

# **When Do Authoritarian Rulers Tie Their Hands: The Rise of Limited Rule of Law in Sub-National China**

by

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*Translation: Promoting Economic Growth is A Political Achievement, Maintaining Social Stability is Also A Political Achievement.*

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To My Parents:  
Yin Shulan and Wang Yanli

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## ABSTRACT

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Chair: Mary E. Gallagher

This dissertation is an empirical attempt to explain the variation in the rule of law in China at the national, provincial, prefectural, and county levels across mainland China's 31 provinces over time.

This research tracks the development of China's formal legal institutions across space and over time, arguing that the variation of the rule of law at the sub-national level in China is caused by the diversification of ownership structure in the local economy. In places where there is a large share of foreign invested enterprises from outside the "China circle," local governments are more likely to finance courts and courts are less likely to be corrupt; in places where there is a large share of state-owned enterprises, domestic private enterprises, and foreign enterprises from within the "China circle," local governments are less likely to finance courts and courts are more likely to be corrupt.

This dissertation also argues that the Chinese Communist Party and governments at various levels only seek to improve judicial impartiality in the commercial realm. Through the *nomenclatura* system and the financial system, the Party

and government still hold strong sway over the judiciary to limit citizens' opportunities to challenge the state in the political and civil realms. As a consequence, the incentive to provide credible commitment to foreign investors contributes to the rise of a limited form of the rule of law.

This dissertation tests these propositions both qualitatively and quantitatively. On the qualitative side, the researcher conducted over a hundred interviews with Party and government officials, judges, investors, scholars, litigants, and ordinary citizens in 7 provinces in 2007 and 2010. On the quantitative side, the researcher compiled and analyzed three original data sets. The first data set includes survey data of ordinary citizens across mainland China's 102 counties in 2003 matched by yearbook statistics on the local political economy. The second combines business survey data in mainland China's 120 cities in 2005 and yearbook statistics of the local economy. The third is comprised of variables on provincial government budgets and other demographic and economic aspects of mainland China's 31 provinces over the period of 1995-2006.

## CHAPTER I

### Introduction

This dissertation is an empirical attempt to explain the variation in the rule of law in China at the national, provincial, prefectural, and county levels across mainland China's 31 provinces over time.

This research tracks the development of China's formal legal institutions across space and over time, arguing that the variation of the rule of law at the sub-national level in China is caused by the diversification of ownership structure in the local economy. In places where there is a large share of foreign invested enterprises from outside the "China circle<sup>1</sup>," local governments are more likely to finance courts and courts are less likely to be corrupt; in places where there is a large share of state-owned enterprises, domestic private enterprises, and foreign enterprises from within the "China circle," local governments are less likely to finance courts and courts are more likely to be corrupt.

This thesis tests these propositions both qualitatively and quantitatively. On the qualitative side, the researcher conducted over a hundred interviews with Party and government officials, judges, investors, scholars, litigants, and ordinary citizens in Beijing, Liaoning, Jiangsu, Shanghai, Jiangxi, Guangdong, and Hainan provinces during the summer of 2007 and spring and summer of 2010. On the

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<sup>1</sup>China circle refers to economies that are adjacent to mainland China geographically and comprised of ethnic Chinese demographically. These economies include Hong Kong, Macao, and Taiwan.

quantitative side, the researcher compiled and analyzed three original data sets. The first data set includes survey data of ordinary citizens across mainland China's 102 counties in 2003 matched by yearbook statistics on the local political economy. The second combines business survey data in mainland China's 120 cities in 2005 and yearbook statistics of the local economy. The third is comprised of variables on provincial government budgets and other demographic and economic aspects of mainland China's 31 provinces over the period of 1995-2006.

This dissertation makes a contribution to four strands of literature in comparative politics. Firstly, this research offers a tentative explanation for why authoritarian rulers, equipped with guns and tanks, rule according to law. As this thesis argues, Chinese local officials tie their hands to seek the cooperation of asset holders who rely on formal legal institutions for contract enforcement and dispute settlement. By using a mixture of governmental apparatus and legal apparatus, Chinese local governments have designed ways to suit investors from both home and abroad who help local officials fulfill their goals. By creating new constituents from asset holders whose interests are tied to the ruler's survival, the Chinese authoritarianism has been resilient despite rapid social and economic changes.

Secondly, this dissertation makes a contribution to the empirical study of foreign direct investment (FDI). While most studies have been focused on how FDI *as a whole* changes the host country's governance and policies, for example, Prakash and Potoski (2006)'s study on environmental practices, Ahlquist and Prakash (2008)'s study on contracting confidence, Larrain and Tavares (2004)'s study on corruption, Neumayer and De Soysa (2005)'s study on child labor, and Figlio and Blonigen (2000)'s study on local government budgets, few studies have differentiated FDI by their sources. As this research shows, foreign investors have different incentives shaped by the investment environments *and* their countries of origin. Especially, the regulatory regimes in the countries of origin have a non-ignorable influence on

how investors conduct business in a foreign country. Further research will benefit from a larger variation in FDI's influences by disaggregating foreign investors by their countries of origin.

Thirdly, this dissertation is one of a few empirical attempts to investigate how one government's action of strengthening its court system affects a connected government's action. It is well documented that "race-to-the-bottom" or "race-to-the-top" dynamics will emerge when governments compete to attract capital. The "race-to-the-bottom" school argues that the fear of capital outflows weakens governments' incentive of providing welfare services, environmental regulations, and nonproductive public goods that citizens value (Oates, 1972; Zodrow and Mieszkowski, 1986; Keen and Marchand, 1996; Cumberland, 1981; Rom, Peterson, and Scheve, 1998; Rodrik, 1997; Schulze and Ursprung, 1999). By contrast, "race-to-the-top" scholars argue that the competition for capital motivates governments to reduce their corruption, waste, and inefficiency, and to provide more growth-promoting infrastructure (Qian and Roland, 1998; Montinola, Qian, and Weingast, 1995; Obstfeld, 1998; Stiglitz, 2000). Although the two sides disagree about whether such competition is desirable, they agree that it exists. However, as Cai and Treisman (2005) show, in a theoretical model, whether competition for capital disciplines government depends on factor endowment of the localities. They argue that the disciplining effect only exists among well endowed units but disappears in poorly endowed units because poorly endowed units are not in the race.

