

**ECONOMIC DEVELOPMENT AND THE RIGHTS HYPOTHESIS:
THE CHINA PROBLEM**

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Working Paper
Draft Date: April 25, 2002

Paper originally prepared for conference on
Law Reform in Developing and Transitional Economies
2-3 July 2001
Ulaanbaatar, Mongolia

Abstract

An important school of thought in institutional economics (the "Rights Hypothesis") holds that economic growth requires a legal order offering stable and predictable rights of property and contract because the absence of such rights discourages investment and specialization. Without the security of expectations offered by such a legal order, according to the Rights Hypothesis, the risks of a great number of otherwise beneficial transactions far outweigh their expected return, and as a result such transactions simply do not occur. Society is mired in an economy of short-term deals between actors bound by non-legal ties such as family solidarity which by their nature cannot bind large numbers of strangers.

The history of China's post-Mao economic reform has provided interesting material against which to test the Rights Hypothesis. Two features of that history in particular stand out. First, the institutions by which rights are enforced, in particular courts, are perceived to be weak, and thus rights are perceived to be unenforceable. (It is perception, which determines whether persons are willing to invest and make deals, that counts for purposes of the Rights Hypothesis.) Second, China has indeed enjoyed substantial economic growth in recent years.

There are many ways to interpret these observations. First, the hypothesis could be right and the observation of weak legal institutions wrong: rights are enforced in the system, but in a way that is not immediately apparent. Second, the hypothesis could be right and the observation of growth wrong: either the statistics are misleading, or growth is actually low relative to what it would have been with stronger legal institutions. Third, the hypothesis could simply be wrong: there is no strong link between legal institutions and economic growth.

Each of the above interpretations has a certain plausibility. On the other hand, they cannot all be correct. In this paper I propose an understanding of Chinese legal institutions and their impact on economic transactions (and on investment in particular) that will allow us, if not to reconcile, at least to refine these different interpretations to make them less mutually inconsistent. More broadly, I will propose a reformulation of the Rights Hypothesis that retains the emphasis on security of property but substantially downgrades the importance of a formal legal system that provides effective enforcement of contract rights.

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1. INTRODUCTION

An important school of thought in institutional economics holds that economic growth requires a legal order offering stable and predictable rights of property and contract because the absence of such rights discourages investment and specialization. In general, the legal order described by this school is something along the lines of the legal systems of the developed countries of the West (excluding Japan, which is rarely discussed). I will call this proposition the "Rights Hypothesis." Without the security of expectations offered by such a legal order, according to the Rights Hypothesis, the risks of a great number of otherwise beneficial transactions far outweigh their expected return, and as a result such transactions simply do not occur. Society is mired in an economy of short-term deals between actors bound by non-legal ties such as family solidarity which by their nature cannot bind large numbers of strangers (Knack and Keefer, 1995: 210-211).

The best known discussion of the relationship between legal institutions and the economy is, of course, Max Weber's.¹ A classic Weberian formulation of the role of legal institutions in the economy states: "The universal predominance of the market consociation requires . . . a legal system the functioning of which is *calculable* in accordance with rational rules."² (As will be shown later, this is not exactly the Rights Hypothesis in its most ambitious form.) A more recent formulation of the Rights Hypothesis can be found in the work of Douglass C. North, who asserts that "impersonal exchange with third-party enforcement . . . [via an effective judicial system] has been the crucial underpinning of successful modern economies involved in the

¹See generally Rheinstein (1954).

²Rheinstein (1954: 40) (emphasis in original). See also Weber (1958: 25): "[M]odern rational capitalism has need, not only of the technical means of production, but of a calculable legal system and of administration in terms of formal rules."

complex contracting necessary for modern economic growth" (North, 1990: 35) and that "the inability of societies to develop effective, low-cost enforcement of contracts is the most important source of both historical stagnation and contemporary underdevelopment in the Third World" (North, 1990: 54). North and others also emphasize the importance of secure property rights: "In response to expropriatory threats of one kind or another, entrepreneurs not only reduce investment, they also invest in less specialized capital (human and physical), which can be moved more easily from one activity to another" (Knack and Keefer, 1995: 219).³ It is probably not unfair, therefore, to sum up the Rights Hypothesis in the words of a recent critic: "productive capitalism needs formal adjudication, judicially enforced contracts,⁴ and inviolable property rights" (Upham, 1994: 237).

2. THE PROBLEM

The history of China's post-Mao economic reform has provided interesting material against which to test the Rights Hypothesis.⁵ Two features of that history in particular stand out for the purposes of this paper. First, the institutions by which rights are enforced, in particular courts, are perceived to be weak, and thus rights are perceived to be unenforceable.⁶ (It is perception, which determines whether persons are willing to invest and make deals, that counts for purposes of the Rights Hypothesis.) Second, China has indeed enjoyed substantial economic growth in recent years.⁷

³See also Weingast (1993: 287) and North (1990: 65).

⁴In this paper I generally try use the term "judicial enforcement of contracts" to refer to the enforcement of contract rights through a formal legal system of the kind envisaged in the Rights Hypothesis.

⁵For a recent qualitative attempt to assess the impact of legal institutions upon economic development in several East Asian countries, see Pistor and Wellons (1999).

⁶For a detailed look at the enforcement powers of Chinese courts, see Clarke (1996).

