

Chinese Legal Reform: Achievements, Problems and Prospects

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I. INTRODUCTION

There is much to be achieved in Chinese legal reform in the next few years. According to the five year plan for legal reform drafted by the Eighth People's Congress, close to 152 laws are expected to be enacted between 1993 and 1998. Although much of the work to develop these laws is on track, there are still many obstacles to be confronted on the way to attaining reform. In particular, there is the tension between the People's Republic of China's ("China") old and new economic structures and between law and politics. Further, there is still a substantial gap to be bridged between the creation of legal norms and the enforcement of such norms. It is these three areas of difficulty that I will concentrate on in this article.

II. OLD AND NEW ECONOMIC STRUCTURES

The tension between China's old and new economic structures is the inevitable tension produced by the shift from a planned economy to a market economy. This tension has manifested itself in four notable ways: (1) legal reform of enterprise in China, (2) treatment of property rights, (3) reform of the law of contracts and (4) reform of China's banking system.

A. *Legal Reform of Enterprise*

Since 1949, the prevailing ideology in China has required the classification of business enterprises according to the nature of the owner of such enterprises. Specifically, under Chinese law, all enterprises were previously classified either as state-, collectively-, privately- or

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individually-owned. Each of these forms of enterprise was governed by its own particular set of laws and regulations. Further, under such laws and regulations, each of these forms of enterprise carried unique rights, duties and liabilities.

This method of classifying economic actors runs contrary to the essence of a market economy. In a market economy, economic actors must be allowed to engage in competition on an equal playing field under the law. It is with this understanding of market economics that the presently emerging legal system has tried to classify economic actors according to their sources of capital and to assign liability accordingly.

As a result, the enterprise forms currently available to economic actors are very similar to the enterprise forms found in many other developed and developing countries. China now has (1) a company law (allowing for limited liability companies), (2) a proprietorship law (allowing for unlimited liability companies), (3) a partnership law and (4) a joint stock cooperative enterprise law.

The first three of these four enterprise forms should seem very familiar to businessmen outside of China. The fourth, however, is perhaps unique to China. The government decided to create this enterprise form as a means of reforming collectively-owned and small-sized state-owned enterprises. The reform of large- and medium-sized state-owned enterprises, by contrast, is to be accomplished by transforming them into limited liability or joint stock companies.

In converting collectively-owned and small-sized state-owned enterprises to joint stock cooperative enterprises, employees of the old enterprise will be given shareholdings reflecting an ownership interest in the new enterprise. This distribution reflects the equity built up in the enterprise by employees in the course of long-term employment. Along these lines, peasants will also become shareholders in village and township enterprises according to the effort they have invested in land that they occupy. As a result, ownership in joint stock cooperative enterprises will not merely derive from investment of capital.

As may well be understood, it has been difficult for China to transform many older enterprises into enterprises modeled according to the new economic structure — i.e. convert state-owned enterprises into limited liability corporations. This difficulty is largely due to the size of these older enterprises, the potential for negative impact on the Chinese populace and the Chinese economy, and the likely social uncertainty that re-engineering such enterprises could create. Such concerns are felt

particularly strongly by many conservatives, who would like to preserve aspects of the old socialist enterprise system.

It is this tension which has made it necessary to redraft China's bankruptcy law. Although the current bankruptcy law was promulgated eight years ago, very few enterprises were declared bankrupt by the courts. The new bankruptcy law is to contain many concepts found in Western countries and is slated to be passed this year, although this deadline seems somewhat ambitious.

It is also as a result of this tension that the present economic system has been forced to retain a place for state-owned enterprises within China's legal regime. This sort of compromise raises many issues which should be of particular concern for foreign businessmen operating in China. Specifically, although most business entities in China bear the word "company" in their name, only about 5% of such entities are governed by China's new Company Law. Most other entities are governed by the laws for state-owned enterprises. Further, as between those companies governed by the Company Law and those governed by the laws for state-owned enterprises, administrative structures and norms are completely different. This is fertile ground for much confusion. Even very important leaders in the government have trouble understanding the economic differences which drive these two enterprise forms, proposing, for example, that the government should enjoy veto power in all companies regardless of whether they are governed by the Company Law and regardless of the government's proportional holdings in any such company. Such thinking is a throw-back to the thinking of a planned economy.