Empirical evidence is still lacking in supporting Cai and Treisman (2005).<sup>2</sup> Previous studies have also not defined conditions under which "race-to-the-top" or "race-to-the-bottom" dynamics emerge. This dissertation research shows preliminary evidence that only prosperous provinces in China are engaged in competition in court spending to prevent foreign investors from moving outside their juris-

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<sup>2</sup>A search through Google Scholar did not show one empirical research that tests this theory.

dictions; this competition, however, does not exist among mid-income and poor provinces. In addition, this dissertation argues that whether there are “race-to-the-top” or “race-to-the-bottom” dynamics *depends* on what types of capital governments are competing for. If governments are competing for foreign capital from outside the “China circle,” there are “race-to-the-top” dynamics in court spending; if governments are competing for state-owned enterprises (SOEs), domestic private enterprises, and ethnic Chinese investors, there are “race-to-the-bottom” dynamics in court spending.

Lastly, this research adds a new dimension to existing answers to a puzzle: how can China achieve fast economic growth with a weak legal system? Unlike previous explanations which focus on administrative decentralization, fiscal decentralization, and the cadre management system (Oi, 1992; Montinola, Qian, and Weingast, 1995; Whiting, 2000), this thesis argues that China’s legal system is adapting quickly to the changing political and economic environments. A marketized and diversified economy has nurtured an increasingly fair, efficient, and effective judicial system that reciprocally supports an increasingly complex and rights-conscious economy.

## **1.1 A Cross-National Puzzle**

A significant number of authoritarian regimes have been or still are transitioning from rule-of-man regimes to rule-of-law regimes. Consider Augusto Pinochet in Chile (1973-1990), Lee Kuan Yew in Singapore (1959-1990), Shah Mohammed Reza Pahlavi in Iran (1941-1979), Chiang Ching-kuo in Taiwan (1978-1988), and Deng Xiaoping in mainland China (1977-1989).

This is puzzling given the fact that rule of law is highly related to good governance whereas authoritarianism is often associated with political instability, lack of public good provision, and rampant corruption (Bueno de Mesquita et al., 2003).

Figure 1.1 shows associations of Kaufmann, Kraay, and Mastruzzi (2009)'s rule-of-law scores and other good governance indicators including government effectiveness, political stability and absence of violence/terrorism, regulatory quality, and control of corruption. As shown, countries' rule-of-law scores are in a positive linear relationship with other good governance indicators. Rule-of-law regimes are more likely to have effective governments, political stability, and regulatory quality, and better control of corruption.

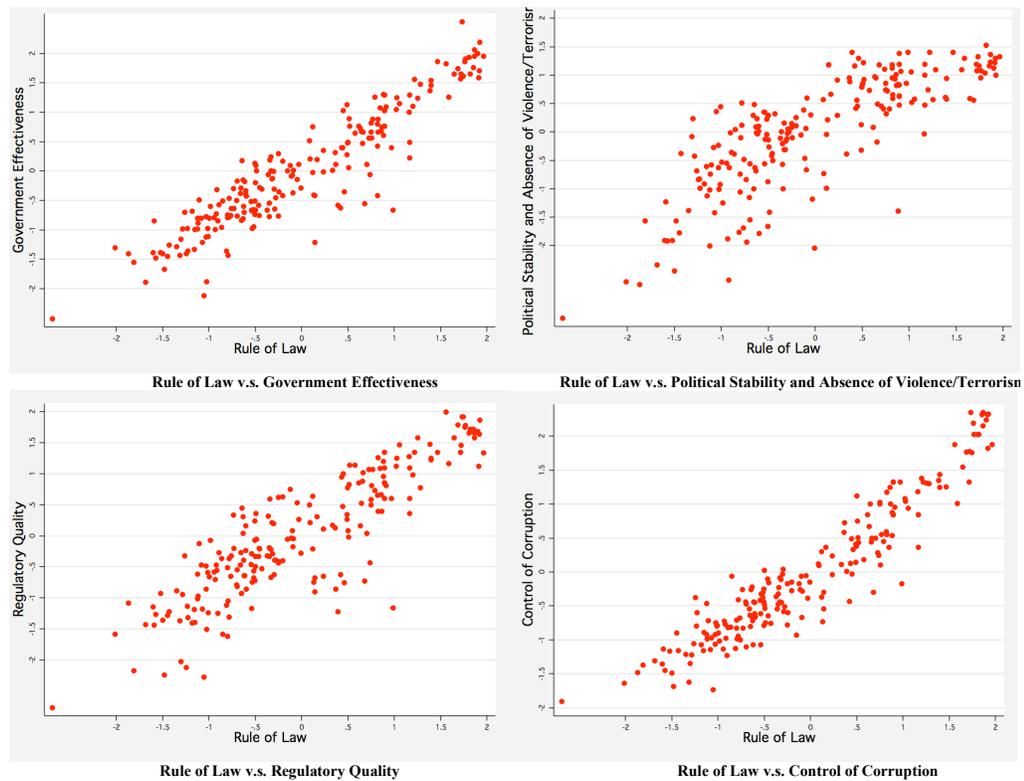


Figure 1.1: Correlations of Rule of Law with other Good Governance Indicators

Source: Kaufmann, Kraay, and Mastruzzi (2009)

Why are autocrats, with the means of repression in their hands, induced to limit their own power and promote the rule of law?

Conventional wisdom contends that the judiciary is not meaningful in authoritarian regimes. As Moustafa and Ginsburg (2008, 1) argue in their critique of the

existing literature, there is “a long-standing presumption among many political scientists that courts in authoritarian regimes serve as mere pawns of their rulers, and that they therefore lack any independent influence in political life.” In the same vein, Pereira (2008, 23) argues that, “Most studies of authoritarianism assume that regimes that come to power by force cannot rely on the law to maintain control of society or to legitimate themselves; their unconstitutional origins are seen as making such an effort contradictory and impossible.” Seminal works on property rights also claim that rule of law is only compatible with democracy (North and Thomas, 1973; North, 1990). The Washington Consensus in the 1990s also believed that democracy, markets, and the rule of law all would develop in unison. The rationale behind this line of thinking is that democracy is an effective tool to make political leaders accountable and prevent them from being predatory.

