

For the first time since the Revolution that created the People's Republic of China in 1949, a new tolerance for private individual and group economic activity is now embodied in laws that explicitly encourage such enterprise. Chinese socialism, drawing both upon Marxian and longstanding Chinese attitudes, generally has been hostile to commerce and has tended to see those who profit by buying and selling what others produce and consume as parasites.[71] Now ideological theoreticians are busy learning new songs that chant the virtues of "commodity socialism", "scientific management", and the importance of developing the communications and trade infrastructure suitable for the "moderately wealthy society" that China is promised to become.

At the same time, connections based on family, clan and locality seem to be reasserting themselves more strongly as familiar ways of doing business, but now are tolerated by the revolutionary regime.[72]

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international contracts in trade and investment transactions, despite their ostensible dependence on recognized international principles, come to be influenced by fluid, flexible and anti-legal Chinese notions. I'll show you my scars sometime.

70. For a discussion on China and the world system, see Richard Kraus, *Withdrawing from the World System: Self-reliance and Class Structure in China, in* THE WORLD-SYSTEM OF CAPITALISM: PAST AND PRESENT 237-59 (Walter L. Goldfrank ed., 1979); Joan Sokolovsky, *States, Classes, and the Chinese Socialist Transition, in* SOCIALIST STATES IN THE WORLD-SYSTEM 157-80 (Christopher Chase-Dunn ed., 1982).

71. *See* SOLINGER, *supra* note 32, at 12-18, 130-35.

72. SULAMITH H. POTTER & JACK M. POTTER, CHINA'S PEASANTS: THE ANTHROPOLOGY OF A REVOLUTION 256-69 (1990). As a society where access to resources, labor and the market is limited and under the control of different groups of officials, China developed an elaborate gift economy based on *guanxi*. Yang's study clearly shows the redistributive function of *guanxi* in Chinese economic life. Yang, *supra* note 3. An official with good *guanxi* is able to get things done when other officials with lesser *guanxi* fail. The Chinese Petroleum Corporation complained about how government departments use their authority to gain extralegal petroleum. Responses from officials point to their need to take care of an extensive *guanxi* network. Peng Bo, *"Xueye" de Liushi [Bleeding Away]*, MINZHU YU FAZHI [DEMOCRACY AND LAW], Dec. 1990, at 2. The fact that children of Party and government leaders are given lucrative positions in newly established corporations in Hong Kong, Shanghai, and other large cities where their

The leadership has recognized that incentive and foreign exchange were needed for faster development, but other structural shortcomings of the Chinese system also provided motivations for reform. There are important interconnections between the two most prominent of these: the desire to create a national market to expand potential productive transactions for enterprises and the desire to expand the role of contract to enable socialist planning to work more effectively.

The perception that contract provided an organizational mechanism that would correct and balance the perceived weaknesses and excesses of the Chinese economic planning system was a strong impetus to use contract as part of reform. As has been pointed out earlier in this article, contract was not seen as incompatible with socialism or planning. On the contrary, the Maoist planning system, like its Soviet model, had employed a system of "contract" to implement planning orders. Once the central planners established goals for inputs and outputs, these decisions had to be made specific by bringing suppliers and customers together. This was done by assigning "dance partners", who provided resources and marketing outlets for products to each other, but who possessed very limited power to set the material terms of their exchange.[73] These "contracts" were not the product of the parties' agreement or exchange and were of only limited significance in defining performance obligations. Moreover, they furnished no expectation of a legal remedy in case of breach. As the transaction unfolded during performance and disappointments occurred, the parties' recourse always was to the supervising official, not to the agreement itself and its legal enforcement.

a. Industrial Reform

The program of reform in the industrial sector had several central objectives. Investment policy was to be reversed, eliminating the Stalinist priority of heavy over light industry. The forced diversion of resources and savings to build large basic industries would be supplanted by a more balanced production program that would increase the availability of manufactured goods for domestic consumption and export. This change was to increase levels of personal consumption and improve living standards. Another objective was to reduce the wasteful consumption of energy that was a major contributing cause

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biggest asset is good *guanxi* is widely acknowedged in China, and has been the target of anti-corruption campaigns.

73. *See supra* notes 49, 50 and accompanying text.

of shortages and stagnant productivity. Finally, increased production was to be accomplished primarily by plant modernization, improved management, and higher efficiency in existing enterprises, rather than by new capital construction. By increasing efficiency, consumption and growth could increase at the same time, while new capital accumulation could actually decline.[74]

The key to this program was to be a set of incentives linking rewards to performance. As in the case of agricultural reform, the reformers took the basic approach of providing incentives for efficiency within the enterprises and creating a greater role for market mechanisms to allocate resources and set prices. Both of these approaches strongly suggested a reduced role for the central agencies of input-output planning in allocating industrial goods and in enterprise management.

The forms these incentives and markets would take remained quite hazy for several years after 1978, and widely divergent views continue to be held by influential leaders up to the present. At the very least, this strategy implied that enterprises were to have some resources of their own, a budget outside the plan. The planning process was bifurcated into a mandatory plan, which continued to establish fixed quotas and provide inputs for a few vital sectors of the economy, and a guidance plan, which set only rough production goals for most other sectors of the economy. These production goals under the guidance plan were subject to adjustment after consultation with central and local authorities. The material inputs and product outputs of items subject to guidance planning were neither guaranteed by the state nor requisitioned for delivery to the state. To an initially small but growing degree, enterprises were to become responsible for acquiring their materials and other inputs and selling their products on markets. Enterprises that over-fulfilled their basic production quotas were permitted to retain profits and could sell products on the market to non-plan customers. Efficient producers could use retained profits for worker bonuses, plant improvements, or supplies to increase production. Markets for goods were expanded as a larger portion of production fell outside plan quotas. As a result, a dual price system has developed under which some goods are sold at low state quota prices and others are sold at higher market prices. The aim has been

74. Perkins, *supra* note 57, at 613-21; Dorothy Solinger, *Industrial Reform: Decentralization, Differentiation, and the Difficulties*, 40 J. INT'L AFF. 105 (Winter 1986); Gene Tidrick & Chen Jiyuan, *The Essence of Industrial Reforms*, *in* CHINA'S INDUSTRIAL REFORM, *supra* note 4, Ch. 1.

to increase the role of markets and eventually bring the two price levels together.

At the heart of the industrial economic reform program was a clearer delineation of the identity of an enterprise and the corollary attachment of responsibility for failures and rewards for success. The preexisting system's rigid centralization and overlapping structures of supervision and authority in the government and Party had created a situation in which no one was in charge. No one could claim credit for gains or be held responsible for failures. As the Communique of the Third Plenary Session of the Eleventh Central Committee of the Communist Party put the matter in announcing the reforms in 1978:

> [O]ne of the most serious shortcomings in the structure of economic management in our country is the over-concentration of authority, and it is necessary boldly to shift it under guidance from the leadership to lower levels so that the local authorities and industrial and agricultural enterprises will have greater power of decision in management under the guidance of unified state planning; . . . it is necessary to act firmly in line with economic law, attach importance to the role of the law of value, consciously combine ideological and political work with economic methods and give full play to the enthusiasm of cadres and workers for production; it is necessary, under the centralized leadership of the Party, to tackle conscientiously the failure to make a distinction between the Party, the government and the enterprise and to put a stop to the substitution of the Party for government and the substitution of government for enterprise administration.[75]

During the early phase of economic reform the basic expectation was that planning and state ownership of enterprises would continue to dominate the economy, but that the central state would be freed from the miring preoccupation with detail that had prevented planners from focusing on the big picture and paralyzed managers by denying them the initiative to execute transactions. Reform through contract would support the decentralization of economic supervision.

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75. Communique of the Third Plenary Session, *supra* note 27, at 6, 12.

B. *The Growth of Contract Institutions Post-1978*

Revolutionary regimes often start with a strong commitment to undoing the structures of the past, including the legal organization of their predecessors. After enjoying a brief period of heady lawlessness, they typically proceed consciously or unconsciously to recreate the past. Oscillations in attitude toward law have been especially sharp and wide in the case of the Chinese revolution that led to the establishment of the PRC. The Communist revolutionaries gained their first successes in the rural countryside; the mechanisms of law and government they developed in that setting were very simple. When the People's Republic was declared in 1949, one of its first acts was to declare inoperative all the laws of the predecessor regime. Nonetheless, much of the administration and judiciary remained in the hands of former Nationalist officials for several years, and it appears that when they were in doubt, the law most familiar to them was applied.

During its first seven years (1949-56), the new regime adopted a number of new laws, including a land reform law and marriage law, both of which had great influence. As socialist planning was established, some laws were adopted to control economic transactions, including contracts. A national constitution was adopted in 1954, along with organic laws for the judicial, administrative and legislative organs of government. These laws borrowed from Soviet models, but on a piecemeal basis. The overall structure of the codes and legal system of the Soviet Union were studied and admired, but were not adopted. At the first session of the National People's Congress in 1954, Zhou Enlai, on behalf of the government, reported on the importance of having a complete legal system. During this period work proceeded on a new civil code, among other laws.[76]

The traumatic political events that began with the Anti-Rightist campaign in 1957 brought successive waves of damage to the legal system. Professionally trained lawyers and scholars, particularly those trained in the West before the Revolution, were obvious targets for these campaigns. Law schools were closed in 1957 and were not to reopen for more than 20 years. Between the waves of the Anti-Rightist Campaign, the Great Leap Forward, and the Great Proletarian Cultural Revolution, tentative efforts were made by the government to revive

76. *See* HENRY ZHENG, CHINA'S CIVIL AND COMMERCIAL LAW 19-24 (1988); Masanobu Kato, *Civil and Economic Law in the People's Republic of China*, 30 AM. J. COMP. L. 429, 433-37 (1982); Edward Epstein, CODIFICATION OF CHINESE CIVIL LAW: HISTORY, FORM AND SUBSTANCE IN THE RECEPTION OF WESTERN PRIVATE LAW (forthcoming 1992).

the legal system and adopt laws, but these inevitably were swept away by the next political wave. For at least a decade during this period, the National People's Congress did not meet and for a longer period its legislative activity was paralyzed. Some draft laws that were brought forward during this period were normative, although not formally adopted by the legislature. For example, the Law Governing the Work of the People's Communes remained in draft form, although it functioned as positive law.

The position and authority of laws, legal institutions, and legal professionals were uncertain at best. The Ministry of Justice was abolished. The Cultural Revolution was a period of radical attack and rejection not just of lawyers and particular laws, but of all positive law and those responsible for it. The slogan was, "Smash the police, the procuracy, and the judiciary." At the beginning of the decade of reform in 1978, all that remained was the shell of legal institutions. The people's court system was in place, but these courts were manned predominantly by untrained persons and operated primarily as criminal courts, with only the shadow of some vestigial civil jurisdiction. Dispute resolution procedures described as arbitration and mediation displaced adjudication, and those neighborhood committees that operated were subject to few legal restraints. Political and Party control over the courts and neighborhood organizations was very tight. Those who had been trained in the law had long since been sent to other activities. The paucity of laws, lawyers, and institutions of law was reflected in the narrow set of activities in which law was invoked. The courts continued to hear criminal charges and punish ordinary, political, and economic crimes, but few would suggest that the punishment of offenders was determined by a legal process during this period. Some divorce and other domestic relations disputes found their way into courts, but most were resolved by neighborhood committees and again law played a small role, if any, in the process.

1. A Growing Concern For Legality and the Growth of Legislation

The transfer of power during the mid-1970s was accompanied by a growing concern for legality expressed at different levels of the regime. To some, legality may well have been connected to legitimacy and law compliance served to support the regularity of the shift in political power. For others, legality was connected with administrative orderliness and the requirement that officials follow set procedures and act within defined authority. These traditional concerns were reflected in the repeated revision of the Constitution and various other organic

laws that defined basic political institutions.[77]

Related to both of these aspects of legality was increased discomfort with the lawless procedures by which punishment, exile, and often death had been imposed during the Cultural Revolution. The specific content of whatever legal constraints were to be adopted seemed less important than some guarantee that the chaos and arbitrariness would not be repeated. Among the first new laws announced were those dealing with criminal procedure and the definition of crime. Probably a majority of the laws adopted during the decade, however, dealt with economic matters, particularly foreign trade.[78] It is difficult to quantify the number of regulations and local ordinances adopted during the decade of reform. A major project at Beijing University Law Faculty is seeking to compile and index this subordinate legislation in a computer data base.