⁷Both the proposition that China's legal system does not provide strong enforcement of rights and the proposition that China has enjoyed strong economic growth in the era of economic reform will, for reasons of space, be taken for granted in this paper and not specifically supported by argument. Obviously, a great deal could be said about both these propositions.

There are several ways to interpret these observations together with the Rights Hypothesis. First, the hypothesis could be right and the observation that rights are not enforced wrong, or at least incomplete: rights are necessary for growth to occur, and growth is occurring: although courts don't effectively enforce rights, rights are enforced somewhere else in the system through some other mechanism. There are, of course, various mechanisms for the vindication of claims arising out of contractual relationships that do not involve the court system. For reasons beyond the scope of this paper, I do not believe that it is appropriate to think of this as the enforcement of *rights* as such. Nevertheless, it is important not to assume that a mechanism for the enforcement of rights *cannot* exist simply because it turns out that courts are not that mechanism.

Second, the hypothesis could be right and the observation of growth a misinterpretation of the data: although substantial growth is occurring now, it may be that much *more* growth would have occurred with a different set of legal institutions or that the growth we see is a one-time transitional phenomenon that will soon stall out in the absence of legal reform along the lines suggested by the Rights Hypothesis. This interpretation is grounded in the fact that the beginning of the reform era saw numerous unsatisfied market segments, particularly in household goods and services, caused by the standard socialist restrictions on economic activity in these sectors. The relaxation of restrictions meant extraordinary profit opportunities for early entrants -- so much so that there was substantial resentment among salaried workers and intellectuals at the hitherto unimaginable sums of money being earned by shoe repairers and hairdressers. Ultimately, however, one would expect additional entrants to compete profits down to normal levels, and indeed the statistics appear to bear out this prediction (Naughton, 1995: 150-151). At some point all niches will be filled except those in which success requires security of property rights or effective judicial enforcement of contracts. At this point, if the Rights Hypothesis is correct, growth will taper off.

Third, the hypothesis could simply be wrong: rights aren't protected but significant growth occurs, and therefore there is not an important connection between the two. As David Trubek pointed out 25 years ago, to say, as did Weber, that a *market* requires a system of effectively enforced rights of property and contract is not the same as saying that *economic development* requires such a legal system unless we take the further step of positing that the only

path to economic development is through the market (Trubek, 1972b: 15). But the history of the Soviet Union and of the People's Republic of China shows that development, at least up to a certain level, can in fact be achieved through planning and without a substantial role for the market.⁸

Equally important and often overlooked is that Weber's formulation, whatever its accuracy, does not strictly speaking require that the legal system provide enforceable *rights* -- that is, the actual ability, in certain special circumstances, to choose to invoke the coercive power of the state in support of one's personal interests. All that is needed is that the system operate in a predictable manner. Therefore, the Rights Hypothesis could be wrong in focusing so strongly on the particular institution of rights. I shall return to this point later.

As can be seen, each of the above interpretations has a certain plausibility. On the other hand, they cannot all be correct. In this paper I will attempt to propose an understanding of Chinese legal institutions and their impact on economic transactions (and on investment in particular) that will allow us, if not to reconcile, at least to refine these different interpretations to make them less mutually inconsistent. More broadly, I will propose a reformulation of the Rights Hypothesis that retains the emphasis on security of property but substantially downgrades the importance of a formal legal system that provides effective enforcement of contract rights.

3. ANALYSIS

Perhaps the main problem with the Rights Hypothesis is that it is too sweeping and fuses concepts that ought to be kept separate. Its proponents too often forget the difference between a market system in particular and economic development in general, between rights in particular and predictability in general, and between contract rights and property rights.⁹

⁸See, e.g., Naughton (1995: 53): "[T]he Chinese economy appears to have strong growth potential regardless of system. Even before reforms, China's economy was growing at respectable rates."

⁹By "contract rights" I mean roughly the right to have a promisor of equal legal status held to her promise or required to pay damages; by "security of property rights" I mean roughly the probability that one's property will not be confiscated unpredictably by (a) government or (b) other parties that government is

a. *Contract Rights and Property Rights*

Proponents of the Rights Hypothesis assert that the legal systems of developed capitalist economies do two important things: they enforce contractual rights against one's contractual partners, and they provide security for one's property. Thus, if a contract is breached, one gets damages or specific performance, and the government neither confiscates one's property unpredictably nor allows other private parties to do so.

These two things, however, are very different. It is quite possible in principle to imagine a system where there exists no effective machinery for the impartial third-party enforcement of contracts, but where the government neither engages in unpredictable confiscation of property nor allows others to do so. In such a system, one will not, of course, see any economic activity that requires effective third-party enforcement of contracts, but one will see activity that merely requires security of property from confiscation.

For what kind of activity is the enforcement of contract rights through a formal legal system the *sine qua non*? The substantial literature on informal and social sanctions, repeated games, and self-enforcement mechanisms¹⁰ suggests that in the end there is perhaps only one kind of deal that can *never* be done without an effective formal legal system: a one-shot deal between strangers who have neither the desire nor the expectation of ever doing business again with the other or with anyone known by the other. In all other kinds of deals, it is possible in principle for another mechanism to provide the needed security and protection from bad faith.¹¹

unwilling or unable to stop. *Predictable* confiscation is economically indistinguishable from a tax, and while excessive taxes can of course stifle economic activity, that is not an issue within the scope of this paper.