However, empirical studies on the correlation between democracy and the rule of law are inconclusive. While some scholars have indeed found that democracies are more likely to protect property rights (Leblang, 1996; Rigobon and Rodrik, 2004), others find no relationship. Figure 1.2 shows a scatterplot of 157 countries’ rule of law scores (Kaufmann, Kraay, and Mastruzzi, 2009) and their Polity Scores both measured in 2008. Obviously, a linear relationship between the measure of rule of law and the measure of democracy does not exist. Barro (2000) argues that the rule of law and protection of property rights occur in both democracies and dictatorships. As Table 1.1 illustrates, some countries score highly on a rule of law index but poorly on an electoral rights (democracy) index.

Barro (2000, 46) therefore concludes that “the electoral rights index has no predictive content for the rule of law index.” So why are authoritarian leaders, equipped with guns and tanks, induced to tie their own hands and rule according to law?

Table 1.1: Countries with High Rule of Law Relative to Electoral Rights in 1998

	Rule of Law Index	Electoral Rights Index
Bahrain	0.83	0.00
Cameroon	0.50	0.00
China	0.83	0.00
Egypt	0.67	0.17
Gambia	0.83	0.00
Hong Kong	0.83	0.33
Iran	0.83	0.17
Kuwait	0.83	0.33
Malaysia	0.83	0.33
Morocco	1.00	0.33
Myanmar (Burma)	0.50	0.00
Oman	0.83	0.17
Saudi Arabia	0.83	0.00
Singapore	1.00	0.33
Syria	0.83	0.00
Tanzania	0.83	0.33
Tunisia	0.83	0.17
United Arab Emirates	0.67	0.17
Yugoslavia	0.83	0.17

*Source: Barro (2000, 37)*

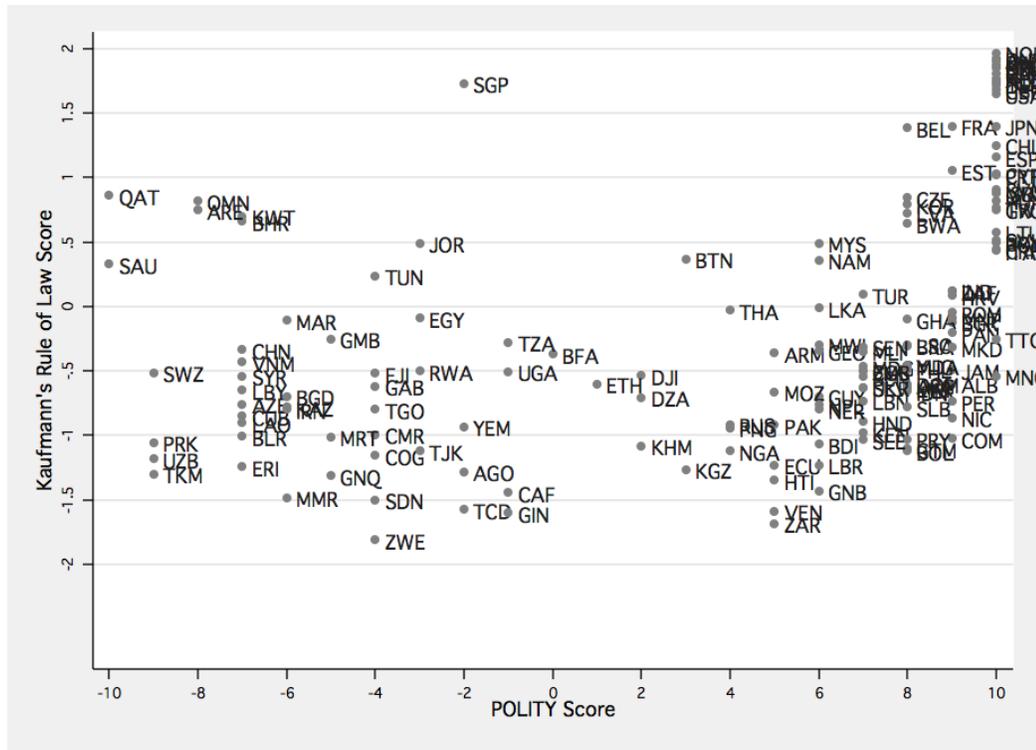


Figure 1.2: The Rule of Law v.s. Democracy

Source: Kaufmann, Kraay, and Mastruzzi (2009) and The Polity IV Project (N.d.)

## 1.2 A Sub-National Approach

This research sets out to explain this puzzle in the context of sub-national China. Within-country comparative research has several advantages.

First of all, rule of law is a complex phenomenon embedded in historical (e.g. civil law system v.s. common law system), political (e.g. two party system v.s. multi-party system or plurality system v.s. proportional representation system), and economic (e.g. planned economy v.s. market economy) conditions. Cross-national research is likely to suffer from collinearity which makes it difficult to tease out a clear causal mechanism from various confounding factors. Within-country comparative research in China is able to control for historical (locales share the similar legal tradition) and political (institutions are identical across the coun-

try) factors and focus on variables of interest.

Secondly, existing measures of rule of law, such as World Bank's Transparency International and Kaufmann, Kraay, and Mastruzzi (2009)'s *Governance* scores are based on surveys. It is difficult to judge whether respondents in the surveys were using the same standard to evaluate the status of rule of law in their own countries due to distinctive cultural and political backgrounds. For example, a corrupt activity that is considered a major crime in Germany might only be seen as a tolerable misdemeanor in China. Although survey methodologists have designed ways to compare answers in different cultures (e.g. vignettes), consistent measures of rule of law have not been developed. Within-country comparative research in China can utilize identical survey instruments to measure rule of law assuming respondents share similar standards across the country.

Thirdly, while many single country studies suffer from low degrees of freedom and lack of variation in units, a large number of sub-national units in China and considerable regional variation make it possible for the researcher to carry out both fine-grained qualitative research and large-N quantitative analysis.