The growth in legislation has emphasized the importance of the research organizations that prepare this legislation within the Government, the National People's Congress and the Consultative Assembly. These organizations are not centralized within the Ministry of Justice, which was reestablished in July, 1979, but are attached to the State Council itself, or to other ministries and organs. Within these research organizations substantial expertise and influence have developed that shape the direction of the laws which emerge from the process. We are informed, for example, that in some cases legal research institutes

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77. *See, e.g.*, Zhonghua Renmin Gongheguo Difang Geji Renmin Daibiao Dahui he Difang Geji Renmin Zhengfu Jieshi Fa [The Law of the People's Republic of China for the Organization of the Local People's Congress and the Local People's Governments] (adopted July 1, 1979) *in* ZHONGHUA RENMIN GONGHEGUO FALÜ QUAN SHU [COLLECTION OF THE LAWS OF THE PEOPLE'S REPUBLIC OF CHINA] 33 (1989) [hereinafter FALÜ QUAN SHU]; Zhonghua Renmin Gongheguo Quanguo Renmin Daibiao Dahui he Difang Geji Renmin Daibiao Xuanju Fa [The Law of the People's Republic of China for the Election of the National People's Congress and the Local People's Congresses] (adopted July 1, 1979) *in* FALÜ QUAN SHU 60; Zhonghua Renmin Gongheguo Renmin Fayuan Jieshi Fa [The Law of the People's Republic of China for the Organization of the People's Court] (adopted July 1, 1979) *in* FALÜ QUAN SHU 47; Zhonghua Renmin Gongheguo Renmin Jianchayuan Jieshi Fa [The Law of the People's Republic of China for the Organization of the People's Procuracies] (adopted July 1, 1979) *in* FALÜ QUAN SHU 51; Zhonghua Renmin Gongheguo Xingfa [The Criminal Law of the People's Republic of China] (adopted July 1, 1979) *in* FALÜ QUAN SHU 97; Zhonghua Renmin Gongheguo Xingshi Susong Fa [The Criminal Procedure Law of the People's Republic of China] (adopted July 1, 1979) *in* FALÜ QUAN SHU 207.

78. In 1989, the director of the Legislation Bureau of the State Council reported that, in addition to international conventions dealing with commercial matters and some 24 bilateral investment protection agreements, China had adopted about 250 laws and regulations dealing with foreign economic matters. Sun Wanzhong on China's Foreign Related Economic Legislation, ZHONGGUO XINWEN SHE [CHINA NEWS AGENCY], Mar. 31, 1989, *trans. in* FBIS—China, Apr. 4, 1989, at 49.

have power to review ministry regulations to ensure their legal correctness.

2. The Growth of Courts and the Judiciary

From its beginning, the PRC did not see being a judge as a specialized position limited to the law-trained. During the revolutionary period heavy reliance was placed on mediation of disputes within families, villages, and communities. After the consolidation of power, a nationwide system of People's Mediation Committees was established, supplemented by a system of people's courts primarily for serious criminal cases. There was tight political and ideological control over the courts and mediation committees and Party influence was strong. During the 1957-1972 period these organizations were all subject to powerful attacks and effectively were disbanded.

Peoples' Mediation Committees were re-established in the early 1980s, and now about one million separate committees with over six million mediators operate in virtually every village and neighborhood in China.[79] These committees undoubtedly hear very large numbers of disputes, including many that would be considered appropriate for litigation in other countries. The committees are also an integral part of the local system of public control and supervise a range of activities, including family planning and housekeeping chores that in other societies might be considered private concerns.[80]

The People's Courts also reappeared, although personnel problems remained formidable for a number of years and limited their activities. Gradually, some trained judges were brought back from the places to which they had been dispersed during the Cultural Revolution.

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79. *See generally* Han Yue et al., *People's Mediation Unique to China*, BEIJING REV., Nov. 30-Dec. 6, 1987, at 19; Stanley Lubman, *Mao and Mediation: Politics and Dispute Resolution in Communist China*, 55 CAL. L. REV. 1284 (1967); Michael Palmer, *The Revival of Mediation in the People's Republic of China: (1) Extra-Judicial Mediation*, 1987 YEARBOOK ON SOCIALIST LEGAL SYSTEMS 219 (1988); Michael Palmer, *The Revival of Mediation in the People's Republic of China: (2) Judicial Mediation*, 1989 YEARBOOK ON SOCIALIST LEGAL SYSTEMS 145 (1989). It is reported that between 1982 and 1988 these committees settled some 50 million civil matters. Gao Aming, *China's Mediation System Unique*, CHINA DAILY, Oct. 10, 1989, at 4. RENMIN TIAOJIE ZILIANG XUANBIAN [COLLECTED WORKS ON PEOPLE'S MEDIATION] (China Social Science Academy ed., 1982); 1987 CHINA LAW YEARBOOK 46-47 (1989).

80. In some urban communities these committees are heavily identified with the elderly women who dominate them and with a maternalistic or officious (depending on your perspective) style of intervention in other people's problems. B. Zhao, *Super Grannies Save a Lost Soul*, CHINA DAILY, Apr. 10, 1990, at 6; Ted Gup, *Granny as Big Brother*, FAR E. ECON. REV., Aug. 17, 1989, at 34.

Mammoth training programs were established to train tens of thousands of existing court personnel. Now these court personnel are being supplemented by law school graduates. In the mid-1980s large numbers of demobilized army officers were assigned to the People's Courts as judges. We were informed that every court in the nation received some of these officers, who generally knew nothing about the law, but were assigned to job positions equivalent to their army rank (e.g., former majors became vice-chief judges, etc.).[81] Before 1985, court personnel numbered 172,000, approximately 10% of whom were college educated. In 1985, a big push took place to raise the quality of legal workers. By 1991, 65% of court personnel are estimated to have a college education, which includes a large number of graduates of TV university, correspondence schools, college extension courses, and the like. The goal for 1996 is to have 70% of all court personnel, 80% of all judges and 90% of all heads and deputy heads of courts be college educated.[82]

A heavy emphasis on continued on-the-job training and the division of the courts into specialized chambers has enabled a higher level of expertise to develop, although it is our impression that in some cities the judiciary continues to have a weak reputation and is seen as being very sensitive to Party advice and influence by the senior bureaucracy. At the same time, there are signs that the professional character of the judiciary is growing as younger judges with more education are appointed, and as Party and government influence on specific decisions declines somewhat. In 1991 a non-Party member, for the first time, was appointed to the Supreme People's Court, suggesting that Party membership no longer is a *sine qua non* for that office.

As of 1986 there were more than 3,000 People's Courts throughout the PRC, staffed by about 150,000 judges, clerks, and other professional personnel. About 90% of the courts and personnel are in the local courts found in rural districts and in the neighborhoods of large cities. The remaining ten percent form the intermediate and higher courts that operate in metropolitan areas and at the prefectural, autonomous regional, and provincial level. These higher courts are likely to have an economic chamber where economic contract disputes will be heard by judges considered specialists. Cases are heard by a panel of three

81. Stanley Lubman reports being told in the spring of 1991 by a mid-level judge in one of China's biggest cities that extensive numbers of such personnel are still being used in the courts.

82. FAZHI RIBAO [LEGAL SYSTEM DAILY], Aug. 27, 1990, at 1.

to seven judges, who may sit with lay assessors. The proceedings are likely to combine adjudication of disputes with several levels of mediation and informal dispute resolution.

The People's Courts dealt with almost 3 million cases in 1990, over 60% of which were civil cases. In recent years the civil cases have consisted largely of divorces and claims on debts. In addition, the courts have also disposed of about one half million criminal cases. Approximately the same number of economic cases are heard by the economic chambers. Ninety percent of these economic cases, or about 600 thousand cases, are contract disputes.[83]

3. The Administrative Bureau of Industry and Commerce (Gongshang Xingzheng Guanli Ju)

Overlapping, if not parallel, sets of institutions were created to oversee the administration of contracts. At first, the administration of transactional agreements among state enterprises (which, with some oversimplification, describes the core meaning of the term "economic contracts") had been entrusted to the supervisory ministries and agencies to which the contracting parties belonged for administrative purposes. It appears that notaries based on the European and Russian models were to have some role in drafting and authenticating contractual documents, particularly in the countryside, but that role has not developed in recent years and has never been large in the urban areas with which the authors are familiar.

Instead, the Gongshang Xingzheng Guanli Ju (literally the Commerce and Industry Administrative Management Bureau, which is often referred to in English as the State Administration of Industry and Commerce (SAIC), and which will be referred to here as the Administrative Bureau) was given new authority to authenticate contracts, to arbitrate disputes, and to mediate conflicts in contracts between parties subject to different supervisory agencies.[84] The origins of the Administrative Bureau are somewhat obscure. One predecessor model is found in the bureaus established in areas under communist control during the 1940s that registered and generally supervised non-

83. *Economic Trials Increase in Courts*, RENMIN RIBAO [PEOPLE'S DAILY], May 12, 1991, at 3.

84. The work of this agency in administering domestic commercial contracts is described in John Spanogle, Jr. & Tibor Baranski, Jr., *Chinese Commerical Dispute Resolution Methods: The State Commercial and Industrial Administration Bureau*, 35 AM. J. COMP. L. 761 (1987).

state-owned commercial activity.[85] The range of market police and supervision functions the agency has assumed also suggests ties to the market supervision functions of the traditional magistrate.

Whatever its origins, during the 1950s the Administrative Bureau was given general supervision of those enterprises that continued to be privately owned. State-owned enterprises were supervised by ministries that managed their operation, and the Administrative Bureau supervised those enterprises the state did not directly manage. As the period of transition to socialism proceeded, the Administrative Bureau diminished in importance and eventually was limited to market policing (e.g., weights and measures), trademark, advertising regulation, and similar functions.

Beginning in the late 1970s, the agency was revived and initially given jurisdiction over contracts between parties who were not subject to the same supervising authorities. It also became increasingly important as free consumer markets were tolerated and became concerned with the registration of enterprises and trademarks. Gradually, the role of the Administrative Bureau in economic contracts has grown, while that of the supervisory agencies has shrunk.

The model for the Administrative Bureau's contract activities has at least five central features. One is educational and motivational; the Administrative Bureau is active across the nation in teaching enterprise cadres how to use contracts, in providing forms for common transactions, and in awarding prizes to enterprises that distinguished themselves in reliable contract performance (this aspect of its work will be discussed in Part Four).

Second, the local Administrative Bureaus register and investigate the capacity of legal persons (discussed in Part Three). In addition to registering enterprises with legal capacity, the Administrative Bureau also registers those agents or managers of an enterprise that are authorized to enter contracts on its behalf. In enforcing the rules regarding those who are permitted to operate as economic actors, the Administrative Bureaus serve an important informational function, since there are likely to be few reliable sources of information both on the enterprise or unit claiming to have capacity and on the individual claiming to be authorized to act on behalf of the enterprise and enter into binding contracts for it. The importance of this function has increased, and today the Bureau is the only agency authorized to issue

85. DONG JIUCHANG & CAI LIANGCAI, ZHONGGUO GONGSHANG XINGZHENG GUANLIXUE GAILUN [A GENERAL INTRODUCTION TO CHINESE INDUSTRIAL AND COMMERCIAL MANAGEMENT STUDIES] 92-93 (1985).

business licenses and register enterprise representatives with power to contract. In this connection, the Bureau serves as a kind of credit reporting agency, attesting to the bona fides and reliability of enterprises under its supervision and enabling enterprises to do business with strangers on the basis of the information provided by the Bureau.

Third, the Bureau claims the right to inspect enterprises to ensure their compliance with contract rules. This is done through a combination of surprise audits and semi-annual written reports from enterprises. Reports from subordinate enterprises are consolidated and forwarded to the Administrative Bureau. Reports include tabulations of the types of contracts, the amount of money involved, the performance status of the transaction, any disputes that have arisen, and the party responsible for the problem. We suspect that the Administrative Bureau in fact has little capacity to carry out this function or to monitor in any significant way the volume of contracts entered by enterprises under its jurisdiction.

Fourth, the Bureau counsels and supervises the formation of individual contracts by parties who come to them for help in a transaction. If, after its investigation, the Bureau approves the contract, it certifies its legality, a step that is particularly valued in transactions between parties who are strangers or who do not have a lot of experience with the particular kind of contract being used. In these transactions the Bureau serves almost as a go-between, providing a link between the parties that continues through performance of the contract. We were told in both Shanghai and Tianjin that when the Administrative Bureau participates in the formation of the contract, it expects to be involved in mediation or arbitration should difficulties arise during performance. The agency thus develops a stake in the deal and considers itself a patron of its performance, although in practice the arbitration arm of the Bureau is distinct from and involves different personnel than those who counsel and certify contracts at formation.

There was an early movement in the direction of requiring Administrative Bureau approval for all economic contracts above a certain size, but this has not spread beyond a few experiments we heard about in the early 1980s. As the sheer numbers and complexity of economic contracts have grown, the practical possibility of Administrative Bureau advance consideration of transactions diminished. It is simply not possible for any agency, particularly one that has not enjoyed high status or especially talented personnel, to audit all proposed contract transactions. Similarly, efforts by the Administrative Bureau to create a system for post-transaction audit of enterprises and periodic review of all of their economic contracts have bogged

down due to the same difficulties.

Finally, the Administrative Bureau offers a range of mediation and arbitration services, particularly in connection with those contract transactions it has certified (these functions will be discussed in Part Four).

Judicial institutions were created alongside the Administrative Bureau. In 1983 an economic chamber of the People's Court was established to adjudicate lawsuits involving economic contracts. The judicial approach is necessarily transactional and focuses only on those contract deals that have gone sour to the extent that one side brings the dispute to the court. The court and the Administrative Bureau compete for much of the same business. The personnel of the two agencies differ in quality, training, and orientation, with each apparently stronger in some communities. Both resolve contract disputes; although the Administrative Bureau promotes administrative style and arbitration, while the court tends to support legality as a value and settles in a judicial context most of its cases.