¹⁰See, e.g., Black and Kraakman (1996), Bull (1987), Greif (1993), Telser (1980), Winn (1994), and the sources cited in North (1990).

¹¹This might be viewed as an extreme position. I believe it is defensible if the qualifications -- particularly the words "never" and "in principle" -- are taken seriously.

(In the real world, of course, the cost of that other mechanism may be greater than the benefit of the transaction to the parties.)

In assessing the impact on the economy of the lack of such an effective system for enforcing contract rights, one must therefore ask just how important such one-shot deals (as well as any other deals for which there exists no reasonably effective informal method of sanctioning breaches) are in that economy or to its development. North and others seem to assume that they are common in advanced capitalist economies. This seems to me to be a question calling for empirical research.¹²

Turning now to property rights, for what kind of economic activity is freedom from fear of arbitrary confiscation by government (or by those whom government allows to act) the *sine qua non*? The answer is clear: just about any kind of investment other than investments with the very shortest of time horizons. In other words, the greater the fear of arbitrary confiscation, the shorter will be the time horizon of any investments. This means that a whole class of economically rational investments -- those with a large payoff, but one which is delayed or stretched out over several years -- will not get made.

In sum, my minimum claim is that the enforcement or lack thereof of contract rights and the security of property rights can involve very different consequences and ought to be conceptually distinguished. My stronger claim is that whether contract rights are judicially enforced is less important than whether property rights are secure: the lack of an effective formal judicial system that enforces contract rights puts out of reach only a relatively small number of growth-enhancing transactions, whereas the fear of confiscation of one's property makes a very large number of growth-enhancing investments impossible.

¹²See, for example, Macauley (1963), in which one-shot relationships between strangers were conspicuously absent in the business community under study.

b. *The Idea of Rights vs. the Idea of Predictability*

Suppose we grant the claim of the Rights Hypothesis that, all other things being equal, it is more conducive to economic development to have predictability than not to have it. Clearly, predictability has economic value; businesspeople often spend money, for example, to see if people are likely to buy a product before they invest in the factory needed to make it. More important to the Rights Hypothesis, however, is the claim that economic development is furthered by predictability in certain specific areas: the enforcement of contract rights and the security of property rights.

Where the Rights Hypothesis again goes too far, however, is in failing to distinguish between predictability and rights. Just as investment in agriculture depends on predictability about matters respecting which the farmer has no legal rights -- for example, that spring will follow winter, or that seeds, if watered and fertilized, will grow -- so we can imagine a legal system that contains no rights but that operates in a predictable manner. A system composed entirely of reglementation -- defined by Weber as "those norms which only embody instructions to state officials as regards their duties, but, in contradistinction to what may be called 'claim norms,' do not establish any 'rights' of individuals" (Rheinstein, 1954: 42) -- could in principle provide sufficient stability of expectations to support a reasonably well functioning market.¹³ Thus, it is a mistake to look solely at institutions that support rights -- such as courts -- to see if stability of expectations can exist. One must look at all the government agencies that adjust relations between parties and have the power to order the transfer of resources from one party to another.

¹³As Weber further remarked, "[P]rivate interests enjoy protection, not as guaranteed rights, but only as the obverse aspect of the effectiveness of these regulations" (Rheinstein, 1954: 44). In other words, if the regulations are effective, private interests can be protected in the absence of any system of rights.

c. *Reformulating the Rights Hypothesis*

The analysis above suggests that there are some serious internal problems to the Rights Hypothesis in its standard form, to say nothing of the problems created by evidence that appears to contradict it. What I propose to examine now are the arguments and evidence in favor of the proposition that whether would-be investors have a reasonable assurance that the fruits of their investment will not be confiscated unpredictably is far more important to economic development than a formal legal system that enforces contract rights.

I will start with the work of Douglass C. North, one of the foremost proponents of the Rights Hypothesis in its full form: that is, the claim that enforcement of contract rights and security of property rights are both necessary to economic development.¹⁴ If one looks closely at North's illustrative examples of the institutions and practices that enabled England on the one hand to grow and prosper and caused Spain on the other to stagnate, one finds that he never, except in the most abstract way, cites the predictable enforcement of contract rights. Instead, he cites examples of greater or lesser security of property against government depredation. The bad old days of the Stuarts, for example, saw "repeated fiscal crises . . . that led them to engage in forced loans, to sell monopolies, and to engage in a variety of practices (including wealth confiscation) that rendered property rights less secure" (North, 1990: 139). North sees the Glorious Revolution as an attempt, among other things, "to solve the problem of controlling the Crown's exercise of arbitrary and confiscatory power" (North, 1990: 139). The success of this attempt led, in North's view, to a rapid development of capital markets and access by the government to an unprecedented level of funds, because lenders had "a clear perception that the government would honor its agreements" (North, 1990: 139). North concludes that

[t]he security of property rights and the development of the public and private capital market were instrumental factors not only in England's subsequent rapid economic development, but in its political hegemony and ultimate dominance of the world (North, 1990: 139).

¹⁴See, e.g., North (1990) and North and Thomas (1973).