This dissertation is based on a *multi-level time-series and cross-section* research design. First of all, this research seeks to explain the rise of limited rule-of-law at the national, provincial, prefectural, and county levels in China. Unlike previous Chinese politics research which is focused on one level of government<sup>3</sup>, this research collects data from the national level to the county level and shows how the theory is applied at various levels. In addition, this research collects cross section and time-series cross section data sets to examine the variation of the rule of law both across space and over time.

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<sup>3</sup>Recent examples include Tsai (2007b)'s research of public goods provision at the village level, Whiting (2000)'s research on private enterprises at the county level, and Landry (2008)'s research on mayors' promotion at the prefectural level.

### 1.3 The State of The Rule of Law in China

People's Republic of China's history in the past 62 years manifests a transformation from a partial rule-of-man regime to a limited rule-of-law regime. Mao Zedong turned the judicial system into a tool of consolidating socialism after establishing the People's Republic in 1949. Courts were employed by the new regime to penalize "counter-revolutionaries" who were associated with the previous Kuomintang (KMT) regime, to sentence landlords who were deprived of properties and rights in the land reforms, and, during the "Anti-Rightist Campaign," to legitimize the punishment of "rightists" who criticized the Party and the government. The *rule of man* in China reached its peak during the Great Proletariat Cultural Revolution in which Mao's own words proved superior to any laws. The whole legal system was almost completely abolished during the Cultural Revolution except that some courts still functioned to adjudicate cases involving "class enemies." Law schools were shut down, bar examinations were terminated, and lawyers were sent down to the countryside.

In the late 1970s, China resumed its state rebuilding process, of which institutionalization of the formal legal system was a crucial component. The post-Mao leadership believed that the installation of a reliable legal system in which there are certain constitutional checks on individual power would prevent political disasters such as the Cultural Revolution from happening. More systematic legal reforms, in which building a professional, efficient, and fair legal system is the essential goal, started in the 1990s as market reforms deepened. A marketizing economy where contract rights need to be enforced by a fair third party and disputes need to be settled efficiently calls increasingly for a well-functioning legal system.

As the first step of moving towards a socialist legal system, China began to legislate. A market economy especially requires "rules of game" to be put into place to regulate behaviors of rational actors whose only incentives are to maximize prof-

its. Figure 1.3 shows the number of various kinds of legislation from 1979 to 2005. Although the National People’s Congress (NPC) is the highest law-making authority, most laws and regulations have been made by local congresses, governments at various levels, and functional departments. As a consequence of “departmental legislation” (*bumen lifa*), laws and regulations become tools for government organs to expand their powers.<sup>4</sup>

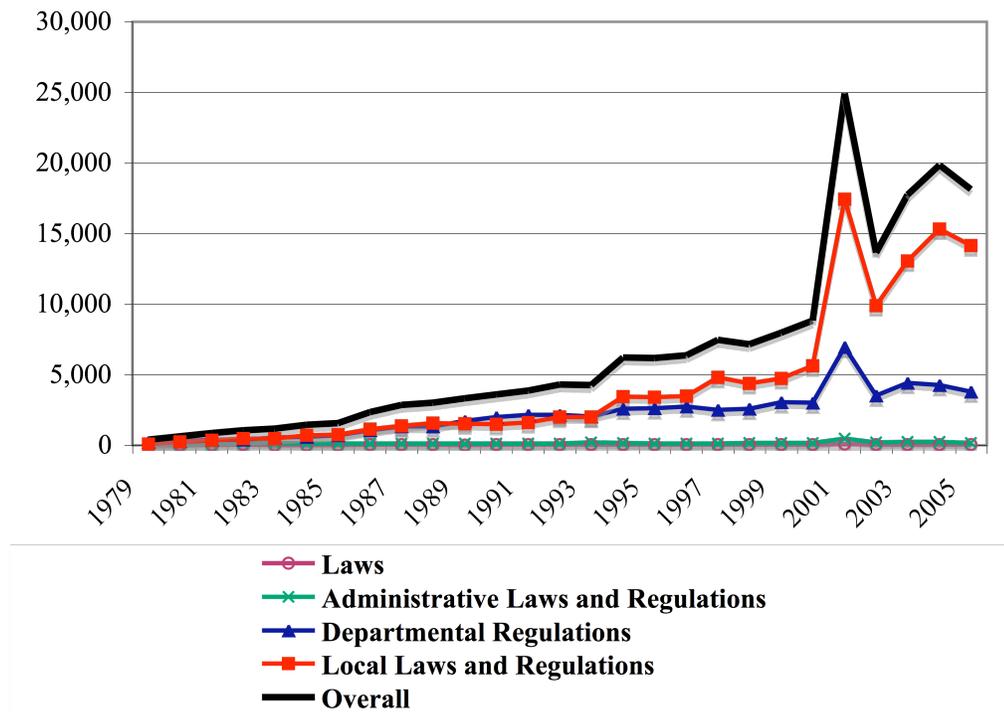


Figure 1.3: Numbers of Legislation Pieces (1979-2005)

Source: Zhu (2007)

Meanwhile, more and more disputes are brought to courts. Figure 1.4 shows the trend of first-instance cases of various kinds accepted by courts at all levels in China from 1950 to 2008. As shown, there are some spikes in the 1950s around the years of the “counter-revolutionary campaign,” land reform, and the “anti-rightist

<sup>4</sup>Subject #21, interview with a government official, Guangdong province, March 29, 2010.

campaign.” And then the numbers kept very low during the Cultural Revolution in 1966-1976. The numbers began to surge in late 1970s when the reforms started. The number of civil cases has experienced the highest growth rate among others, while economic cases rank second. In addition, since the passage of the Administrative Litigation Law in 1989, citizens began to use law to sue the government. But the number of administrative disputes has remained very low due probably to the low probability of winning a case against the government.