4. The Growth of the Legal Profession and Legal Education

By 1986 there were over 15,000 full-time and 20,000 part-time lawyers in China, most of whom worked in 3,300 legal advisory offices.[86] These lawyers appear for clients in court, give legal advice, and assist in transactions. In addition to the lawyers in legal advisory offices, a growing number of enterprises have employed legal advisors, as have some government bureaus. Most lawyers are salaried at very modest levels of compensation. The status of "experimental programs", under which some legal offices have been permitted to sell their services directly to clients, has been unclear since 1989.

Law in China is a young profession. With the exception of a small number of lawyers who were trained before 1957, the entire profession has been trained since 1978. Most are under thirty years old and 75% are under 45.[87] Since 1986 entrance to the profession has been by a standardized examination. Colleges and universities produce only about 4,000 law graduates per year and many of these do not become

86. Cheng Gan & Yang Xiaobing, *Lawyers With New Acceptance in China*, BEIJING REV., July 11-17, 1988, at 18; *Qualified Lawyers to Increase to 80,000*, CHINA DAILY, Jan. 16, 1991, at 3. *See generally*, James Feinerman, *Law and Legal Profession in the People's Republic of China*, Ch. 4 *in* MERLE GOLDMAN ET AL., CHINA'S INTELLECTUALS AND THE STATE: IN SEARCH OF A NEW RELATIONSHIP (1987).

87. Cheng & Yang, *supra* note 86, at 18.

practicing lawyers. In comparison, more than 51,000 persons study law by correspondence school and 76,000 more are reported to be taking law courses offered by television and night schools. Graduates are permitted to take the national qualifications test for lawyers every two years, although only 10,000 of 90,000 test takers were found qualified.

With the possible exception of the small number of courses specializing in international economic law, it does not appear that legal education is a high prestige specialty for university students in China. This is suggested by the modest entrance examination scores of students in law at Peking University in 1979, which fall below those of students majoring in international trade, economic management, sociology, and economics.

5. The Growth of Contract Law

A striking feature of the laws on contracts that have been enacted since 1979 is their diversity. Instead of creating a general system of contract law to govern all legally enforceable agreements, at least three distinct sets of contract rules have been established.

One is the set of agricultural responsibility contract rules that have been used to organize the redistribution of rural land to households. As we have noted earlier, these arrangements were put in a contractual form that resembles the agreements used in traditional China for deals between landlords and tenant farmers. The resolution of the millions of disputes involving such cases is largely outside the court system.

A second set of contract rules concerns economic contracts; that is, agreements between units of socialist production. This group of contract rules was originally understood to provide the bureaucracy with a more effective way to supervise the execution of the plan.

A third set of contract rules is found in the shadowy set of laws on civil agreements between individuals. These rules were understood to be peripheral and of limited significance because of the narrow concept of private property and the limited role assigned to individually-owned enterprises that might enter into such agreements. Before 1987, it was unclear what legal foundation, if any, such individual interests had and what law, if any, defined them. It was widely anticipated that these civil agreements would be defined more clearly as the projects to draft and adopt a civil code gathered momentum

during the 1980s.[88] Experts we consulted at the time expected that the new civil code would bring under its wing all forms of legally enforceable contracts in a single general law. Ultimately, a number of provisions on civil contract were included in the General Principles of Civil Law that were adopted by the National People's Congress in 1986 after the failure to adopt the more ambitious Civil Code. The guidance provided by the General Principles is limited, however, since they do not contain any provision that clearly defines the permissible scope of civil contracts.

This three-way division is just the beginning of the fragmentation of contract law that occurred during the early 1980s. Economic contract law, in turn, is divided into two distinct sets of laws: the Economic Contract Law[89] which deals with domestic contracts and the Foreign Economic Contract Law,[90] which deals exclusively with contracts with foreigners. The Foreign Economic Contract Law lives alongside a set of special contract regulations that apply in special economic zones established in the coastal provinces for trade and investment with foreigners. To further complicate the picture, as of 1988, China acceded to the United Nations Convention for Contracts for the International Sale of Goods. This Convention creates a distinct set of legal rules that govern contracts of sale between persons in the PRC with a place of business and persons in one of the other countries that have adopted it. If one wishes to know what Chinese rules apply to a sales contract between a Chinese enterprise and a foreign seller, one will have to determine whether the seller's place of business is in a nation that is a party to the UN Convention, and if not, then whether there are special foreign trade zone rules that apply. Only if the other sets of rules are excluded should one examine the applicability of the Chinese national Foreign Economic Contract Law.

Looking at domestic economic contract law, the fragmentation continues. In 1981 the National People's Congress enacted an Economic Contract Law. This statute provides a very general framework for contract making and enforcement, offset against detailed provisions for particular kinds of contract transactions. The first sixteen articles of the law state some basic principles in a high level of

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88. *See, e.g.*, ZHENG, *supra* note 76, at 43; BASIC PRINCIPLES OF CIVIL LAW IN CHINA (William Jones ed., 1989) [hereinafter BASIC PRINCIPLES].

89. ECL, *supra* note 5.

90. Zhonghua Renmin Gongheguo Haiwai Jingji Hetong Fa [The Foreign Economic Contract Law of the People's Republic of China] (adopted Mar. 21, 1985, effective July 1, 1985), 1985 GUOWUYUAN GONGBAO 217 [hereinafter the Foreign Economic Contract Law or FECL].

generality. The next nine articles provide a few rules each for a number of special kinds of economic contracts: sales, construction, processing, transport, electrical power sales, storage, leasing, and loans. Beginning with Article 27, there are then five general articles on modification and rescission. This is followed by a Chapter on Liability for Breach, which follows the same pattern, six brief and general articles on liability are followed by ten much more detailed articles defining liability in the context of each type of economic contract. The Law ends with ten general articles on dispute resolution, contract administration, and jurisdiction. Curiously, hidden in these final articles is Article 54 which provides: "Individual operator-households and village commune members who contract with legal persons should follow this law."[91] This provision is clearly intended to deal with the large number of rural households that have adopted the responsibility system for agricultural production. We shall have more to say on this issue in the next part of this paper.

These special categories of contract are likely to puzzle a foreign reader, who may well question why they are singled out for special treatment. The answer appears to be that each of these categories represents a class of transactions that are claimed as the special concern of a different central government ministry. Special regulations have been promulgated for most of these categories of contract to preserve the bureacratic turf of the supervising ministry.[92]

A final fragmenting dimension deserves mention. Most contract law in China is national law enforced by the unitary state. In recent years, with permission from the Central Government, several of the larger cities have issued their own local ordinances on contract enforcement[93] which vary substantially from the national legislation.[94]

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91. ECL, art. 54.

92. JEROME COHEN, CONTRACT LAWS OF THE PEOPLE'S REPUBLIC OF CHINA 61-159 (1988).

93. *See, e.g.*, Tianjin Municipal Economic Contract Administration Regulations, *reprinted in* TIANJIN RIBAO, Nov. 6, 1987, at 2 [hereinafter Tianjin Contract Regulations].

94. It is beyond the scope of this article to examine in detail the major legal issues raised by the Economic Contract Law and its application in the courts. At least three important sources of guidance for interpretation are provided for judges and parties: judicial decisions are reported, although often in truncated form in newspapers and collections of cases; municipal governments and national ministries have published explanatory regulations for economic contracts in their jurisdiction; and the Supreme People's Court and municipal high courts issue circulars instructing judges how to treat difficult issues. Judicial decisions are undoubtedly also influenced by Party organs, but no published material describes this process. The major substantive themes for Economic Contract Law cases include:

1. *Legal personality* — the *faren* puzzle and who is authorized to enter into a contract, that is, who is authorized to be an economic actor. ECL, arts. 2, 54.

III. WHO GETS TO MAKE A CONTRACT WITH WHOM?—THE EVOLUTION OF THE QUESTION OF LEGAL PERSONALITY

Anglo-American contract law tends to be rather abstract and universal in describing the ambit of contract. The typical American contract law treatise or contracts course in law school arranges cases in doctrinal terms, rather than in terms of the kind of transaction involved. A transaction between two large corporations is likely to appear next to a case involving a surgeon and a patient to repair an injured hand or beautify the patient's nose.[95] Deals between merchants are placed next to promises by uncles to give nephews a trip to Europe if they behave well at school.[96] All are seen as contracts; all are understood to be governed by the same general principles. The broad generalizations of doctrinal rules tell us little about what sorts of transactions should be organized by contract and which should be built on other organizing models.

Coming from this background, it is instructive to consider some of the puzzles now facing contract law in China. The Chinese example reminds us that the generalizations of our law of contract only work to the extent that they do because we have a very broad definition of social personality and of persons who are recognized as appropriate economic actors. The usefulness of contract as a tool of economic

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2. *Remedies* — What are the consequences of failure to perform? What does "specific performance" mean when the breacher cannot perform? What does "damages" mean when there is no market on which to buy substituted performance. Questions of restitution and reliance expenditures and their measurement remain. This may explain the heavy use of penalties. But what is the concept of fault in contract failure? Does this explain why courts tend to split the difference? ECL, arts. 35-47.

3. *Modification* — Are the parties free to modify their deal? If contract is in service of the plan it is hard to see how they can be. This should show the independent interest of supervisors in the transaction. ECL, arts. 27-31.

4. *Supervening Events* — What kinds of contract performance failures are excused? What is the scope of the contracting party's "responsibility" ? What natural events excuse non-performance? What acts of state and supervisors relieve the parties of responsibility? Are the state or supervisors liable for their intervention? ECL, arts. 33, 34.

5. *Fault and Breach* — Does liability depend on fault? This is the mirror image of excuse under 4. What kind of fault is needed? Negligence? What if there are failures of performance on both sides? It appears that the Chinese courts prefer to allocate fault. ECL, arts. 32-47.

95. Those lucky law students who avoid spending their first hours in the paper chase attempting to untangle the consequences of the "hairy hand" of *Hawkins v. McGee*, 146 A. 641 (N.H. 1929) are likely to have to deal with the vexed plaintiff in *Sullivan v. O'Connor*, 296 N.E.2d 183, 185 (Mass. 1973), whose nose, the court tells us, "now had a concave line to about the midpoint, at which it became bulbous . . . and the two sides of the tip had lost symmetry."

96. Hamer v. Sidway, 27 N.E. 256 (N.Y. 1891).

organization is conditioned by the presence of such socially-defined notions as autonomous economic and social personality. Group membership, the social definition of who is an insider and who is an outsider, and the relational distance and proximity among actors determine the appropriateness of contract between two parties.

How can one make a contract with a stranger when the mechanisms of legal enforcement are weak? At the other extreme, a very intimate relationship may be incompatible with the impersonal assertion of legal rights. How can one make a contract with someone so close that it is not possible to assert distinct, much less conflicting, interests?

The appropriateness of contract also is connected to the concept of legal personality; that is, whether the party asserting a claim under an agreement is a competent legal personality empowered by law to engage in economic activity and to assert claims arising from it. This may seem strange to an American lawyer bred in a system that long has assumed the personality of individuals, and that has been very liberal in permitting corporations, partnerships, trusts, and other fictive legal personalities to form, do business, and assert claims. Unlike English law (and perhaps that of Massachusetts), American law has been sympathetic to claims raised not only by the parties who formed an agreement, but to broadly defined classes of intended beneficiaries, who claim the benefits of bargains they were not parties to and in which they have furnished no consideration. These beneficiaries enforce promises that were not made to them and for which they have not paid.

A. Who Is Permitted to Make a Contract?

Chinese contract law comes out of traditional and socialist sources that operate on quite different assumptions and greatly restrict the pool of actors who are recognized as capable of asserting a legally cognizable claim. The definition of social units and legal personality has long been a complex problem in the Chinese system. In traditional China, individuals were recognized by the state as part of a family, clan, village, or guild. Their identities were embedded in these hierarchically structured networks of relationships. At the top of these organizations were persons whose considerable power was recognized by the state. They were *sui juris* persons. The tendency to define individual identity in group and relational terms persists in contemporary Chinese societies.

When the Chinese Communist Party took power in 1949, a concerted effort was made to place the population into class categories

that would distinguish between enemies and friends -- those who were targets of the revolution versus those who were to be its beneficiaries. Political and economic rights were allocated according to one's class status, which follows the individual through life and even passes to the next generation. Entitlements to education, jobs, housing, and other benefits have been allocated since 1949 in significant part on the basis of class background, which is understood to provide an index of civic virtue and political reliability.[97]

An equally monumental task for the newly established regime was the registration of individuals as members of a household and as part of a work unit (*danwei*). This registered status has tremendous impact on the capacity of the individual to move, change jobs, or participate in economic activity. Under the system that was in place well into the 1980s, a worker could buy a train ticket to a city two hours away only with the permission of the unit. The system continues to fix the individual physically in one place and also establishes his or her position socially and economically. Beginning in 1958, the importance of collective identity was amplified and units became larger and more encompassing. Rural residents, comprising most of the population, became members of communes that might include tens of thousands of individuals. The common interests of all members of society were emphasized and they were seen as "eating from one big pot".