When he looks at Spain and the reasons for its decline in the 17th century from the mightiest empire in the West since Rome to the status of second-rate power, North tells a story of "the expulsion of Moors and Jews, rent ceilings on land and price ceilings on wheat, [and] confiscations of silver remittances to merchants in Seville" as disincentives to productive activity (North, 1990: 115). In *The Rise of the Western World*, North and his co-author also note the disincentives to agricultural investment in Spain occasioned by the Crown's grant to the shepherders' guild of the right to run sheep over agricultural land owned by others (North and Thomas, 1973: 4).

What all these examples have in common is that they essentially involve the government either keeping a promise to preserve the expected value of an asset or else not allowing others to deprive one of the expected value of an asset.¹⁵ They simply do not show anything one way or the other about the need for enforcement of laws of property and contract against third parties with whom one deals.

A similar emphasis on freedom from arbitrary and unpredictable confiscation can be found in a study by Stephen Knack and Philip Keefer (1995), an often-cited effort to test the Rights Hypothesis empirically. While the authors state or imply at several points in their study that what they are testing is the importance of rights of both property and contract to economic

¹⁵In buying a house, writes North,

the discount from the frictionless exchange envisaged in economic theory will be greater to the degree that the institutional structure allows third parties to influence the value of the attributes that are in the utility function of the buyer. These could include the behavior of neighbors, the likelihood of theft, and the possibility of changes by local authorities in zoning ordinances that may affect the value of the property. The greater the uncertainty of the buyer, the lower the value of the asset. . . . It is worth emphasizing that the uncertainties described above with respect to the security of rights are a critical distinction between the relatively efficient markets of high income countries today and economies in the past as well as those in the Third World today. (North, 1990: 63.)

growth, an examination of their methodology shows that in fact contract enforceability, even if measurable and measured accurately, has little or no part in the indices with which they correlate economic growth and private investment.

Knack and Keefer use two indices, both based on indicators compiled by private international investment risk consultants, that they believe measure directly the dimensions of property rights emphasized by North and others. The first of these indices is derived from the International Country Risk Guide (ICRG)¹⁶ and is the aggregate of five variables measuring expropriation risk, rule of law, repudiation of contracts by government, corruption in government, and quality of bureaucracy. The second index is derived from Business Environment Risk Intelligence (BERI)¹⁷ and is the aggregate of four variables measuring contract enforceability, infrastructure quality, nationalization potential, and bureaucratic delays. They find that both the ICRG and the BERI indices outperform other indices of property and contract rights used in previous studies,¹⁸ and that while the ICRG index explains growth best, the BERI index explains private investment best.

What the authors do not do is to attempt seriously to distinguish property rights from contract rights -- i.e., the security of an expectation that one will not be subject to arbitrary and unpredictable confiscation as opposed to the security of an expectation that one will be able to enforce a promise made by another with whom one does business. They attempt to tie unreliability of government promises to unreliability of all third-party promises with the assertion that "[i]t is likely that if private actors cannot count on the government to respect the contracts it has with them, they will also not be able to count on the government enforcing

¹⁶For further information on this source, including a description of the methodology, see <<http://www.prsgroup.com/icrg/icrg.html>>.

¹⁷For further information on this source, see <<http://www.beri.com/>>.

¹⁸These other indices did not purport to measure property and contract rights directly, but instead used measures of political violence or political freedoms and civil liberties in the belief that these measures could be a suitable proxy for the absence or presence of secure property and contract rights. See, e.g., Barro (1991), who uses measures of political violence, and Scully (1988), who uses measures of civil liberties.

contracts between two private parties" (Knack and Keefer, 1995: 210), but this assertion rests only on a superficial symmetry and is not convincing. While the ICRG and BERI indices both present plausible measures of security against unpredictable expropriation, the ICRG contains no measures of contract enforceability and only one of the four BERI variables attempts to do so. Consequently, while the Knack and Keefer study supports the Rights Hypothesis with respect to security of property rights, it simply does not address the importance of contract rights. Furthermore, security of property rights -- at least as discussed by North and as measured by Knack and Keefer -- has little to do with formal legal institutions. It is much more a question of political institutions (Weingast, 1993: 286).

In short, while the Rights Hypothesis is generally stated in terms of a formal legal system that protects rights of property and contract, the qualitative and quantitative work that purports to support the hypothesis tends to focus almost exclusively on security from arbitrary expropriation, without being concerned about whether that security comes from a well functioning legal system or simply a wise government that prudently declines to exercise the power it has to expropriate in order to maximize its ultimate revenue from taxing the income stream. Contract rights are simply not addressed at all.

d. The China Problem

We can now return to the issue raised at the beginning of Section 2: what are the implications of the evidence from China for the Rights Hypothesis as reformulated to stress freedom from fear of confiscation?

Imagine two plots of land side by side in the Chinese countryside. On one sits a typical TVE¹⁹ making buttons. On the other toils a farmer. Both the factory and the farmer carry on their

¹⁹TVE is the general term used for township and village enterprises: businesses that are typically founded and run by local government. Technically they belong to the collective sector, as opposed to the private sector or the state sector, and are therefore said to be "owned" by the citizenry of a particular locality. This ownership is for all intents and purposes meaningless even as a formality; all the important indices of ownership rest with local government (Naughton, 1994: 267). Although it is important in understanding TVEs to know that they are run by and for government bodies, not private investors, it is

business under the same local government. If they have a contract dispute, the same court system will hear (or refuse to hear) their case. In short, from the standpoint of the ability of the formal legal system to protect their contract rights, they are similarly situated. Yet it is very likely that the TVE fits the general national pattern of solid growth in investment and output in its sector,²⁰ while the farmer fits the pattern of slow growth in agriculture relative to the remarkable growth of the early 1980s.²¹ Why might this be so?