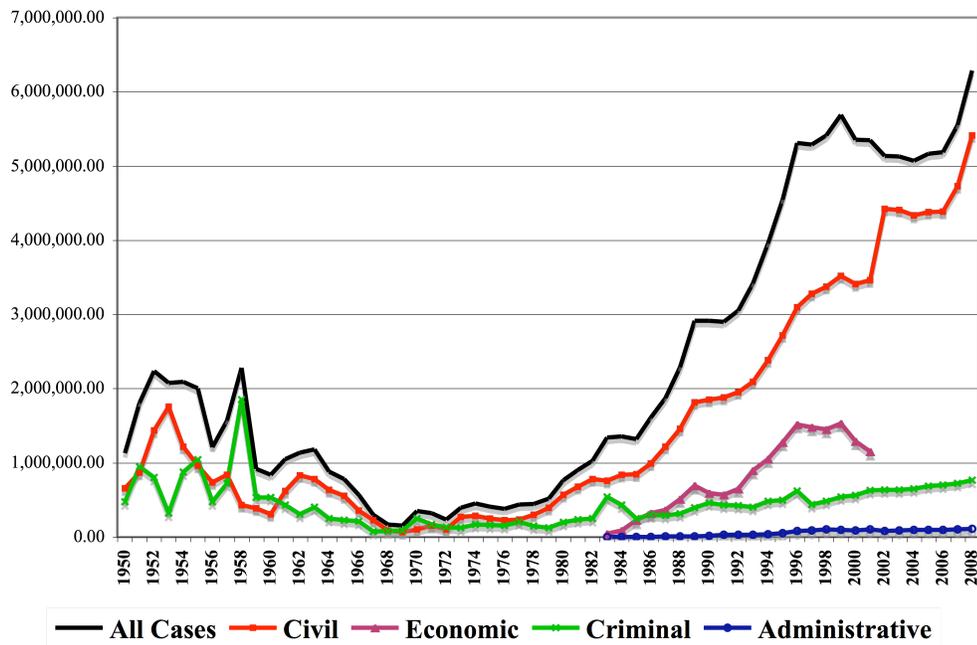


Figure 1.4: Number of First Instance Court Cases (1950-2008)

Source: National Bureau of Statistics of People’s Republic of China (N.d.) and Zhu (2007)

Adjusted by population growth, Figure 1.5 shows the litigation rate of three kinds of disputes from 1979 to 2008. Litigation rate is defined as the number of first-instance cases brought to courts per 100,000 people. Unlike the conventional

claim that Chinese culture is against litigation (Fei, 1998), in the reform era, Chinese are increasingly litigious.

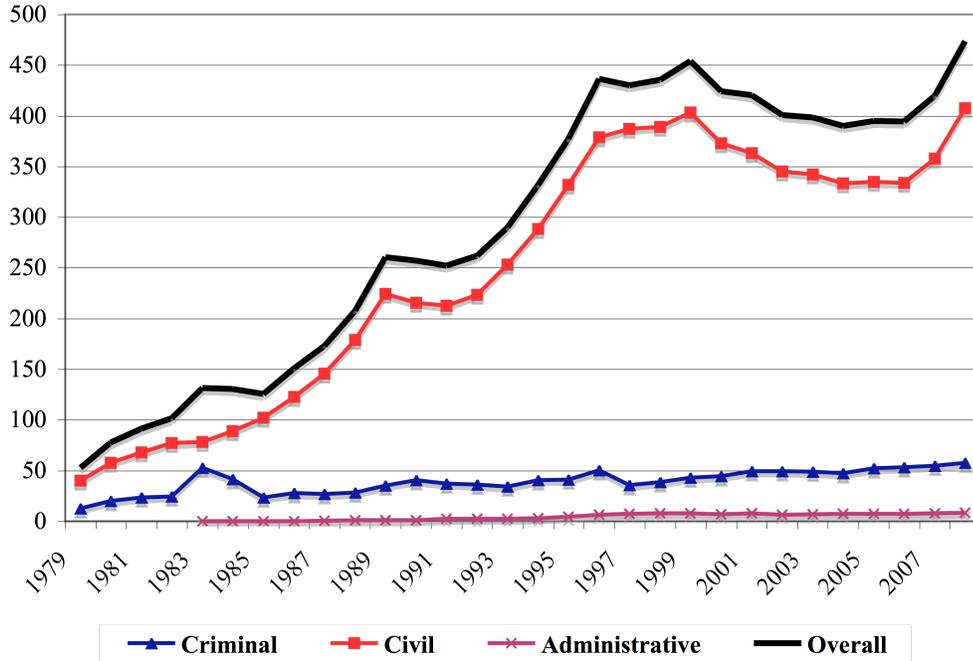


Figure 1.5: Litigation Rate (1979-2008)

Source: National Bureau of Statistics of People’s Republic of China (N.d.) and Zhu (2007)

At the same time, as China opened its door, investors from outside mainland China started to conduct business in China. Figure 1.6 shows the numbers of civil and economic disputes involving investors from Hong Kong, Macao, and Taiwan (the so called “China circle”) and investors from other foreign countries. Consistent with the trend of FDI inflow (Chapter II), disputes involving foreign investors started to increase steadily in the 1990s. And disputes involving investors from within the “China circle” almost always outnumber those involving other foreign investors. This is possibly due to two reasons. Firstly, the number of investors

from within the “China circle” was larger than that of other foreign investors in this period (1983-1998). Secondly, because of differences in management style, corporate culture, and organizational structure, foreign invested enterprises (FIEs) from within the “China circle” are more likely to have disputes than those from outside the “China circle” (Chapter II).