The period of reform since 1978 in part has been a reaction to the excesses of this collectivist perspective. Greater flexibility has been shown in the creation of new and often smaller units, and some assertions of individual economic interests — attacked as "tails of the bourgeoisie" during the Cultural Revolution — have been recently recognized in Chinese law.[98]

Shifts have occurred in the definition of these legal categories, but it remains the case that Chinese law entertains a even more limited concept of the capacity of natural persons and non-governmental associations to engage in economic activity and to contract. From the beginning of the reform period there has been widespread fear by conservative elements that contract responsibility would be a major step in the unwinding of socialism and the state ownership of the means of production. To mollify these fears the contract law adopted

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97. *See* RICHARD KRAUS, CLASS CONFLICT IN CHINESE SOCIALISM (1981).

98. *See generally* PAT HOWARD, BREAKING THE IRON RICE BOWL 77-143 (1988); MARCIA YUDKIN, MAKING GOOD: PRIVATE BUSINESS IN SOCIALIST CHINA (1986); Zhao Zhongfu, *Enterprise Legal Persons: Their Important Status in Chinese Civil Law*, 52 LAW & CONTEMP. PROBS. 1 (1989).

was an economic contract law. The only lawful contracts are those between legal persons, that is, economic units organized or recognized by the state. By the law's terms, individuals generally cannot make economic contracts; their agreements are governed by civil law, if they are legally enforceable at all (which, in practical terms they usually have not been).

There are several dimensions to these changes, and to an outsider, the connections between them appear quite tangled and unclear. A first set of issues centers on the general necessity for government permission to engage in economic activity and the bureaucratic attitude that the number of autonomous economic actors should be limited. To Western ears this first set of issues sounds like a matter of business regulation, registration, licensing, and the like, except that as in many American licensed occupations, there is a very strong element of cartelization, seeking to control the activity by restricting the number of participants.

A second set of issues turns on the degree to which natural persons shall have capacity to make agreements that the state legal machinery will enforce. The Chinese term, *fa ren*, is only imperfectly captured by the literal English translation, *legal person*. By and large, legal persons are now limited to state and collective units, although the line is fuzzy when it applies to individual operator-households (*geti hu*). The label "individual operator-household" almost always describes a family household which usually has one individual member who is the economic actor, although other family members may participate in the work. These issues came to the fore in the debates over a Civil Code that would define the legal status of individuals in a collectivist society. It also is prominent in the development of a distinct body of economic contract law, which from the outset limited the group of economic actors to legal persons, but which has been under continuing pressure to expand its definitions and allow other persons and associations to participate. This shift represents recognition by the leadership that once a privately owned and managed economy is encouraged to develop, the profit incentive makes it impossible to control those who can and those who cannot do business.

Yet a third set of issues asks how associations and groups are formed in society, how the group gains the legal capacity to enter contracts, and who has the power to act on behalf of that group. This set of issues is perhaps the most cloudy of all, for it implicates matters of intragovernmental organization, as well as the possibility of the creation of privately owned business associations. Currently, all enterprises and units in China are said to be either state agencies or

collective associations, with a very limited role recognized for household, individual, and privately-owned enterprises.[99] The rich debates of the 1980s on the creation of private companies and other business organizations not owned by the state, goes beyond the scope of this article.[100] The process by which the state forms new units has not been the subject of published law. Perhaps more surprising, we have not found a Chinese informant who can coherently explain the general process by which a unit is created. These issues might be summed up by the simple question to whom one applies in the government or the Party in order to establish a new unit. Clearly there is a political and, therefore, a Party dimension to the process, but the details remain obscure even to knowledgeable Chinese informants. What we can say with confidence is that the system makes permission to operate an enterprise valuable by making it scarce; it rations the necessary permissions to enhance the power of those who can grant this favor.

During the period of economic expansion of the mid-1980s, we observed a variety of devices used to deal with the limits government regulation placed on those who were not legal persons. In some cases new units were established with official permission, although our Shanghai informants (who were very much in a position to know) laughed when we asked them to describe the official process by which a unit is established. Many budding enterprises borrowed the identity of a unit established for another purpose. Universities opened factories, neighborhood associations operated knitting mills and profited by permitting their name and identity to be used by an entrepreneur.

A second device to circumvent the requirements of legal personality was to use household and other collective identities. The system always recognized some limited role of individual economic activity, largely in the provision of personal services — barbers, peddlers, clothing cleaning, and repair. During the period from 1968 to 1978, the permissible ambit of such activities was severely restricted, as was permission to enter these fields. In the 1980s, more permissive policies prevailed, in part as a way to absorb large numbers of jobless urban

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99. Howard Chao & Yang Xiaoping, *Private Enterprise in China: The Developing Law of Collective Enterprises*, 19 INT'L LAW. 1215 (1985); Edward Epstein & Ye Lin, *Individual Enterprise in Contemporary Urban China: A Legal Analysis of Status and Regulation*, 21 INT'L LAW. 397 (1987); Thomas Gold, *Urban Private Business in China*, 22 STUD. IN COMP. COMMUNISM 187 (1989); Zhao, *supra* note 98, at 1.

100. *See generally* Howard Chao & Yang Xiaoping, *The Reform of the Chinese System of Enterprise Ownership*, 23 STAN. J. INT'L L. 365 (1987).

youth who were "awaiting assignment" after leaving school. Since the state was unable to find jobs for these people, they were encouraged to open photo shops, provide repair services, and otherwise find their own way. In form, if not in substance, the individual operator-household was a kind of unit, not an individual. The definition of permissible household economic activities expanded, however, providing a way for the family to become the unit for activity barred to the individual. To expand production, exchange, and services, Article 54 of the Economic Contract Law provides that individual operator-households and village commune members may contract with legal persons.[101] This provision seems designed to encourage the making of rural responsibility contracts without opening the floodgates to all kinds of contracts between individuals who are not legal persons.

Uncertainty about the appropriate role of contracts by individuals contributed to the political difficulties experienced in trying to adopt a comprehensive Civil Code. As early as 1981, drafts of a thick Civil Code were circulating among specialists in Beijing. The document went through many drafts in the years of negotiation that followed before it was ultimately presented to the National People's Congress in 1987. The opposition effectively blocked the adoption of the Code, despite powerful support within the government and the Party. Ultimately, a compromise was struck in which the Congress adopted a short and general version of General Principles of Civil Law.[102] By late 1987, however, at least one major city had adopted a local contract ordinance that was substantially more tolerant of contracts by individuals than the national law.[103] The practical application of this enactment to the commercial contracts of individuals has yet to be clarified on a national level.

B. Why Does the State Want to Restrict the Persons Who Could Make Contract?

There are several ways to explain the efforts by officials to limit permission to engage in contract in China. During the Ming and Qing Dynasties, a small, highly centralized bureaucracy supervised a vast

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101. ECL, *supra* note 5, art. 54.

102. *See generally* BASIC PRINCIPLES, *supra* note 88; ZHENG, *supra* note 76; Edward Epstein, *The Evolution of China's General Principles of Civil Law*, 34 AM. J. COMP. L. 705 (1986); Tong Rou, *The General Principles of Civil Law of the PRC: Its Birth, Characteristics, and Role*, 52 LAW & CONTEMP. PROBS. 151 (Spring 1989).

103. Tianjin Contract Regulations, *supra* note 93, at 2.

and diverse empire that was understood to form a unitary state with a unitary economy. To maintain control and to ensure the flow of revenues to the state from its remote parts, the county magistrate, the official at the lower end of the bureaucracy, had to rely on local community leaders, such as retired scholar-officials and heads of guilds, who were successful merchants.[104] The authority of the official over the merchant-agent was based on the hierarchical Confucian ideology, which assigned a low status to the merchant. In fact, as one might expect, given their wealth and the meager salaries of county magistrates, merchants had considerable influence over local officialdom. The magistrate tended to play only a limited direct role in the supervision of commerce, leaving most of the job to organizations of merchants. The magistrate, during the Ming and Qing Dynasties, relied upon agents and runners to deal with the market regulation aspects of his responsibilities.[105]

Cartels were established, dominated by merchant guilds and brokers, ostensibly to control markets and limit access to them to ensure the trustworthiness of those who were permitted to participate. Of course, this strategy served the interests of the merchants whose permission to trade represented a valuable economic asset, enabling them to extract monopoly profits from those who dealt with them. Tax collection was farmed to some of the same groups. From the perspective of the person who wants to participate in this market the rule seems to be "what is not permitted is forbidden"; you need permission for everything. In this way the official was able to enhance his position vis-a-vis merchants, fulfill his official duties, distance himself from direct involvement in the grubbiness of business, and thus appear to be acting out the hierarchical norms that placed him above the merchant. At the same time, those merchants lucky enough to find a preferred place were able to avoid the "chaos" of a market with large numbers of "irresponsible" actors. Their profits and financial ability to pay off the needs of officials were secure in this cozy non-competitive situation. The preference for cartels and limited market entry is tied to the association between cartel power and the alliance between those merchants possessing that power and the officials who granted it.

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104. MANN, *supra* note 51.

105. HUANG LIU-HUNG, A COMPLETE BOOK CONCERNING HAPPINESS AND BENEVOLENCE (FU-HUI CH'UAN-SHU): A MANUAL FOR LOCAL MAGISTRATES IN SEVENTEENTH CENTURY CHINA 107-25 (Djang Chu trans. & ed., 1984); CHU T'UNG-TSU, LOCAL GOVERNMENT IN CHINA UNDER THE CH'ING (1988).

The official who holds the power to grant participation in the cartelized market has a continuing interest in the scarcity of that ability to participate, since it amplifies his control. This control may claim benevolent motivations on the theory that in a well-run, fully-supervised market, people will not be cheated in buying and selling. The spur to the virtue of the merchant and the tax collector, however, is the supervisory power of the official, not the pressure of competitive buyers and sellers, or the consent of the citizens and taxpayers to the system. The claim is that the state gets to intervene and control the economy for the welfare of the nation without its virtuous officials becoming too soiled by day-to-day contact with the potentially corrupting influence of trade. In fact, the opportunities for collusion between official and merchant and their joint capacity to extort monopoly profits from trade without constraint are likely to lead to corruption of all participants.

This formal structure based on connections between officials and merchants, with its limitations on permission to engage in trade and its grants of cartel power to those it favored, also facilitated the creation of social relationships and informal channels of influence. From a merchant's perspective the official system provided little trustworthy protection, particularly as soon as one stepped outside one's local community. For outsiders, courts and magistrates were of little help in pressing claims against local merchants, who had close ties to the officials in that community. Prudence dictated doing business only within the family, within the clan, or within other relational networks. There the sanction for honest behavior is based on the bonds of family loyalty, a common connection to an ancestral home, or a common link to a patron, superior, or teacher. In this way, the system of limited authorizations to engage in commerce, served not only to reinforce the official hierarchy, but also strengthen the informal influence networks that complemented the official structures.

Merchants and officials each possessed one form of power, yet they were mutually dependent to accomplish their central goals. Merchants had low status ideologically, but had great economic power and the knowledge and connections to use them. They needed the protection and approval of the officials and derived much of their wealth from tax farming and other delegated public functions. Officials were at the top of the formal hierarchy, but needed merchants to raise the money to support their regime.

Traditional ideas regarding the limitation of those permitted to engage in commerce and the unsavory nature of trade found close parallels in Marxian attitudes toward commerce and the role of the

state. The trader, who makes money by buying and selling what others produce, is seen as a parasite and class enemy.[105] Such activity can only be made safe by state ownership of the means of production and a state monopoly on the channels of distribution of goods.

What emerged during the Maoist period was an idealized and rather undifferentiated vision of the community, in which class and functional lines were blurred. Individual identity was connected to membership in a large collectivity, and the distinction between insiders and outsiders was seen as a "feudal relic" that must be rooted out with revolutionary zeal. In economic terms, everyone was seen as eating out of one big pot (*daguofan*).[107] Commercial activity was located within this largely undifferentiated collectivity, and all attempts to establish a distinct identity were to be resisted. Disputes between enterprises or other parts of the state economy were to be dealt with as management problems within the state. The assertion of distinct interests by claims was seen as evidence of lack of commitment and identity with social progress.

C. *Insiders and Outsiders: Non-Legal Social Institutions that Have Rules and Influence Whether People Are Likely to Make Contracts With Each Other*

Contract is an institution heavily influenced by the social characteristics of the setting in which transactions occur. Within a family unit, for example, affective ties are very close and there is likely to be little if any room for contract. Husbands and wives, parents and children make agreements all the time, but they can enter into contracts only by putting aside their relationship and creating a distance in their positions. The promises made in such close relationships lack legal enforceability in most legal systems for two reasons: people in such transactions are likely to feel that to invoke the law will be bad for the relationship, and others will feel that legal enforcement of these kinds of "private deals" would be bad for the courts.