B. Property Rights

With regards to rights in land, all land in China used to be non-transferable. As China moves towards allowing assignment of rights in land, the question of how to treat the rights of peasants in relation to the land that they occupy has become increasingly important. The possibilities include treating the interest of the peasants in such land as a right of ownership or as a contractual right. If peasants are treated as owning the land which they occupy, this would allow them to sell their land to others. It would also lead to a polarization of rich and poor in the countryside, a result that the Communist party is not likely to tolerate. However, if peasants are treated as merely having a contractual right in their land, it seems unlikely that they will have any incentive to invest

for the long-term in the development of their land, as the duration of a contractual right is relatively short. Nor does there appear to be any easy resolution of this problem with regards to making land assignable.

Defining the property rights inherent in assets held by state-owned enterprises is equally controversial. One school has argued that such enterprises should be given free reign in the treatment of their property. This is described in Chinese as *faren suoyou quan* (lit., legal entity total rights). But according to such a view, a state-enterprise could freely dispose of property which properly belongs to the state. Many people in China, including government leaders in high positions, think that this could lead to adverse consequences, and they are consequently unwilling to go down this route. However, if the rights of state-enterprises in their assets are defined as mere operating rights (*jingying quan*), as they currently are, this will limit the incentive of state-owned enterprises to put their assets to the most efficient use. Somewhere in between these two extremes is a middle-ground which is being called "overall legal entity property rights" (*quanbu faren caichan quan*) in documents of the Communist Party.

As a corollary to this controversy over assets held by state-owned enterprises, a similar controversy is being played out with regards to assets held by collectives. However, a mechanism for reform in this area has been provided by the creation of joint stock cooperative enterprises, as discussed above.

C. *Contract Law*

In the field of contract law, as with most other aspects of law touching on China's economy, the current system is largely the result of the contradictions inherent in China's reform from a centrally-planned economy to a market economy. At present, there are three separate sets of contract law extant in China: the Economic Contract Law, the Foreign Economic Contract Law and the Technology Contract Law. The appropriate contract regime for any transaction is determined according to the types of parties contracting and the subject matter of the contract. For example, contracts involving foreign parties are generally regulated by the foreign economic contract law.

In the push to overhaul China's legal system, this fragmentation in the law of contracts is to be changed. In two years, a uniform law of

contracts is to be promulgated.¹ Notable reforms have been proposed with regard to this unified law of contracts. Under the present economic contract law, there is no provision for offer and acceptance because within a planned economy a contract is signed according to whatever plan is determined by the government, and not according to the free-will of contracting parties. By contrast, one of the proposed goals of the new contract law is to prevent excessive state interference into the formation of contracts and thereby to facilitate the operation of the market economy.

However, there is some dispute as to what constitutes excessive state interference. As recently as 1994, the State Council ordered that all international futures trading transactions should be halted because of the many problems that had arisen from such transactions. Opinion was divided as to whether such involvement on the part of the government was excessive in the context of a market economy. Similarly, there was the question of the McDonald's located on Wangfujing Street in Beijing. Were the actions of the Beijing City government excessive interference or ordinary and necessary?

D. Reform in the Banking Sector

In terms of China's banking system, a law to govern the operations of the central bank and commercial banks in China is presently being drafted. The key issue which circumscribes these reforms is the tremendous amount of debt burdening state-owned enterprises. In the era when China operated with a planned economy, state-owned enterprises enjoyed relatively easy access to loans from banks to subsidize deficits in accounts. Borrowed money was frequently used to pay for even routine operational expenditures. As a result, state-owned enterprises have run up debts for hundreds of billions of renminbi to China's banks. This debt load presents a tremendous obstacle to the reform of China's banks.

Initially, authorities called boldly for most of these bad loans (*si zhai*, lit., dead debts) to be waived. This proposal has been rejected, however, by Zhu Rongji, China's Deputy Premier Minister, as setting a bad precedent.

1. There are some thinkers in China who have argued that only the economic contract law and the foreign economic contract law should be merged, leaving the technology contract law as a separate regime.

Although solutions are not easy to come by in this area, a measure which would at least allow banks to avoid such problems in the future would be the promulgation of a law of secured interests (*dan bao fa*).

III. LAW AND POLITICS

The second difficulty facing Chinese legal reform is the contradiction between the country's legal and political structures. This contradiction is illustrated by the relationship of the National Peoples' Congress (the "NPC") to the executive organs of China's government. Although, under the Constitution, budgets drafted by the State Council are to be approved by the NPC, the State Council has frequently broken ceilings imposed on the budget without obtaining prior consent from the NPC. In a draft law proposed six years ago, called the supervision law (*jiandu fa*), the powers of the NPC would have been shored up against the executive organs. This law would have given the National People's Congress power to review the performance of China's executive organs. However, it never progressed beyond the status of a draft.