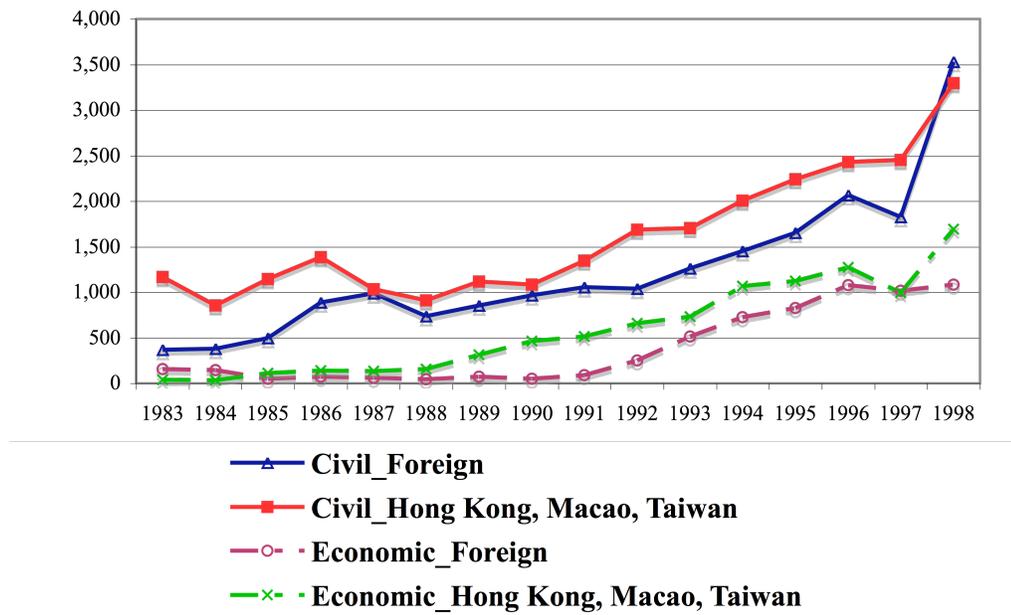


Figure 1.6: Number of Cases Involving Foreign Investors (1983-1998)

Source: *The Research Department of The Supreme People’s Court (2000)*

Another trend in the reform era is the decline of alternative dispute resolution (ADR), especially mediation. Figure 1.7 shows the numbers of disputes mediated by people’s mediators (*renmin tiaojieyuan*) and disputes adjudicated by judges. And Figure 1.8 shows the number of first-instance court cases that were settled through mediation rather than adjudication in courts. In both cases, the proportion of mediated cases is declining over the years among all cases. In its substance,

mediation requires compromise between the two parties, and a resolution is not necessarily in accordance with the law. The decline of mediation further reflects the rise of rule-of-law spirit in Chinese society.

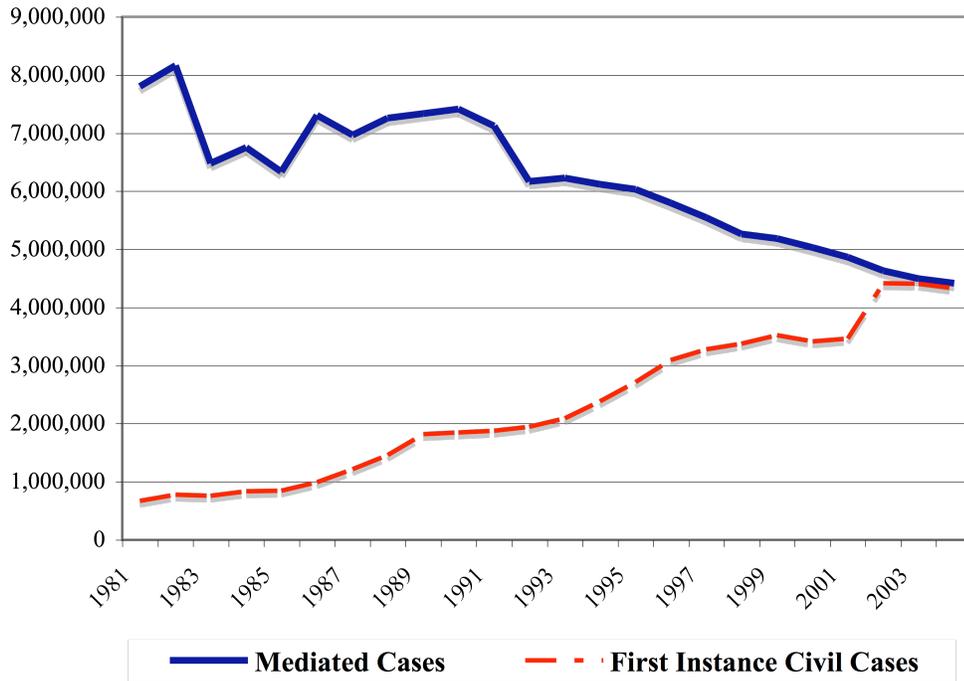


Figure 1.7: Number of Mediations and Litigations (1981-2004)

Source: Zhu (2007)

As the societal demand has increased for the legal system, the state’s supply has also increased. The number of judges has increased from 60,439 in 1981 to 190,627 in 2004. In 1981, there were only 6.08 judges for every 100,000 people, whereas the number was 14.69 in 2004. The number of lawyers has grown from 8,571 in 1981 to 107,841 in 2004. For every 100,000 people, there were 0.86 lawyers in 1981 and 8.3 in 2004. Figure 1.9 shows the numbers of judges and lawyers per 100,000 people from 1981 to 2005. The quality of judges has also improved over the years. In 1987, only 17.1% of the newly-appointed judges had junior college (*dazhuan*) degrees,

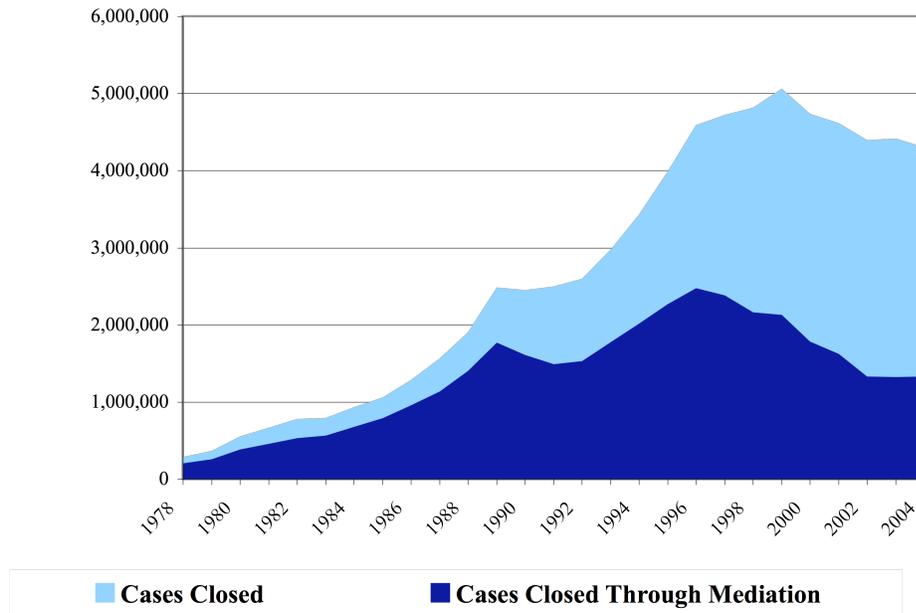


Figure 1.8: Number of Cases Mediated in Courts (1978-2004)

Source: Zhu (2007)

this number increased to 66.6% in 1992, 84.1% in 1995, and 100% in 2000. Chapter III documents the qualification requirements for judges.