To invoke legal remedies in an intimate relationship may seriously threaten the relationship. Antenuptial agreements make binding arrangements for those about to enter matrimony, and separation agreements provide for support and other economic links between those

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105. *See* SOLINGER, *supra* note 32, at 130-35.
107. HOWARD, *supra* note 98, at 17-44.

in the process of dissolving their marital relationship. But, in general, courts do not hear disputes between those currently married regarding the agreements they make between themselves during their marriage.[108] Only in America is a court likely to entertain even briefly the possibility of a suit by a child against parents for child-raising malpractice. The continental nature of American society and the weak ties linking family members and members of other social groupings mean that few strangers are too remote to sue, and few are too intimate not to sue. Autonomy means that group ties are less likely to be so important that a claimant would not risk disturbing them by a lawsuit.

The heartland of Contract is the band of transactions that are made between near-strangers. Here legal sanctions are feasible and may marginally contribute to the reliability of the deal, but they do not materially threaten the relationship. The tendency of contract law is to create opportunities for persons and enterprises to become economic actors. On a social level, this tendency is expressed in terms of with whom one will be willing to do business. On a legal-structural level, contract law expands the choices of the ways business will be structured: by a deal around the kitchen table enforced by the family, by a bargain among friends sealed with a handshake and the threat of loss of intimacy, by a memo from the manager to the department head enforced within the enterprise, or by a contract that looks ultimately to state enforcement in the courts.

In contrast to the organizational mode of association characteristic of the West, Chinese people create their society by the logic of *cha xu geju*, or the "differential mode of association."[109] As Fei Xiaotong pointed out:

> The Chinese pattern of social organization is like the circles that appear on the surface of a lake when a rock is thrown into it. Everyone stands at the center of the circles produced by his or her own social influence. Everyone's circles are interrelated. One touches different circles at different times and places.[110]

The concentric circles thus formed are hierarchical in relation to

108. Balfour v. Balfour, [1919] 2 K.B. 571; McDowell, *Contracts in the Family*, 45 B.U. L. Rev. 43, 47 (1965).

109. FROM THE SOIL, *supra* note 3, at 25-36.

110. *Id.* at 28.

the individual, with the innermost circle being the closest. As Fei explains:

> Our social relationships spread out gradually, individual by individual, resulting in an accumulation of personal connections. These social relationships form a network composed of each individual's personal connections. Therefore our social morality makes sense only in terms of these personal connections.[111]

Within such a relational network, invocation of legal enforcement is also likely to be improper and probably less effective than the sanctions furnished by the group itself. Contract use in China is conditioned by social and physical proximity. The figure below presents four distinct situations, each has implications for the use of contract.

	Insider	Outsider
Local	Contract is to be avoided	Contract is not needed
Distant	Contract may be helpful, but is irrelevant	Contract is necessary

Insiders generally do not make contracts with each other; to do so would be insulting, especially when they are located in the same community or are within easy reach. Invocation of the law may be helpful when insiders live far from each other, but is irrelevant to the parties if the social circle is intimate. In that situation reputational and reciprocal losses are likely to be much stronger sanctions than contract damages because other parties are involved in the network and inevitably will become involved in the transaction. Those who do business in such a network are likely to be tied by kinship or to have been introduced to each other by another member. The transaction is likely to be part of a series of transactions involving the same parties. It is undesirable to invoke the law in such a setting for fear of embarrassing the person who introduced you to the party on the other side. These same relational concerns preclude bald cheating by either

111. *Id.* at 35-36.

side. Many relational network ties exist in rather grey areas of ill-defined obligations. These obligations are best kept vague lest they conflict with vertical hierarchy requirements and come to be seen as seditious conspiracies against superiors.[112]

If social proximity is a limit on the use of contract, so is remoteness, as the Chinese experience suggests. If the stranger is within reach, a contract is not needed because social sanctions may be quite adequate. If she is remote, then invoking legal enforcement is often necessary. However, if the stranger is too remote, then Chinese legal institutions are unlikely to provide ways to reach her and sue. Remoteness was a problem in the past in Europe and America. It was difficult to find and reach out and bring the stranger into court; the problems of proof are complicated by distance and differences of local custom, and if a judgment was obtained the difficulties of enforcement in a distant community were likely to be insurmountable. Many of these problems have been overcome only within the past generation in the West. In China, everyone from over the hill is still likely to be seen as a stranger, in part because it is likely to prove difficult to enforce claims against them. Conversely, the party who does business at home is likely to have a distinct advantage in disputing with a stranger. A multitude of cases involving parties from different counties and provinces indicate that there is a well recognized home court advantage in China. These features are not limited to the formal or official mechanisms for resolving disputes. It is dangerous to deal with a stranger — that is, someone who does not fit neatly into familiar hierarchies and relational networks. There is likely to be insufficient information about the stranger and his trustworthiness, reputation, and capacity to perform. Both official and informal sanction systems are likely to work unsatisfactorily in such a situation. Making a deal with a stranger involves assumption of substantial risks. Modern Western law tries to reduce these risks and costs by establishing ways to reach distant strangers and assert claims against them. Western society relies even more heavily on institutions that provide information and reliable credit for transactions between strangers. Banks and credit agencies reduce risks by enabling a party to find out the reputation of the party on the other side, by substituting the credit of a reliable party (usually the bank) for that of the stranger, and by increasing the likelihood that,

112. Professor Hugh Scogin has pointed out to us that while this analysis is correct for commercial contracts, it may not accurately describe labor contracts in China, which have become more common and have developed since our period of field observation. Labor agreements appear to use contract to establish an intimate relationship in the workplace.

if the stranger reneges, his reputation will be hurt in his home community. China continues to have a long way to go in providing these protections for doing business with remote outsiders.

The availability of contract has supported expansion of the number and kinds of potential economic actors by making it safer to deal with distant partners and strangers. Our interviews in Shanghai and Tianjin led us to believe that individual entrepreneurs determine whether to use contract to structure their economic relations on the basis of perceived effectiveness of social sanctions. But contract does not merely structure economic relations; it tends to structure social relations as well. Contract sometimes transforms an economic relationship into a social one and thus can turn outsiders into insiders. Individual operator-householders interviewed in Shanghai often claimed that after doing business with the same person for a while, they became *zijiren* ("family members") *bufen bici* ("making no differentiation between self and other").

Conversely, contract may objectify a social relationship and turn insiders into outsiders. Some entrepreneurs complained that relatives, by asking for a contract, treat them as mere outsiders. "My cousin even negotiated the terms of the contract with me. He was so *jianwai*" (the personality characteristic of treating someone as an outsider). Contract provides opportunities for objective external relationships to displace ties based on social network and other grey areas. When the mechanisms that sanction contract performance are credible, it becomes possible to do business with and ultimately to trust strangers. Then contract can transform social and group relationships into individual relationships.

Over the decade of reform, contract moved beyond being simply a formal technique to supplement planning in the service of socialism and to keep the foreigners happy so they would buy, sell and invest. Increasingly, it became apparent that contract has the potential to support the establishment of markets, to expand the cast of characters, and to convert hierarchical and *guanxi* relations into legal relations.

IV. THE SOCIAL EMBEDDEDNESS OF CONTRACT DISPUTE RESOLUTION

The legal procedure used to enforce promises defines the practical usefulness and meaning of contract. Patterns and processes of dispute resolution determine whether it is worthwhile to assert legal claims. Legal norms often are stated in general or abstract terms; they gain specificity in the concreteness of procedure as they are shaped by the

expectations that grow out of shared social experience. When the institutions for dispute resolution are centered in the family or the clan rather than in the state, it is easy to see their cultural roots. But the same connections are also observable even in the United States, where there are over 3,000 largely independent county-based systems of courts, most of which are locally selected, staffed by local residents, funded primarily out of local taxes, and typically quite idiosyncratic in practice. Only a rash lawyer will appear in a strange court assuming that the practice there is similar to the way things are done at home.

Procedural rules often are of limited rationality, which also suggests their local cultural basis. For example, the rules of evidence used in an American jury trial hardly represent a rational scientific choice of methods to approximate truth. Despite the genius of scholars like Wigmore, who attempted to systematize the rules governing the admission and exclusion of evidence in a jury trial at common law, the power of the rules and their continued use is more closely connected with longstanding social habits of storytelling than with the epistomological principles of scientific investigation. Similarly, the basic choice of procedural law between a judge-centered system in European and Asian countries or an advocate-centered system in English speaking countries can be explained coherently only in terms of deeply held attitudes toward authority and legitimacy within a particular society.

A. *The Chinese Process of Disputing Inhibits Reliance on Litigation for the Vindication of Contract Interests*

The process of dealing with a dispute that arises during contract performance is continuous with the interaction that led the parties to come together and reach an agreement to transact business in the first place. The pattern of disputation is shaped by the pattern already assumed by the transaction. These patterns lead the disappointed party either to identify a difficulty that occurs during contract performance as "just one of those things" that must be accepted and endured, a "problem" that calls for communication and adjustment with the other side, or the occasion for appropriate outrage and a demand for legal redress.[113]

Several features of Chinese organization that we have described already play an obvious role here. The weakness of formal methods for

113. *See generally* William L.F. Felstiner, *Influences of Social Organization on Dispute Processing*, 9 LAW & SOC. REV. 63 (1974).

the vindication of claims, the crucial importance of informal network relationships with duration over time, and the restrictions on legal personality discussed in the last topic, all limit the attractiveness of the vigorous assertion of a claim. Our Chinese informants express these limitations when they repeat traditional aphorisms that describe disputes and litigation as a serious disruption of harmony for which both sides deserve to be punished. It also can be seen in disputing behavior that avoids pressing an advantage too hard. Van der Sprenkel, in her study of Qing legal institutions, emphasizes the great extent to which conflicts were resolved through informal, nonjudicial mediation in the family clan, craft or merchant guild, or neighborhood.[114] In Qing China, the disappointed party was prohibited from going to court before submitting the dispute to clan or guild hearing. The Qing Codes contained no formal rules on contract disputes.

The remarkable discomfort of modern Chinese with the assertion and declaration of rights that finds one side to be in the right and the other side in the wrong is observable both in the behavior of parties and in the reactions of officials in the PRC and elsewhere. The fear of the kind of polarized solutions that legal procedures usually produce, in which one side clearly wins and the other side clearly loses, can be found in many cultures, including America. Participants in lawsuits hurt each other's feelings. This is one explanation for the widespread popularity of arbitration and conciliation in long-term relational contracts, such as franchises and distributorships. Given a limited market, litigation may mean that a supplier is effectively cut off.

The reports of contracts cases by Chinese courts are remarkable for the frequency with which even the formal court process ends up by splitting the loaf to avoid having sore losers. Even when one side is declared to be completely right, the remedy awarded will usually stop short of awarding the full relief provided in the contract.[115] This is particularly remarkable because, for reasons we shall discuss later in this part, Chinese contracts often provide for penalty payments instead

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114. Sybille Van der Sprenkel, LEGAL INSTITUTIONS IN MANCHU CHINA (The Athlone Press 1962). More recent research by Phillip Huang suggests that Northern Chinese peasants quite frequently resorted to the court system to settle civil disputes during the late Qing and Republican periods. Huang, *supra* note 39. *See also* Mark Allee, *Code, Culture and Custom: Foundations of Civil Case Verdicts in a Nineteenth-Century County Court*, *in* CIVIL LAW, *supra* note 39.

115. This tendency is identified as the reciprocity norm in Roderick Macneil, *Contract in China: Law, Practice, and Dispute Resolution*, 38 STAN. L. REV. 303, 341-42, 360-61, 375-79 (1986).

of compensatory damages based on the economic value of the promise breached. The court often does not order the breaching party to pay the amount that is specifically provided in the contract. Interviewees say "ability to pay" is more important than what is written in the contract. From the official Chinese point of view, "socialist cooperation" should be the guide for behavior. The contract may say pay RMB 10,000, but you will only get RMB 2,000, and are told to forget about the rest because of "socialist cooperation."

1. The Process of Disputing: When is Less Than Perfect Tender Defined As a Problem?

The objective situation of commerce in China, poor communications, weak markets, shortages, and disorganization reduce expectations regarding promised performances. It is said that Chinese business people are not so sticky about exact dates of delivery, exact quality, and other specifications of performance. The idea of *chabuduo* ("almost the same"), discussed by Hu Shi, was seen during the Republican Era early in this century as a national characteristic of the Chinese that impeded modernization.[116] Specifications precisely stated in the contract are not understood to be precise, because there are too many factors not under control of the contracting partners. Because of these limited expectations, deviations of performance during the transaction are less likely to be perceived as a breach and the occasion for a serious dispute. Instead, the disappointed party expects these things to happen and "lumps" them if it cannot like them. The threshold for the identification of an occurrence as a problem is higher in such a society. These characteristics are congruent with any less developed economy and may have little to do with Chinese society as such. Indeed, much higher standards of performance can be observed in the Chinese societies of Taiwan, Singapore, and Hong Kong, where different market circumstances create expectations of performance.