It would be foolhardy, of course, to attempt a single-factor explanation of what is undoubtedly a complex phenomenon. First, the TVE and the farmer are not *identically* situated with respect to the ability of the formal legal system to enforce their contract rights. The TVE is a bigger actor and has more resources and clout in the community than a single farmer. Second, the TVE, again because it is bigger and has more resources and clout, is better situated than the farmer to take advantage of other mechanisms that might substitute for enforcement of contract

equally important to understand that these government bodies in many cases wish to maximize profits and operate in a competitive market environment. Most importantly, unlike state-owned enterprises, TVEs have no hope of central government support if they run into trouble, and their workers, unlike SOE workers, have no implicit guarantee or expectation of employment. Thus, they face a hard budget constraint. For a contrary but distinctly minority view, holding that "money-losing TVEs typically stay in business, despite their inability to repay debts", see Wang (1990: 225).

²⁰Available statistics show a steady rise over the ten-year from 1990 through 1999 in a number of relevant indices of TVE activity: fixed investment, circulating funds, profits, business revenues, and value added. Employment, however, has remained steady since 1993, and the total number of TVEs has decreased from a peak of about 25 million in 1994 to about 21 million in 1999 (China Township and Village Enterprise Yearbook 2000, 2000: 15-18). See also Wang & Kalirajan (2002).

²¹See generally Li, Rozelle and Brandt (1998). Between 1955 and 1980, when reforms began spreading in earnest, the annual per-person increase in grain production was 1.3 kilograms. From 1980 to 1984, that figure rose to 16.2 kilograms. Between 1984 and 1993, the figure fell to 2.9 kilograms even though agricultural policies had, if anything, become more liberal than before (Prosterman, Hanstad and Ping, 1996: 91). The explanation appears to be strongly connected with the move from collective farming to family farming. At the beginning of 1980, 1% of rural households had made this shift. By the end of 1984, 99% of rural households had (Lin, 1992: 38). Once the shift was complete, apparently, there were no more gains to be had from it.

rights through the formal legal system -- mechanisms ranging from gathering information about the trustworthiness of prospective contractual partners to hiring thugs to collect on contract debts. But these explanations do not really contradict, and in fact can be viewed as supporting, the reformulated Rights Hypothesis, which downgrades the importance of a formal legal system that can enforce contract rights between strangers.

From the standpoint of incentives for investment, it may simply be that all the large returns that can be obtained from investment in agriculture at China's current technological level have already been achieved, whereas light industry is still far from this point. But empirical research seems to suggest that there is in fact room for significant further returns from agricultural investment:

Many agricultural scientists in China have concluded that farmers could obtain crops two to three times larger than what they currently harvest. The farmers we talked to also acknowledged that the land could afford much larger yields. Yet few of them had made any major alterations to their plots, even though they all knew that such changes would boost their output. (Prosterman, Hanstad, and Li, 1996: 93.)

Why are these investments not being made?

The farmers' reluctance to sink money and labor into any extensive modifications can be directly attributed to their underlying fear that they may not be able to hold on to their property long enough to realize a return on their investment. (In contrast to the changes already made, the costs of which were recovered quickly, the next phase of improvements will take many years to pay for themselves.) Back in 1984 the central government ordered that land contracts be extended for 15 years, but local officials have not implemented this policy to any significant degree. Indeed, very few farmers even possess written contracts granting them the right to tend a specific plot. And when they do obtain a contract, the expiration date is often left blank, or the term may change without warning, or the contract

may be terminated far short of what was originally promised. (Prosterman, Hanstad, and Li, 1996: 93.)²²

This analysis is reinforced by a survey study conducted by Li, Rozelle, and Brandt (1998), which found a strong and robust connection between the right to use land for long (or indefinite) periods of time and the making of land-saving investments, although they did not conclude that the lack of such rights carried a high efficiency cost.

While agricultural growth has slowed considerably, growth in the TVE sector continues apace. Apparently TVEs (or more precisely, the investors and managers of TVEs) do not have the same fear of confiscation of the fruits of their investment that farmers have. If indeed this is part of the explanation, it makes sense, for a key feature distinguishing TVEs from farmers is that TVEs are the creatures of local government, precisely the same body that farmers fear will confiscate their land. While farmers, therefore, face radical uncertainty as to the results of long-term investments such as well-digging or the terracing of fields,²³ TVEs, whatever their other problems, face no real uncertainty in this area at all. Provided the economics are right, the only concern of the investor (local government) is the unlikely one that several years down the road the central government might confiscate all or part of its treasury.²⁴

²²Note that the contract spoken of here is not an ordinary commercial contract with another party of equal legal status, but a contract with the local government for long-term land tenure. Thus, a violation of that contract by the local government in redistributing the land is more appropriately viewed as a problem of security of property against government confiscation than as one of enforcement of contract rights in business dealings.