Despite these national progresses, the development of the rule of law is quite uneven across space. Studies have found significant variation in evaluation of the legal system (Gallagher and Wang, 2011), people’s preference for courts (Shen and Wang, 2009), trust in courts (Landry, 2011), implementation of laws and regulations (O’Brien and Li, 1999), and the effectiveness of law (Lu and Yao, 2009) in different places in China. The variation is puzzling given that China is a unitary state where institutions are identical across the country.

Figure 1.10 shows the number of legislation pieces by provinces in 2005. As shown, while Guangdong, Beijing, and other prosperous provinces had made thou-

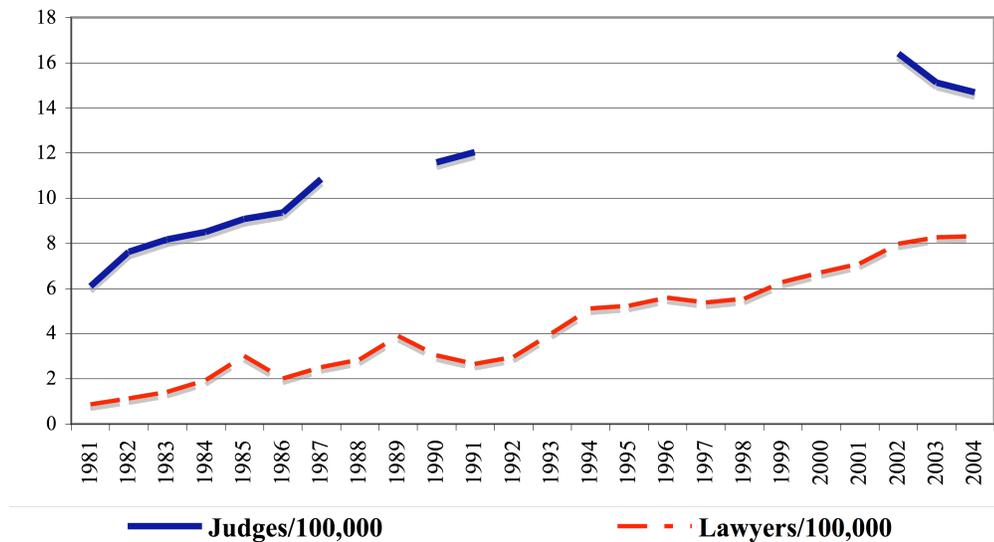


Figure 1.9: Numbers of Judges and Lawyers per 100,000 People (1981-2004)

Source: Zhu (2007)

sands of laws and regulations by 2005, Tibet had only made 350. Similarly, Figure 1.11 shows the litigation rate (number of first-instance court cases per 100,000 people) by provinces in 2004. While there were 1,307.9 cases brought to courts by every 100,000 people in Beijing, the national average was 390.2, and the number was merely 177.5 in Tibet.

The same pattern appears in the supply side, too. Figure 1.12 shows the numbers of lawyers per 100,000 people across 31 provinces. Beijing, the national capital, is on the top with 54.3 lawyers per 100,000 people, whereas Tibet only has 1.3 lawyers.

So why is there such a large variation in a unitary state where political institutions are identical across the regions?

## 1.4 Main Arguments

I argue that the rule of law will emerge in autocracies only when both the autocrat and asset holders find it in their interests to act according to the law. The theory starts with an assumption that the rule of law is not a desirable outcome for both autocrats and asset holders. Autocrats would certainly prefer the rule of man to the rule of law. In rule-of-man regimes, rulers have unlimited power, while in rule-of-law regimes, governmental powers are bounded by constitutional limits. Similarly, the rule of law in which a ruler treats all businesses equally would not be the best case scenario for capital: an investor would obviously prefer a “rule-by-me” situation in which laws and regulations favor herself against her competitors.

Autocrats will rely on rule of law when they anticipate that their returns by making their behavior predictable are higher than the returns to making it arbitrary. Autocrats’ ultimate goal is to remain in power. To do so, autocrats cannot rely solely on repression; they need cooperation. However, an autocrat who must adhere to what laws prescribe has no incentive to cooperate with all social groups. A ruler only needs to cooperate with the organized who can pose a credible threat to her rule and those who control valuable assets that can be mobilized for the ruler’s use. Investors are such a group of people whose cooperation is most needed by a modern autocrat.

Assets holders, on the other hand, vary on two major dimensions: bargaining power and preference. They can only get what they want by having strong bargaining power *vis-à-vis* the ruler. Assets holders’ power comes from the credible threat to withdraw urgently needed cooperation.

Assets holders also have different preferences for the rule of law. Their preference is a function of their existing (or potential) connections to the ruler. If they could negotiate a better deal with the ruler and guarantee the safety of their properties at a lower cost through extralegal means, such as particularistic contracts,

personal connections, or patron-client ties, they would not demand the ruler adhere to laws, since a fair legal system would benefit not only themselves but also their competitors. Only when property holders' cost of obtaining the ruler's protection through non-legal means is higher than that through legal means, should they prefer a rule-of-law government through which a formal contract needs to be signed and legally enforced.

Hence I argue that the rule of law is more likely to emerge in an autocracy when all of the following three conditions are met simultaneously:

- (1) The ruler needs the cooperation of asset holders to maintain power;
- (2) Asset holders have strong bargaining power vis-à-vis the ruler;
- (3) Asset holders find legal means the most efficient way to enforce contracts and settle disputes.