2. The Process of Disputing: Direct Communication Between Parties Is Inhibited When Reliance Is on Network and Go-Betweens

Once the threshold that defines an event as a problem is reached, relational features of Chinese commercial organization lessen the

116. Hu Shi, *Chabuduo Xiansheng Zhuan* [*Biography of Mr. Almost*] *in* HU SHI: ZHONGGUO XIANDAI ZUOJIA XUANJI [HU SHI: SELECTED WORKS OF MODERN CHINESE WRITERS] 39-40 (1987).

likelihood of confrontational disputing between the parties. Weak markets and weak legal enforcement of claims are connected with heavy reliance on commercial relationships based on networks facilitated by go-betweens. A less direct assertion of rights less often leads to litigation. One can rely only on business partners one is related to, one went to school with, or with whom one is connected by a common relationship to an important friend. That friend is likely to have directly or indirectly introduced the two parties to the transaction. By implication the friend serves as a guarantor, and often also is expected to serve as mediator for disputes that may arise during performance. The link is trust based on relationship, but that means that confronting the party who has caused the problem is a delicate matter. First of all, it means admitting that something is wrong, implying a lack of trust, and disrupting the harmony of the relationship.[117] If there was not a go-between in the formation of the transaction, it is likely that a third party will be sought who can be informed of the problem and asked to act as a go-between in resolving it. The go-between's job at this point is simply to ascertain whether or not there is a problem.

The go-between is someone both parties know and respect. Sometimes the link is not direct, but through another person. After a potential dispute is perceived and the go-between is contacted, there may be a number of outcomes. One is that there is no problem: the other party performs the contract and immediately apologizes for causing concern. The initiating party then is likely to deny that there was ever any concern. Another possible outcome is that there is indeed a problem: the party cannot perform the contract. Since contract performance may be less important than maintaining the relationship, a party that finds itself unable to perform may take steps to limit the injury and try to preserve the relationship. The disappointed party also may decide that the relationship is more important than insisting on performance of the contract. This was stated very clearly to us by a group of Shanghai knitwear enterprise managers:

> Say I have signed a contract with Jia to deliver 500 sweaters in October. When Yi, with whom I have no contract but who is very important to me wants 300 sweaters from me, I am likely first to stall and hope Jia won't ask me where the 500

117. *Cf.* Hiroshi Wagatsuma & Arthur Rosett, *Cultural Attitudes Towards Contract Law: Japan and the United States Compared*, 2 UCLA PAC. BASIN L.J. 76 (1983).

> sweaters are. If he inquires or becomes concerned, I would tell him that I only have 200 sweaters and hope he will understand my problem. Yi's good will is more important than the risk of losing Jia as a customer. But Jia usually will understand, since there is some consensus on who is important, especially if Jia is a friend or family. Family does not always come first in the short-run. Family are people you can count on to understand your problems, such as having to buy the good will of an outsider. Family members are unlikely to cheat you, but their honesty can be deadly.[118]

If the disappointed contracting party believes that the other party is capable of performing the contract, he is likely to seek the help of a third party. At this stage, an intermediary who has some influence over the other party is likely to be chosen. But the intermediary chosen cannot be the immediate boss of that party, lest it be seen as bribery. Typically after one identifies the appropriate person, one approaches the person with a gift of some sort if one knows this person oneself. The gift may range from a bottle of wine to a TV set. If the parties don't know the go-between personally, they find someone who does, give the secondary intermediary a gift, and ask this person to give a gift to the go-between. The more individuals that one has to go through to locate the appropriate intermediary the more costly the resolution will be, therefore one's scope of relations or *guanxi* is very important for not only social but economic reasons.

3. The Process of Disputing: Heqing, Heli, Hefa

When we asked Chinese economic court judges how they go about deciding cases in a very incomplete legal framework, they cited to us the old adage, *Heqing, Heli, Hefa* whose literal translation is "according to people's feelings or affection, according to propriety or reason, according to the law." This adage can be analyzed on at least two levels. One level depends on whose point of view is adopted: from the disputing partners' point of view or from the judge's point of view; and the other is at what stage in the resolution process it becomes appropriate to apply each principle (i.e., first you deal with affection, then you reason, and then you apply the law). One meaning of this adage is "[i]n resolving disputes, first pay attention to the relationship

118. Interview with managers, in Shanghai (June 1989).

between the parties, then consider what is right and wrong, and only then worry about the law." A more likely reading is that all three factors — relationship, rightness, and the law — must be integrated by the judge in resolving the case. Yet a third possible reading is that law is worthless unless its rules are informed by a sense of rightness and, primarily, by sensitivity to normative relations between the two parties. Judges believe that their decisions have to go beyond the technical aspect of law, that is not only *hefa*. Their decision must also be congruent to natural reason, *heli*, and appropriate to the feelings of people, *heqing*.[119]

From the perspective of most of the economic court judges we interviewed, contract enforcement is not best accomplished by too rigid an insistence on the letter of the law and the precise terms of the contract. The letter must be softened by deference to the relationship of the party and the moral demands of accommodation. We think this is one way of understanding the tendency that runs throughout the processes of the court and the Administrative Bureau to suspend a lawsuit in mid-course and attempt to resolve the dispute by informal mediation. In this sense *heqing, heli, hefa,* serves as an everpresent limit on the power of the formal rules and upon the power of the terms of the contract to define the rights of the parties. In most legal systems the precise enforcement of an extremely one-sided written contract will be unacceptable to the judge. Enforcement at some point becomes unconscionable, and a misuse of state power in the service of injustice. The location of the point where a court will substitute its judgment for that of the parties expressed in the terms of the agreement is a major task that in American law often is understood as a form of interpretation of the parties' agreement. Our observations and discussion in China suggest that this point is reached much sooner in China; that is, judges feel significantly less bound by the precise terms of the contract and freer to soften and compromise the impact of failure to perform on the breaching party.

Our interviews with Shanghai judges identified three situations when they felt obligated to enforce the letter of the law and not free to seek accommodation and compromise for the sake of relationship:

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119. *Heqing, heli, hefa* is the principle of judging upheld by Chinese magistrates for centuries. *See, e.g.*, Sybille Van der Sprenkel, *supra* note 111; ZHONGHUA FAWAN, *supra* note 53, at 416-18; Wang Huizu, *Xuezhi Yishuo, in* 1 WANG LONGZHUANG YISHU 37-38, 50-51 (1970). Anthropologists also noted its operation in Republican China. MORTON FRIED, FABRIC OF CHINESE SOCIETY: A STUDY OF THE SOCIAL LIFE OF A CHINESE COUNTY SEAT 209-11 (1953). Fried found that residents' first preference in dispute resolution was to appeal to affection, and "appealing to the law" was treated as the least desirable and a last resort.

a. Illegal Contracts

The law provides that certain contracts are contrary to the national interest and must be declared invalid. When a party asks the court or the Administrative Bureau to declare such a contract invalid our informants felt that their discretion was very limited.

b. Specific Performance

When a plaintiff insists that the court order the breaching defendant to perform the contract in addition to paying damages for the breach, the court may feel inhibited from seeking a middle ground. Three crucial circumstances are whether the defendant in fact has the ability to perform (otherwise, ordering specific performance will not be a vain act), whether the performance is available from another source, and whether performance is crucial to the ability of the complaining party to fulfil the state plan. If performance by the defendant provides the only way that the plaintiff can meet the demands of the plan, the judges told us they feel obliged to ensure that the contract serves the plan.

c. Deliberate Breach

Contract liability is based on the simple failure to perform as promised and does not depend on the intention of the breacher to violate the agreement. When the court decides that a defendant is deliberately breaching the contract, however, our informants indicated that there was less room for a compromise resolution of the dispute. In other words, the deliberate breach itself has injured the relationship and diminished its value, so that it no longer overrides the value of legality.

B. Western Strategies Regarding Contract Remedies Are Often Inappropriate in China

Contract law is based on assumptions about the availability of social infrastructure to support contract performance which China does not yet meet. At a very basic level, contract law involves promissory responsibility; if a party fails to perform a contractual obligation, that party will pay the injured party the financial equivalent of performance. This implies that contracting parties have access to wealth in the form of credit or savings and can turn to that wealth to pay their obliga-

tions.

1. Specific Performance

In Western nations that are part of the Civil Law tradition, the code may claim that the basic remedy for contract breach is specific performance, that is, a judicial order directing the breaching defendant to perform as promised.[120] Even in these legal systems that claim specific performance is a primary remedy, courts more frequently order nonperforming parties to compensate the party injured by nonperformance with damages rather than performance. As a practical matter, the breaching party may not be able to perform, and that difficulty is the cause of the breach in the first place. Unless a defendant clearly has the ability to perform, the court is simply creating unpleasant enforcement problems by decreeing specific performance. Little is accomplished by such an approach.

Anglo-American law has a long tradition of distrust for specific performance, in large part because of sensitivity to the enforcement problems that will confront the court. Either the promised performance is infeasible, in which case ordering specific performance will be futile, or the promised performance is quite feasible, in which case it should be easy to purchase it from someone else in the market. The basic assumption of most western legal systems is that substitute contract performance is available in the market.[121] If the goods are not delivered, the disappointed party simply finds another source of supply and charges the breaching seller the difference between the contract price and what the goods cost from the other source, which is referred to as the "cost of cover". In the view now popular in American courts, it often will increase the wealth of both parties for a high cost seller to breach, avoiding the loss on the performance of what is for him an unprofitable deal, but leaving the disappointed buyer not very disappointed at all, because she can purchase the goods on the market for less than the contract price. In this way contract serves the efficiency of transactions and avoids waste of resources.

The assumption that cover is possible underlies modern American attitudes toward contract and leads to a very conservative set of contract remedies. Parties are encouraged to make contracts because the consequences of failing to perform are not likely to be catastrophic.

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120. CONTRACT LAW TODAY, *supra* note 25, ch. 6; TREITEL, *supra* note 26, ch. III & IV.

121. E. Allan Farnsworth, *Legal Remedies For Breach of Contract*, 70 COLUM. L. REV. 1145, 1149-60 (1970).

The party who finds it onerous to perform is liable only for the difference between the agreed contract price and what it will cost to find someone else willing to do the job. If the contract price reflects market conditions, the disappointed party should be able to find a new supplier at the same price and the damages will be zero. Only if the market price has risen or the original agreement set the price too low will there be any damages at all. If market prices are stable, the situation will approximate that just described as typifying Chinese courts, that is, judicial remedies will be limited and modest. Indeed, one way of understanding the reluctance we attribute to Chinese judges to award substantial sums as damages or penalties is that they assume a high level of price stability. When the disappointed party ultimately seeks substitute performance in a stable price market, it will be at or about the price of the breached contract.

2. Who Pays the Damages?

The sanctions of contract remedies, particularly damages, make sense only when the burden of liability falls directly upon the nonperforming party. There is little incentive for injured parties to go through the inevitably difficult process of litigation and contract enforcement if the reward at the end is an abstract statement that they were right and the other side is wrong. In most legal systems the award of damages provides that incentive, and the successful claimant is better off economically for receiving those damages.

Contract remedies assume that the parties to enforceable agreements are autonomous actors with access to wealth. If such a party is ordered to pay damages, its other behavior will be constrained by the loss of wealth; it will cost that party something. Conversely, damages awarded to an injured party are valuable to it, they give her wealth she otherwise would lack. But these assumptions do not fit the socialist system of capital allocation. If a socialist enterprise is profitable, it is expected to remit profits to the State. If a state enterprise loses money, the State is expected to replenish its capital in order that it can continue production for socialist ends. Bankruptcy and unemployment are avoided in such a "soft budget" system, but so is responsibility for contractual nonperformance. If a State enterprise is ordered to pay damages, it simply turns around and seeks to persuade its benefactors in the state to make up the shortage created. If an enterprise recovers damages, they go to the State. In such a system money goes in and out of the same pockets with little impact on the enterprises, on their managers, or on their behavior. A persistent challenge to the contract

system is to find a way to motivate performance of contract by state enterprises.

For that to happen in a socialist system of state-owned enterprise, some way must be found to separate the interests and financial position of the state from those of the enterprise. Only then will the enterprise be responsible for its nonperformance and the other party better off for having enforced the contract. Until that separation is made, the independent contract law judge inevitably will be in conflict with the official in the supervisory agency that oversees the enterprise. Viewed this way, contract is more than a neutral form, an empty vessel that can be filled to organize any kind of political system. From this perspective, contract implies a degree of economic freedom for enterprises and a corollary degree of economic responsibility, including independence from the state budget.

3. Damages and the Judgment-proof

If parties possess little wealth and if markets are weak so that alternative performances are unavailable, it may be difficult to give meaning to concepts of contract responsibility. Yet these features are particularly notable in a poor, centrally-planned, state-owned economy. In China, capital is allocated by the state through banks under a plan. Little illicit credit is available to enterprises outside this system. Similarly, open markets exist for some, but not all, commodities. If a contract is not performed, the disappointed party may not have any practical way to purchase a substitute if awarded damages.