²³It should be noted that the diagnosis of Prosterman, Hanstad, and Li (1996) is not unchallenged. James Kung and Shouying Liu question this diagnosis on the basis of survey results showing that farmers did not have a strong preference for private ownership and that a majority reported that they preferred the existing system of periodic land redistribution to account for changes in family size (Kung and Liu, 1997: 33). The key flaw in the authors' argument, however, is that a preference by farmers for a particular system is by no means equivalent to a refutation of the proposition that that system contains severe disincentives to agricultural investment. A detailed discussion of their findings is, however, beyond the scope of this paper.

²⁴Even this concern may not have a substantial effect on investment patterns, since all alternative investments will carry the same risk. The only way open to local government leaders for the certain

Whether TVEs do indeed enjoy a unique security of expectations in investment is controversial. A substantial body of literature exists asserting that the Rights Hypothesis, even when limited to property rights, is refuted by the success of TVEs in what is claimed to be an environment of vague and insecure property rights. As will be shown below, I believe that this literature places undue emphasis on formal instead of realistic categories of ownership and therefore does not succeed in its challenge to the property rights element of the Rights Hypothesis.

Weitzman and Xu, for example, noting correctly the hollowness of the formal ownership rights of "the community", go on to conclude that TVEs have "no owner in the spirit of traditional property rights theory" (Weitzman and Xu, 1994: 132). They reject the local government as a candidate for the role of owner on the grounds that it lacks several elements of full control: it is restrained from firing workers who are community residents, for example, and "has to take into account . . . the preferences of residents" in its decision making respecting the establishment of TVEs (Weitzman and Xu, 1994: 134). This hardly disqualifies local government as owner. If a private entrepreneur faced statutory limits on her ability to discharge workers, we would not conclude that she was for that reason not a true owner. With respect to taking into account the views of residents, a decision to establish a TVE is hardly the same as the continuing series of decisions involved in running one, and in any case Weitzman and Xu fail to distinguish between what the local government *must* do and what it would be *wise* to do as a matter of policy. There is no question that the local government could, if it wished, set up a TVE without popular approval, in the same way that it can levy taxes and fees without popular approval.

Because they reject the notion that local government is an owner with clear rights of management, usufruct, and disposition over the assets of the TVE, they find TVE success a puzzle, and resort to a concept of cultural propensity to cooperate (*lamda*) in order to resolve it. They assert that conventional property rights theory assumes a low-*lamda* culture in which

avoidance of confiscation is to consume government funds now through the familiar rituals of banqueting and travel at public expense.

clearly defined property rights are needed to prevent shirking and opportunistic behavior. Perhaps China's TVEs are able to succeed, they hypothesize, because they exist in a high-*lamda* culture where formal rights and binding legal rules are less important.

The problem with *lamda* as an explanatory variable is that it turns out not to explain anything. Weitzman and Xu use it to account for different outcomes (e.g., differential rates of success for firms with a TVE structure) when all other factors are held equal. The question, however, is what these "other factors" are. If they turn out to be everything that we can think of that might be relevant to TVE success, then *lamda* is by definition simply a residual category for things we cannot think of. In other words, *lamda* is just a label for things we cannot explain. But there is no particular reason to equate the unexplained with "culture". Given that *lamda* is a residual category, one would expect it to get smaller and less important the more we learn about identifiable factors contributing to TVE success.

The claim of unclear property rights is repeated by David Li in another frequently-cited article:

[N]o one can claim that the Chinese non-state sector enjoys clearly defined property rights. Most of the non-state firms are collectives and other kinds of non-private firms. The owners of these collective firms are often loosely specified, e.g., all residents in a community (Li, 1996: 2).

Li then develops a theory to explain why ambiguity and vagueness could actually be advantageous. The analysis is flawed, however, by its origin in the notion that there is any vagueness about ownership of a TVE. While the category of "all residents in a community" is indeed vague, and while one can certainly find various pronouncements to the effect that the owners of a TVE are "all residents in a community", this ownership is no more meaningful than the "ownership" interest of French citizens in Air France and deserves equal attention -- that is to say, none -- in a legal or economic analysis. Thus, one can indeed claim that property rights in the non-state sector are, at least sometimes, clear:

Local residents possess no "right of membership" in TVEs, nor do TVE workers possess any rights to participate in TVE management. In most cases that have been studied, township and village officials in their official capacity possess all the key components of property rights: control of residual income; the right to dispose of assets; and the right to appoint and dismiss managers and assume direct control if necessary (Naughton, 1994: 267).

Other scholars whose analysis is distracted by the perceived need to take into account somehow the ownership rights of "the community" or "local citizens" (as opposed to the local government) include Chang and Wang (1994),²⁵ Che and Qian (1998),²⁶ and Hong (1995).

If, as I argue, ownership rights over TVEs and their cash flow are not significantly ambiguous or vague, then the critical distinction between a TVE run by local government and a

²⁵The authors argue that TVEs are afflicted by a problem of separation of ownership from control that stems from ownership by citizens combined with management by the local government. But this is to get caught up in formalisms. *De facto* ownership is in the hands of local government. The separation of ownership from control occurs because the local government, as an abstract entity, can act only through human agents such as government officials. Yet another layer of agency is created when those officials in turn appoint others to manage the TVE. In any case, the principal-agent problem is no different from that faced by state-owned enterprises (SOEs) or large private enterprises in market economies:

The problem is that the state as the owner was unable to manage each enterprise by its own, and need to appoint managers to do it. Similar principal-agent conflict within large private enterprises also exists in market economies. In other words, the ownership and management of SOEs have always been separated. The managers of SOEs were appointed or recruited by the state. (Lin, Cai and Li, 1997: 55.)