Other interesting ideas for limiting the discretion of the executive organs have been proposed, such as creating a mechanism for judicial review of laws by establishing a special constitutional committee, but none have seen fruition. Such proposals involve issues of extreme sensitivity because they would subject acts of the executive branch to review, which would, in effect, be to subject the Chinese Communist Party (the "CCP") to review. The CCP is unwilling to limit its discretion in this way.

The questions raised by the tension between politics and law have been particularly poignant in three areas: (1) in the development of laws for freedom of speech and freedom of the press; (2) in determining the role of the judiciary in China; and (3) in determining the role of the CCP within the context of China's reform.

A. *Freedom of Speech and Freedom of the Press*

A law is currently being drafted in China concerning the freedom of speech and freedom of the press. However, many people are concerned about the role of such a law. They point out that while such laws may be designed to protect people's rights, they may also act to limit people's rights. The example given for the latter proposition is the demonstration law enacted after the Tiananmen Square Incident. Far

from guaranteeing individual rights, this law acted to deprive people of their right to demonstrate. The double-edged nature of these types of law has been a significant concern of the legislature.

B. Judicial Independence

Not long ago, *Legal Daily (Fazhi Ribao)* published a commentary in which the author raised the idea of judicial independence. Although the article was criticized by the government, there are individuals in China who believe that an independent judiciary is necessary to the efficient development of a market economy. Judicial independence has also been proposed as an antidote to corruption in the courts. Currently, the activities of courts are subject to supervision by committees organized by the local representatives of the CCP. As a result of such supervision, and as a result of the dependence of local courts on local financing, the courts are vulnerable to pressure to act in a way which protects local interests and adds to the problem of local protectionism in China.

Based on these concerns, some people have argued for the creation of an integrated court system that is independently administered and separately financed. Such reform would not be easy, requiring an amendment both to the Constitution and to the practices of the courts. This poses a significant obstacle to any meaningful reform in this area.

C. Role of the CCP

The attempt to reform China's legal system has inevitably raised questions about the continuing role of the CCP. These questions were particularly manifest in the drafting of the Company Law, where many argued that any system of corporate governance must provide for representation of the CCP's interests. Concurrently, a document circulated by the Central Committee of the CCP mandated that the CCP committee within each company must be allowed to participate in decision-making. The legitimacy of this document is widely debated, but it serves to demonstrate the urgency of the question.

Assuming that the CCP should play a role in corporate governance, it is still not clear what mechanism for participation is the most appropriate. Alternatives range from reserving one position on any company's board of directors for a CCP representative to requiring that CCP members staff certain positions within a company.

In any case, threading a course for legal reform between the political exigencies of China and existing political interests is likely to be a difficult task. The circumstances of the Company Law is but one example.

IV LEGAL NORMS AND LEGAL ENFORCEMENT AS APPLIED TO THE GOVERNMENT

The third difficulty facing legal reform in China is the existing contradiction between the promulgation of laws and the enforcement of laws. Although many excellent laws have been promulgated in China, enforcing these laws is a continuing problem. This problem is particularly severe where the government is concerned, as failure on the part of the government to observe the law undermines the whole concept of the rule of law

A notable example of the government's refusal to observe the law is the recent pattern of regulation by the State Council. According to the Constitution, the NPC is vested with legislative authority, while the State Council has authority only to declare administrative orders and ordinances. However, as previously noted above, on several occasions, where the State Council felt that its proposed draft budget was not likely to be passed by the NPC, it gave effect to its proposals in the form of a regulation. Another example is the recent draft of a securities law for China. This draft was prepared by a committee of scholars headed by the prominent economist Li Yining and has already been approved by the Financial and Economic Committee of the NPC. However, because the State Council disagrees with certain provisions, the draft has yet to be adopted, despite the fact that the Standing Committee of the NPC has held several sessions. The conclusion drawn by many from these legislative clashes between the State Council and the NPC is that the State Council enjoys too much power in relation to its legally mandated role.

In addition to the problem of separating the powers of the different branches of the government, there is the problem of legally defining the parameters of government authority in general. Besides its power to promulgate laws, the government has the power to issue administrative plans or orders of sweeping scope, as it did in the heyday of the planned economy. Further, the government has unbridled discretion to interpret the law or to suspend enforcement of a law by administrative fiat. If something is not done to limit the government's ability to arbitrarily

manipulate the law, people will lose their confidence in the concept of rule by law

In light of these problems, one should not be overly optimistic about the prospects for improvement within the next 5 to 10 years in the enforcement of laws in China. Although by the end of this century, I think China will have the trappings of a comparatively complete legal system, the situation will not be equally promising in terms of the credibility of this system. Serious attention must be paid to resolving this question and encouraging respect for rule by law rather than rule by man in China.