4. Damages Depend On Markets

The general assumption underlying contract remedies is that the disappointed party can purchase the promised performance on a market. To the extent this assumption does not apply, Western law is confronted with difficult questions of calculating damages, particularly the consequential damages that flow from the breach. The definition of consequential damages has presented vexing difficulties to many legal systems.[122] The problems associated with damages that cannot be avoided by cover often lead parties to commercial contracts to provide in the agreement that damages will be fixed at a given amount. These clauses are labelled liquidated damages when they are

122. *See, e.g.*, LOOKOFSKY, *supra* note 26.

tolerated. Anglo-American law has had many centuries of bad experience with such clauses, however, which traditionally have been viewed with hostility and labelled as penalties.[123] A major problem with a penalty clause is that the amount of the penalty is likely to bear no relation to the actual economic loss from the breach and may be insensitive to the size of the fault. Small deviations from the promised performance can visit catastrophic penalties on hapless parties. More importantly for the economic system, the size of the penalties can lead the parties to behave in ways that are undesirable for the larger economy and perform agreements that result in the inefficient allocation of resources, when everyone would be better if the transaction were aborted and the performance purchased elsewhere on the market.

Market structures are notably weak in China, and the proportion of situations where cover will not be available is large as a practical matter. Compensatory damages provide a sensible remedy in a smaller proportion of cases. This reality forces the Chinese judge in one of three directions.

One possibility is to emphasize specific relief and order the performance of the agreement rather than award damages for the breach. Chinese legal authorities claim that specific relief is primary, although in our conversations, working judges recognized its limitations. You can't get blood from a stone, and you can't get performance of the impossible. Moreover, ordering performance involves the court in a potentially lengthy process of supervision of a business the judge may know little about; and it threatens a confrontation between defendant and court that offends Chinese sensibilities (and everyone else's too). Chinese enforcement of court orders is no stronger than that of the rest of the world.

A second strategy is to rely heavily on penalty clauses as the measure of damages. This in part reflects the necessity of finding a substitute for the non-existent market price. So long as penalties are relatively modest or are scaled so that they reflect the gravity of a particular breach, they may provide a surrogate for the absent market price. It appears from reported court decisions that Chinese judges often reduce the amount of the penalty below that provided in the agreement to arrive at a number that seems to reflect the actual loss from the breach.

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123. *See, e.g.*, Ian Macneil, *Power of Contract and Agreed Remedies*, 47 CORNELL L. REV. 495, 499-513 (1962).

This indicates the third strategy, which is for judges to soften the penalty terms or avoid applying them altogether by steering the cases into "informal mediation" and settlements. Every legal system in the world depends on the draconian potential of the formal law to motivate the vast majority of litigants to settle their claims outside a formal court decision.[124] Chinese court procedure provides an unusually rich range of opportunities for judges to take this approach, even during the course of trial. Preference for settlement and accommodation is one way to understand the emphasis on equity and relationship expressed in *heqing, heli, hefa.* Only as a last resort need the court refer to the rigid rules of law.

To the extent that markets are unavailable as a reference point for remedies contract law in China has limited capacity to foster the efficient allocation of resources. Penalty clauses, specific performance and half-a-loaf settlements are likely to encourage the continuation and performance of contracts that both sides and society at large might all be better off breaching. Rather than disciplining contracting parties and leading them to use the available resources efficiently, these practices place a higher value on relationship.

C. Motivating Contract Compliance

Western contract law operates on the assumption that it is the sanction of the law, particularly the award of damages and occasionally ordering specific performance, that are primary social supports motivating parties in society to observe their contracts. This is almost certainly an exaggerated view of the importance of the law. We do not know the extent to which people keep their agreements. Often contracts are observed even though the law would impose no penalty for breach. Interests in reputation and the maintenance of ongoing relationships powerfully motivate us to keep our promises and the law's sanctions probably do not add much force to those motivations in most cases. In China the legal force motivating contract performance seems even weaker than elsewhere. The threats of damages and specific performance are likely to be ineffective in many cases. We have been struck in our observations in China with the variety of motivations the regime has mobilized in support of its programs of contract. Some of these programs have cognates in the West, but many appear unique in scale

124. *See, e.g.,* Arthur Rosett, *Discretion, Severity and Legality in Criminal Justice,* 46 S. CAL. L. REV. 12 (1972).

and the vigor with which they are pursued.

Since the aims of the contract system and the techniques that might be effective to motivate contract compliance may lead in divergent directions, the choice of technique to motivate compliance with contract will depend on whether the aims or compliance are given priority. For example, one aim of the contract law system is to encourage economic actors to engage in commerce by reducing the transaction costs associated with doing business with unreliable people, particularly strangers. This aim is likely to lead to emphasis on protection of parties' economic expectations in transactions and to a rather conservative measure of compensatory damages, much like that observable in the West. The law assures that in the event of breach the injured party will receive the financial equivalent of performance, but no more. This leads to a system in which both the making of contracts and their breach are quite cheap and carry little moral stigma. The emphasis will be on substituted remedies (damages) rather than specific performance, and those damages that are recognized will be narrowly defined and limited to economic losses. But lowering the price on contract breach undercuts the motivation of parties to perform their contracts and reduces the pressures for contract compliance.

On the other hand, the aim of society might be to enforce morality and to motivate people to keep their word. Concern for the morality of promise keeping is likely to lead to a legal system that will punish promise breakers and order them to perform what they promised on pain of afflictive moral reeducation. It is also likely to lead to emphasis on educational programs that will impress on citizens the importance of promise keeping and mobilize public approval behind those who do keep their word.

Another aim of the contract system, particularly in a socialist system, is to ensure that the state plan is executed according to its terms so that other transactions that are planned in reliance on this transaction also will be able to go forward. In a non-socialist context there may also be concern for the interests of others in those contract performances that will effect their economic and social interests (workers, suppliers, the larger community). This concern leads to seeing these third parties as beneficiaries of the contract with legal standing to assert claims under it. Concern for the state plan or for the interests of third parties results in a system that limits the power of parties to make their own deals, to modify or cancel these deals once the interests of third parties have matured, or to adjust their disputes by negotiated compromises that do not explicitly take into account the interests of the non-parties. It is also likely to lead to a system that

puts emphasis on penalties for nonperformance to secure the interests of non-parties, even in situations when the failure to perform does not create a direct economic loss to the other party.

1. The Continuing Role of Supervisory Agencies

Contract law as enforced through courts in China has not been able to make concepts of economic damages work very well. Explanations include the absence of a reliable market upon which a disappointed party can obtain substituted performance, the difficulties of separating enterprises from the state, and the problems of awarding damages in a poor society where only the state has funds and only the state suffers losses from nonperformance. The courts we observed use penalties, mediation, and specific performance to circumvent these shortcomings. The development of economic courts, contract laws, and contract lawyers in China during the decade of reform has been remarkable, but incomplete. We turn now to the part played by other organizations to the totality of the significance of contract as an institution.

The introduction of contract in the PRC has been matched by modification in the planning process including a reduction in comprehensive, centralized, mandatory, input-output planning. Despite the emphasis on enterprise and transactional autonomy through contract, the governmental institutions of the old system have not been dismantled. Factories and enterprises remain under the supervision of ministries at the national, provincial or municipal level. Economic activities are coordinated at each of these levels by an Economic Commission (*Jingwei*) that actively participates in planning, budget, and executive management.

The supervising agencies and the Economic Commission determine the enterprise's call upon state resources, set the payments the enterprise must make to the State, and influence with parallel Party organs, the personal careers of key managerial personnel. The supervising agencies use these levers of control and influence to induce enterprises to use the contract system, to educate key personnel on the use of contracts, to promulgate contract forms for common transactions, and to police contract performance. For example, in Shanghai budgetary allocations to enterprises are decided by the Economic Commission on the basis of a variety of stated measures of efficiency and effectiveness. The aim is to reward and expand successful enterprises and discipline the inefficient. Contract performance is one of the measures used. Each enterprise must report to the Economic

Commission the number of contracts entered during the reporting period and what happened in these transactions. The expectation is that contracts will be fully performed and the failure to carry the deal through to completion as agreed is seen as a deviation. The official with whom we discussed these reports saw it as a problem if enterprise management entered into transactions they lacked the means to perform or if they failed to deliver. The suggestion was that if the enterprise was in doubt whether it could find the resources to perform the contract, it should not undertake performance. Modification of a contract or the entry of contracts that the parties later mutually may decide not to perform would be reported as non-performed contracts. It should not be too surprising that the supervising agencies see contract as a tool for their control over the operations of the enterprise and therefore that they discourage decisions by the parties to change or cancel the deals undertaken as conditions change. They state this interest in control in terms of the morality of contract performance. The assumption appears to be that the party with whom the contract is made will have no alternative source of supply and that a failure to perform will create a cascade of defaults down the chain of distribution.

2. The Role of the Administrative Bureau

The multiple functions of the Administrative Bureau (*Gongshang Xingzheng Guanli Ju*) were described in Part Two. The Bureau serves as a market police, supervises free markets and peddlers, registers enterprises, trademarks and regulates advertising. Only a modest portion of the Bureau's personnel are concerned with contract matters. The Administrative Bureau is organized at a national, provincial, municipal, and district or county level. The local Bureaus report for some purposes to the local Party organ and local government, and respond for professional activities to the national agency. In Tianjin, for example, cases that involve over RMB 5,000,000 are handled by the Municipal Administrative Bureau, others are dealt with at the district level. Most of day-to-day operations of the Administrative Bureau are handled at district and county level. The Administrative Bureau in Tianjin has about three to four thousand personnel, only about 130 of whom are assigned to the municipal level Administrative Bureau. Under the municipal level there are nineteen district and county Bureaus, each of which has about 200 officials, most of whom are concerned with market police, weights and measures. During our stay in Tianjin in 1987, we observed large numbers of these market police

sweep several times a week the free market that operated around the bus terminal across the avenue from our university. Several dozen officers would roust out the unlicensed peddlers, check scales for accuracy, and appeared to be looking for vendors of stolen or illicit goods.

We were informed by an official of the Bureau in Tianjin that only about 10% of the Bureau's personnel were concerned with contract matters, including those charged with arbitration of contract disputes, as well as the certification and approval of contracts and forms. This comes to 14 officials at the municipal level, all of whom we were told are college graduates, most of whom majored in economics. These officials go through short legal training courses organized by the National Administrative Bureau. We were informed that about two to three hundred contract cases are arbitrated by the Bureau in Tianjin each year. Very few of these go to court after arbitration and in very few cases does the court reverse the arbitral award. In Tianjin, more contract disputes are referred by parties to the court than to the Bureau. Most of the cases that do go to court are resolved by mediation, not trial. The court does not use an arbitration model.

3. Other Contract Supervision Programs

Four other kinds of supervising agencies deserve mention, although we were not able to trace their contract enforcing activities in detail. Until the period of reform the allocation of credit by banks was seen as a political and planning decision, not primarily determined by the likelihood of repayment or profitability. We were told by our Shanghai and Beijing informants that contracts were evaluated by the banks before the Reform, but this practice had been discontinued. Since 1989 banks again have been asked to check contracts before making a loan, and contract performance is used as evidence of creditworthiness in the emerging banking system. Those who fail to perform their contracts are assumed to be less likely to fulfill their obligations to the bank.

In a socialist context, contract failure may be indistinguishable from breaches of the plan, misuse of state resources, and ultimately as a form of financial corruption. During the late 1980s, procurators at the provincial and municipal level were reported in the press to have instituted drives against economic criminal infractions that included activities that sound to a western reader like contract breach. Under Article 7 of the Tianjin Contract Regulations of November 1987, signing an improvident contract causing loss can lead to economic and

criminal responsibility.[125] Many of these cases involve failures to pay debts. During the same period the powers of auditing agencies for the government and the Party were amplified to emphasize an annual audit of all enterprises that would include their contract activities. These audits appear to have both governmental and Party discipline dimensions.

Finally, it should be noted that many failures of contract performance are dealt with by another set of political organizations, the neighborhood people's mediation committees. There now are over a million such committees throughout China, organized on a village basis in rural areas, and in small neighborhoods in urban communities.[126] These committees are often identified with the elderly women and men who form the backbone of the local organizations. They are a familiar sight in city neighborhoods performing low level police, inspection, and regulatory duties. These committees also serve as important vehicles of mass mobilization for public programs, such as family planning, informing the inhabitants of the neighborhood of rules and laws with notices on public blackboards, and by personal contact. The mediation committees also are important as the forum for the disposition of millions of small civil and criminal complaints annually, many of which involve debts and other credit disputes, housing, inheritance, and similar transactions that are too small or otherwise not within the jurisdiction of the People's Court system. Many of these disputes involve the small service providers, peddlers and vendors who form the core of the private sector of the Chinese economy. Each such enterprise is likely to be small, and in total they form a minor segment of the reported national product, but they employ in excess of twenty million urban inhabitants and are a vigorous and rapidly growing part of the economy.[127]

4. Contract Compliance Programs

a. Education to Contract Virtue

The Chinese leadership sees the introduction of contract as the occasion for a massive educational effort that mobilizes a number of government agencies. It is hard for an outsider to comprehend, much

125. Tianjin Contract Regulations, *supra* note 93, § 7, at 2.

126. *See supra* note 79. For a detailed description of dispute resolution in a county of rural Shandong, see Ross, *supra* note 60, at 15.

127. Gold, *supra* note 99, at 196-98.

less to evaluate, the scope of some of these programs. For example, a recent report on general legal educational programs run under the Party and State Council by the Ministry of Justice claims that in the first law study program launched throughout China in 1986, 750 million Chinese citizens took part.[128] At the other extreme, Universities and ministry institutes have trained tens of thousands of enterprise legal experts, lawyers, and court personnel. The Administrative Bureau has been primarily responsible for two intermediate forms of education: the training of enterprise personnel regarding contract administration, particularly the use of contract forms, and the use of contests and awards to publicize enterprises that meet standards of contract performance.