²⁶The authors analogize the township to a multidivisional firm, with each TVE as a division within the firm, the local government as the board of directors, and local citizens as stockholders. While the analogy of the TVE to a division within a multidivisional firm is well taken, the notion of local citizens as equivalent to stockholders is difficult to accept. Among other things, they have no vote in "firm" management and they have no identifiable, protected, and transferable right to any of the wealth created by the "firm". Simply being in a position to benefit from local government expenditure if one still resides in the area when the expenditure is made is not enough to support this analogy in a meaningful way.

privately-run enterprise is that the TVE does not need to fear arbitrary expropriation, either direct or indirect through oppressive taxes and fees.

The threat of arbitrary expropriation in China today does not come from the central government; it comes from local government.²⁷ It is local government that is the most closely acquainted with a firm's financial health and that has the greatest incentive and ability to loot it. A firm owned by local government is obviously not subject to this uncertainty, since the local government internalizes the cost of whatever decision it makes about distribution of TVE profits. Local government investment in an enterprise, then, is (unlike local private investment) absolutely undeterred by the worry that the investor cannot fully capture the return on the investment. With respect to superior levels of government, it appears that the property rights of local levels of government are quite robust.²⁸ Superior levels of government do not in general take from inferior levels without compensation.

With this security against expropriation, local governments can not only invest more than private entrepreneurs, but they can invest more efficiently. As Knack and Keefer (1995: 219) point out, an investor concerned about expropriation is likely to invest in less specialized capital (human and physical) that can be moved more easily from one activity to another. Not only does this have static efficiency effects, but it also discourages dynamic gains from innovation, since such innovation is more likely to thrive where there is specialization.

The Chinese example also sheds some interesting light on the question of whether economic development actually requires rights or simply predictability. While China's legal system does not seem to protect the former very well, it may offer a reasonable degree of the latter.

²⁷For this reason, I do not find convincing the claim of Chang and Wang (1994: 447) that local citizens are designated as formal owners of TVEs in order to make credible a commitment by the central government not to expropriate.

²⁸See generally Granick (1990) and Naughton (1995: 43).

A good deal of discussion of the Chinese legal system is in terms of what it lacks: there is a lack of enforcement, a lack of legal consciousness, a lack of trained judges.²⁹ All this is true, and indeed in many cases these lacks are seen as deficiencies by Chinese legal scholars and others working in the system. In part because the institutions of the Chinese legal system come with labels that are customarily translated using familiar English words -- "courts", "judges", "laws", etc. -- without much thought about whether such words are really appropriate, pointing out the ways in which the Chinese system is *not* in fact like the system in which we use these terms is a necessary part of understanding that system. But it is far from sufficient. The Chinese legal system itself, like the society of which it is a part, does not function on the basis of what it lacks; it functions on the basis of what it has. Because the Rights Hypothesis is essentially oriented to the would-be investor's ability to predict what will happen to the investment, the question should be not whether China possesses or lacks courts that enforce rights, but simply whether investors and others engaged in business in China have adequate predictability for their needs.

To the extent the legal system has anything to contribute to this, China's -- or any other country's -- system is not any the less capable in principle of doing so simply because it consists largely of Weberian "reglementation" and not "claim norms".³⁰ Further inquiry, therefore, would be more usefully focused on the question of predictability than on the presence or absence of enforceable legal rights.

The inquiry into predictability must also ask: predictability for whom? Proponents of the Rights Hypothesis typically assume that there must be predictability for private economic actors, because they assume that economic development requires a market and that a market requires private actors. Putting aside the question of whether or not economic development in fact requires a market, it does not appear to be true that a market requires private actors. What it does generally require in order to have meaningful bargaining over prices is actors that are trying to

²⁹I confess to engaging in this kind of discussion myself (Clarke, 1996). I am grateful to Ellen Hertz for discussions regarding the problems with this approach.

³⁰This characterization of the Chinese legal system raises more issues than can be dealt with adequately in a mere footnote. I discuss these issues more fully in Clarke (1995). See also Stephens (1992).

buy low and sell high. The Chinese case certainly demonstrates that governmental actors such as TVEs are capable of fulfilling this role and that a market can flourish in the absence of significant true private actors.³¹ Therefore, even if it could be shown that private actors do not enjoy the benefits of predictability in contract and property, that need not be fatal to economic growth. We might find at the same time that non-private actors *do* have predictability and can create flourishing markets and economic growth.

4. CONCLUSION

One of the reasons why proponents of the Rights Hypothesis have so often lumped security of property together with enforcement of contract rights may be that societies characterized by security of property from arbitrary government confiscation also tend to be characterized by the relatively effective enforcement of contract rights. Thus, they have mistaken effect for cause. China presents an invaluable case study for the hypothesis because although it seems that rights of any kind are not well protected through courts and the legal system, economic growth does take place, and it seems to take place in those sectors that are free of the fear of arbitrary government confiscation. Such sectors can exist in China in a way they cannot in other developing countries because of the near absence of true private sector in industry and the dominant role played by governmental bodies -- however much they may be forced to play by the rules of the market -- as economic actors.