Our discussions with officials of the Shanghai and Tianjin Administrative Bureaus highlighted the limits of the attempt to control contract behavior by audits and limits on the use of forms. A representative of the Shanghai Administrative Bureau described their contract audit program to us in very glowing terms that produced snickers from our more sophisticated Shanghai colleagues. It became clear as the discussion progressed that large steel mills and other industrial enterprises enter into hundreds of thousands of agreements each year, making the kinds of audit procedures described by the Bureau representative wholly unrealistic for an agency with very limited trained personnel and little experience in the specific realities of the transactions. In Tianjin, the 1987 Economic Contract Regulations contain detailed provisions for the registration of contract forms by enterprises with the Bureau and their detailed review. Bureau representatives told us that the limited capacity to review these forms led the Bureau to accept and file without further action forms submitted by "expert" units like banks and transport companies. Factories are permitted to print their own forms and just notify the Bureau. General and incidental contract users are encouraged to adopt the Bureau's printed forms for general use and for activities that cross the jurisdiction of different supervisory agencies.

b. Contests, Awards and Certificates

Throughout the nation the Administrative Bureau is the sponsor of contests that lead to enterprises being awarded certificates and other prizes for their performance of contracts. This activity serves a dual

128. *China Launches Law Education Drive*, CHINA DAILY, Feb. 26, 1991, at 1.

educational function. To win the award the enterprise has to train its personnel to meet the standards of performance. The awards themselves serve a distinct educational purpose, for they are widely reported in advertisements in local and national legal newspapers and provide potential business partners of the winning enterprise with valuable information regarding their trustworthiness. Such prizes and certificates become the grist of the reputational mill, helping an enterprise build a valuable reputation and disciplining its behavior to conform with contract norms. National competitive campaigns of this sort have been held since 1985. We were informed that the Economic Commission set the criteria and policy concerning the campaign and the Administrative Bureau is the implementing agency. Typical announced criteria include:

> (1) Sincerely carry out the Economic Contract Law in establishing contracts. Enter no illegal contracts or invalid contracts.
> (2) Enter contracts only within the enterprise's productive capacity: that is, contracts are to be entered only within the enterprise's production plan.
> (3) Perfect the system of contract management. This requires staff training, supervision and audit of contracts, and the maintenance of archives on contracts.
> (4) Achieve and maintain a 100% performance rate for all contracts except for those not within the control of the enterprise. We understood this exception to allow only for changes in the mandatory plan by superior authorities and not to permit a general excuse of changed circumstances.
> (5) Sincerely respond to personal visits and letters from customers.
> (6) Raise economic efficiency; for example, by developing a reasonable structure for inventory control through the use of contracts material supply, management, and distribution of goods. This campaign is an important way to increase the competitiveness of the enterprises since the main elements for competitiveness are quality, timely delivery, and service, all of which are embodied in the terms of the enterprises' contracts.

Enterprises within the municipality can apply for designation as a "Contract Observing Enterprise." The district or county Administrative Bureau and the enterprise's business supervisory agency conduct a preliminary investigation and accept the application. After a second check the recommendation goes to the municipal Administrative Bureau

for review before approval by the People's Government of the Municipality are announced. Enterprises so designated may use the award in their advertisements. This designation is given a prominent place in television and newspaper advertisements. We were informed that in Tianjin in 1985, over 200 enterprises applied for the designation, 104 won the title; in 1987, 280 applied, 182 won. Altogether, Tianjin has more than 50,000 enterprises. The designation is given for a year and renewed upon checking. So far, no one has been dropped.

D. The Courts, Administrative Bureau and the Private Resolution of Contract Disputes

The resoluton of contract disputes may involve the courts or the Administrative Bureau, but perhaps more commonly, dispute resolution may be undertaken by the parties privately, sometimes through an intermediary. There are two distinct situations when the Administrative Bureau may be invoked in a contract dispute. One is when the agency was involved in drafting, notarizing, or registering the contract. The agency in this situation is expected to actively monitor contract performance. As Bureau workload increases, however, this active role, except during periods of mass campaigns, becomes impossible. Instead, the agency waits until one or both parties bring the problem to it.

The second situation is when the parties to a contract that had not previously been the concern of the Bureau bring a dispute that has arisen during performance to it for resolution. The Administrative Bureau mediates and arbitrates disputes as part of its functions to manage and supervise economic contracts. But it is not the only agency to do that. The parties' options include informal and private mediation by third parties, as well as mediation through the parties' supervisory agencies (which may be informal or formal), and the courts. Informal mediation of any sort is generally preferred, and that by private individuals is most desired. Courts and the Administrative Bureau compete for clients, and there is regional variation in which agency is preferred. The choice of Bureau or Court appears related to the perceived effectiveness of the two bodies in a particular community, the costs involved, and the competence and fairness of their personnel. Our sample was very small, but our informants in Tianjin appeared to have a much higher opinion of the Administrative Bureau than our informants in Shanghai. Conversely, our informants in Shanghai showed respect for the quality of the Economic Court, while those in Tianjin were less impressed by their court, which they saw as dominated by retired military officers and criminal prosecutors.

A 1987 study of contract behavior in five cities by the China Law Economic Reform and Legal Environment Research Group points to the different preferred methods of dispute resolution adopted by enterprises.[129] It found that while the number of contract disputes has increased tremendously from 1985 to 1986, the number of law suits in general went down during the same period. Most enterprises chose to settle their quarrels privately. Furthermore, as Table 1 indicates, enterprises differ in their preferred means of contract dispute resolution depending on their ownership status. State-owned units predominantly went for private resolution (29%), while collective-owned firms tended to seek help from the Administrative Bureau (23.8%). If we treat those "not clear" responses as suggesting a non-formal resolution of the dispute, then the overwhelming majority of cases were resolved in private.[130]

Table 1. Dispute resolution of Supply contracts by Ownership Status of Enterprises[131]

	Ownership Status	
	State	Collective
Superior Agency	7.1	7.5
Courts	25.4	22.5
Administrative Bureau	8.0	23.8
Privately	29.0	22.5
Not Clear	30.3	23.7
Total	224	160

Two other points in Table 1 are worth mentioning.

(1) Formal mediation through one's supervisory agencies has greatly diminished in importance. Regardless of type of enterprise, this is the least used form of dispute resolution. While the hierarchical

129. XIONG JINING, ZUZHI YU HUANJING DE HUDONG [THE INTERACTION OF ORGANIZATION AND ENVIRONMENT] (1990).

130. *Id.* at 99.

131. *Id.*

control of enterprises dominant before the reform seems to be waning, control by law courts does not dominate. This can be seen from the large number of disputes settled privately.

(2) When parties elect to exercise their legal rights in a dispute, some go to court and others choose the Administrative Bureau. The Administrative Bureau is clearly favored by collective-owned enterprises. One interpretation is that these enterprises are more closely supervised by the administrative agencies, and there is an ongoing relationship between the two, whereas courts are more impersonal. On the other hand, the court is relied on by state enterprises for two reasons. One is that state enterprises tend to have better knowledge of law and the legal process, and better trained legal personnel, and therefore are better equipped to deal with the courts. Another reason may be that breach of contract under the plan damages the interest of the state and therefore the authority and prestige of the court rather than the Administrative Bureau is likely to be invoked.

Why did enterprises prefer to settle privately? Xiong's study found that the overwhelming reason given by enterprises was "in consideration of the working relationship with the other party," followed by "law suits don't solve problems."[132] These are clearly interrelated. If going to court cannot solve the problem, it is better to settle privately to maintain an ongoing relationship. This pattern of response clearly indicates the reliance of enterprises on fixed business partners, and suggests the weakness of market opportunities to find other partners.

V. CONCLUSION

As we attempt to assess the results of the changes in contract law in China since 1978, we see inconclusive and divergent trends. The growth of contract law during the decade of reform was the result of leadership decisions motivated by a desire to improve economic performance and be incorporated in the world system. The leadership's aim was to supplement socialist planning and bureaucratic control of the economy with a limited market operating in large part through contract mechanisms. The intention was to expand the set of economic players, to decentralize planning controls, and to subject enterprise management to a degree of market discipline through responsibility contracts, all of which was to be accomplished without a drastic loss of political control.

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132. *Id.*

We argue that the leadership's choices were significantly influenced by values and priorities embedded in the Chinese experience, both before and since the founding of the PRC in 1949. For example, the decision to create a separate Economic Contract Law and the reluctance to establish a general civil law competence for individuals to enter economic contracts seems motivated by such socially embedded factors. These factors also exerted an influence on the program that emerged, because its execution was in the hands of subordinate and local officials whose perceptions of these new contract institutions were heavily grounded in the same cultural experience. Perhaps the clearest example is the agricultural responsibility contract that was the first major step in reform in 1978. The devolution of responsibility from the work brigade to the family working the land was shaped by grassroots influences from below. The form these responsibility contracts took clearly shows the memory of pre-revolutionary land tenancy contracts (*baogan*), which provided a familiar model for local village and unit leadership. In this way both the center and the locality has been influenced by socially embedded factors in choosing the path of contract reform.

The result of this reform has been the creation of weak legal institutions. Courts are creatures of the level of government (i.e., national, provincial, or county) that creates them, appoints the judges, and which continues to supervise in detail their activities. It has proven difficult to reach consensus on the formal norms of contract law, producing statutes marked by their generality and vagueness and by stubborn political opposition in the National People's Congress that has blocked adoption of a comprehensive Civil Code. In a society still dominated by state ownership of enterprises, contract law remedies based on the payment of damages necessarily are weak and ineffective.

Persistent inconsistencies mark the definition of legal personality, as officials try to expand the number of economic actors while attempting at the same time to maintain control over the definition of who may engage in economic activity. The emergence of contract law undermines a traditional feature of Chinese social organization, for a major lever of state power in the local community was control by government of the number of economic actors. The process of dispute resolution draws heavily on traditional practices and upon motivations for contract compliance other than legal remedies.

Yet at the same time we see new trends in the way economic activity is organized by contract in practice. New institutions, organizations and professional personnel are growing up as the result both of directives from the leadership and from pressure from below.

We see people negotiating many millions of contracts in domestic economic transactions each year, we see enterprises and their legal advisors integrating contract practices into daily management of their operations. Over one half million contract cases annually come to the People's Court system and a comparable number are submitted for resolution to the Administrative Bureau. Certainly a much larger number of contract disputes are resolved privately, peacefully, and without apparent bureaucratic intervention. Contract law and legality have built substantial human constituencies as hundreds of thousands of legal professionals (judges, notaries, lawyers) have been trained and entered career paths that give them a stake in the legal enterprise. Most sizable enterprises have recognized the importance of contract expertise by bringing legal advisors into management. These are substantial phenomena and suggest important change. In these respects it might appear that legal change has been a driver of economic transformation.

The contract system that has emerged is at least a means to implement the plan and to expand economic activity by providing transactional security through legal sanctions. It also regulates the market as it expands, by assigning responsibility to economic actors. Beyond these minimal effects of the use of contract, we see four other consequences of the development of contract law that may be more problematic.

First, the introduction of contract inevitably increases the number of potential economic actors and, as the discussion of legal personality demonstrates, limits the power of the state to select and control those who may participate in the market. This potential undercuts basic and longstanding patterns of political control over local communities.

Second, the increase in the number of actors and the weakening of the hierarchical supervisory controls associated with planning supports the decentralization of administrative control over the economy.

Third, patterns of contract dispute resolution and remedies encourage economic behavior that emphasizes the individual interests of actors at the expense of collective interests. This feature tends to support economic activity inconsistent with the communal assumptions of the plan.

Fourth, contract law has the potential to limit and expose the use of informal connections and abuses of the economic power of the state for personal gain. The availability of impersonal contract law institutions provides a competitive alternative to, and therefore potentially undercuts, the networks of informal connections.

We see these trends and institutions growing, but whether they will become dominant in Chinese economic life depends on other dimensions of reform. The state is using contract to create at least a partially market-driven economy, yet at present the opportunities for contract are limited by the restrictions on permissible economic actors. The motivation of parties to take contract seriously is weakened by the difficulties of fashioning credible remedies for breach that will fit the realities of the parties' situation. These limits suggest that contract institutions will gain the capacity to shape social behavior only as economic markets become more dominant factors in setting the terms of trade and more deeply penetrate the habits and expectations of the community. Moreover, as the legal institutions of contract become more effective, the transaction costs of using contract should decline. If agreements can be reliably enforced legally at low cost, contract will be able to compete better with influence networks as a means of structuring economic relationships. At that point, longstanding embedded notions of relationship should be displaced by contract and a new social reality will be established. This seems to be a problem of absorption: contract will not be a vital institution until what was originally decreed by the leadership is integrated into social practice. Until then, contract will be most meaningful in transactions with foreigners and other strangers, those who are too remote to respond to network ties, but not so remote that even legal sanctions and the pressures of relationship are infeasible.