The reformulation of the Rights Hypothesis presented here may also offer a solution to Max Weber's "England problem."³² Weber believed that "the degree of legal rationality [in England] is essentially lower than, and of a type different from, that of continental Europe (Roth and Wittich, 1968: 890). Yet he could not avoid observing the strength in England of precisely

³¹As numerous scholars have pointed out, the key difference between TVEs and state-owned enterprises is that TVEs face a hard budget constraint. See, e.g., Che and Qian (1998: 3) and Li (1997). See, however, Steinfeld (1998: 239-240), who asserts that as TVEs become large and successful, they may be able to attract central bank loans, enjoy a softer budget constraint, and experience a decline in performance. See also Wang (1990: 225).

³²See generally the discussion in Trubek (1972a: 746-748).

the kind of capitalism for which he had posited the necessity of legal rationality. It may be, of course, that Weber simply defined too narrowly the type of legal rationality truly necessary. On the other hand, it is worth pointing out what England *did* have in common with the successful capitalist countries of Western Europe, a feature tirelessly pointed out by North: a government that made credible promises not to confiscate and that did not allow others to do what was in effect the same thing.

What about the contract rights half of the Rights Hypothesis? It makes intuitive sense to suppose that a large class of economically advantageous transactions will not take place if there is no legal system in place to enforce the promises parties make to each other. Why is it that this part of the Rights Hypothesis, if not outright wrong, at least has not nearly so much explanatory power as has been claimed for it by its adherents?

Part of the answer, as suggested earlier in this paper, may lie in the fact (if it is a fact) that in most economic transactions, third-party enforcement through government coercion is not in fact the only effective enforcement mechanism available, because one-shot deals between people who are and intend to remain strangers are in practice not of great importance in modern capitalist economies. Obviously such a proposition requires empirical support. An excellent study of so-called "relational practices" in Taiwan shows just how very far you can go even in the absence of an effective formal legal system (Winn, 1994: 193).

The analysis presented here has policy implications in addition to academic ones. The World Bank, for example, has begun to consider "governance" issues as a consideration in the award of loans, with such issues defined as whether a country has "the rule of law": a system in which

- a) there is a set of rules which are known in advance, b) such rules are actually in force, c) mechanisms exist to ensure the proper application of the rules and to allow for departure from them as needed according to established procedures, d) conflicts in the application of the rules can be resolved through binding decisions

of an independent judicial or arbitral body and e) there are known procedures for amending the rules when they no longer serve their purpose.³³

However desirable it might be to have such a system for a number of reasons, it is far from clear that it is the *sine qua non* of economic development or, more prosaically, the effective use of World Bank loans.

A further policy consequence follows from the relative unimportance of a formal system for the enforcement of contract rights. If a national government has limited resources to devote to growth-enhancing institutions, those resources would be better used in creating an effective structure for the prevention of arbitrary confiscation (either outright or in the form of excessive fees, bribery demands, arbitrary taxes, etc.) instead of for the creation of courts that could fairly adjudicate contract disputes and enforce their decisions. While a fair and efficient court system for the adjudication of contract disputes is no doubt a desirable thing for any country to have, there is a great deal of evidence to suggest that non-governmental actors can set up substitute institutions that do the job reasonably well, even if they do not have the state's monopoly on the legitimate use of force. There is not, however, any such thing as a social remedy for confiscation of one's investment. Thus, businesses need state protection less from each other than from organs of the state. It may be that an advanced level of contractual protection is necessary in advanced economies, but even in advanced economies it appears that a great deal of business is done without resort to court enforcement of contract rights.³⁴

I will conclude with what may appear to be a concession to the full form of the Rights Hypothesis: at some point, it seems to me, we must admit that the *complete* absence of a formal legal system is going to have a detrimental effect on economic development that cannot be fully or even substantially remedied by informal social or other sanctions. This is very close to the situation of crisis in Russia described in a recent article by Bernard Black and Reinier Kraakman (Black and Kraakman, 1996), who have attempted to formulate principles of a "self-enforcing"

³³Shihata (1991: 85), cited in Upham (1994: 233). Shihata was General Counsel of the World Bank when he made these remarks.

³⁴See, for example, the landmark study by Macauley (1963: 55).

corporate law for Russia that might be able to salvage some useful economic activity³⁵ in a society where the formal legal order has broken down almost completely. (Even shareholders, for example, may not want a company to disclose its true operating condition and profits for fear that that would make it more vulnerable to extortionists and effective tax rates in excess of 100% of pre-tax income (Black and Kraakman, 1996: 1927-1928).)

Yet what their article really shows, I believe, is that it is profoundly misleading to view the barrier to economic development of such a society as the lack of an effective formal legal system. To say that Russia needs enforcement of contract rights in order to get economic development begs the question of what would have to be true about Russia for it to be able to have judicial enforcement of contract rights. Arguably, Russia needs an entire new commercial culture, an effective tax collection and fiscal disbursement system to pay for courts and judges, a tradition of honesty among public officials, control over crime, and a host of other factors -- in short, a whole new society. Suppose that new society were somehow in place and we observed an upsurge in economic growth: it would be missing the point to give all the causal credit to the judicial enforcement of contracts that came along with those social changes.

³⁵It must be admitted that Black and Kraakman never explicitly say that the point of their work is to facilitate useful economic activity and thereby raise living standards, but it seems implicit that they believe Russian society will be better off with a well-functioning corporate law than with a poorly-functioning one.

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