However, every autocrat will face a dilemma in legal reforms. A strong judiciary is a double-edged sword in the sense that it will not only provide credible commitment to investors who will potentially help the autocrat remain in power but also provide openings for disgruntled citizens and social groups to challenge the autocratic regime in a way that undermines the autocrat's power. The solution to this dilemma is to build the rule of law in a limited form. In the limited rule of law, autocrats tie their hands in the commercial realm to safeguard the properties of investors, enforce contracts, and settle disputes impartially while imposing constraints on citizens' rights to challenge the state in the political and civil realms. Autocrats achieve this through staffing professional judges in commercial courts, prioritizing funding to courts with large number of commercial disputes, or minimizing administrative interference in economic cases while at the same time increasing the costs of filing administrative disputes and lowering the benefits of winning an administrative case against the state.

To apply the theory in the Chinese context, this research assumes that Chinese local officials are *promotion-opportunity maximizers*. To maximize their probabilities of getting promoted, Chinese local officials have strong incentives to protect properties of investors who contribute to local tax revenue and economic growth. On the other hand, investors have different preferences of how their properties should be protected. Foreign investors from outside the “China circle” have a stronger preference for judicial fairness compared to domestic investors and ethnic Chinese investors from within the “China circle” because 1) foreign investors are not as competitive as domestic investors or ethnic Chinese investors in seeking *government* protection of properties; 2) foreign investors are subject to stricter and more transparent internal auditing and operating rules imposed by their countries of origin. Hence, foreign investors exert strong pressure for a fair and reliable legal system. By contrast, state owned enterprises (SOEs), domestic private enterprises, and foreign enterprises from within the “China circle” prefer to enforce contracts and settle disputes through the government because it is less costly than going to court. Local governments, therefore, are likely to strengthen local courts if the government is reliant on foreign capital from outside the “China circle” for tax revenues and economic growth. By contrast, local governments are likely to weaken local courts if the government is reliant on domestic and ethnic Chinese firms for tax revenues and economic growth.

Meanwhile, facing the dilemma, Chinese governments at various levels only seek to improve judicial impartiality and judicial efficiency in the commercial realm. Through the *nomenclatura* system and the financial system, the Chinese Communist Party (CCP) and the Chinese government still hold strong sway over the judiciary to limit ordinary citizens’ opportunities to challenge the state in the political and civil realms. As a consequence, the incentive to provide credible commitment to foreign investors from outside the “China circle” contributes to the rise of a lim-

ited form of the rule of law where commercial disputes are settled in an increasingly fair fashion whereas judicial unfairness is still prevalent in cases involving ordinary citizens.

## **1.5 Organization of the Dissertation**

The dissertation includes an introductory chapter, a theoretical chapter, three empirical chapters, and one concluding chapter. The chapters are organized in the following way.

Chapter II spells out a theory that explains the occurrence of limited rule of law in authoritarian regimes and its application in the context of sub-national China. I argue that the rule of law is more likely to emerge in an authoritarian system when three conditions are met simultaneously: 1. The ruler needs the cooperation of asset holders to maintain power; 2. Asset holders have strong bargaining power vis-à-vis the ruler; 3. Asset holders find legal means the most efficient way to enforce contracts and settle disputes. Applying the theory in the Chinese context, I argue that Chinese local officials are more likely to rely on rule of law when they rely on foreign capital from outside the “China circle” for tax revenues and economic growth. Conversely, Chinese local officials are less likely to rely on rule of law when they depend on state owned enterprises, domestic private enterprises, and foreign capital from within the “China circle” for revenues and growth. I also argue that the rule of law in authoritarian regimes is in a limited form. Autocrats only have incentives to build rule of law in the commercial realm while at the same time imposing constraints on citizens’ political and civil rights in using the court to challenge the state.

Chapter III, drawing from qualitative interviews, laws and regulations, and government documents, describes the setup of China’s judicial system, the institutional details of Chinese local courts as legal and bureaucratic organizations, the

formal and informal rules embedded in courts, the political environment of local courts, and the roles that courts have played in promoting economic development and maintaining social stability. As shown in this chapter, the Chinese Communist Party and the Chinese government have used the personnel and financial system to control the judiciary to prevent the court being used by ordinary citizens to challenge the state. The major findings of this chapter can be summarized in the following statements: 1. The Chinese judicial system is highly decentralized; local courts depend on local Party committees and governments. The center has ineffective mechanisms to monitor local courts; 2. Courts as legal institutions are egalitarian in the sense that all judges have equal authority, whereas courts as bureaucratic organizations are hierarchical, where judges with administrative posts exert significant influence on ordinary judges. The bureaucratic nature triumphs the legal nature; 3. Informal rules subvert formal rules in major aspects of running a court: appointment, removal and dismissal, and evaluation of judges, Party leadership in judicial affairs, and government intervention in individual cases; 4. Courts lack fiscal autonomy. Local court funding almost completely depends on local governments; 5. Courts selectively protect properties of local firms; 6. Judicial unfairness and corruption has been a major reason for social unrest, but it is very difficult for the center to detect it because of local repression.

Chapter IV examines the conditions under which local officials in China have any incentive to build clean and reliable courts. This is a quantitative chapter that tests the theory using survey measures of judicial corruption and court quality at the county level and prefectural level. The first matrix is a cross-sectional data set of 102 Chinese counties. The measure of judicial corruption is drawn from a survey on the Institutionalization of Legal Reforms in China 2003, conducted by the Research Center of Contemporary China (RCCC) at Peking University. The explanatory variables are collected by the author from government released year-

books. Using ordinary least squares (OLS) and two-stage least squares (2SLS) regressions, the analysis shows that the weight of foreign capital in the local GDP has a significantly positive effect on judicial honesty across China's counties. The analysis also finds that local governments' financial support is an important factor that contributes to judicial integrity. The second matrix is a cross-sectional data set of 120 Chinese cities. Drawing from World Bank's Business Environment Survey, this chapter constructs and explains a variable measuring investors' "confidence in courts." Using OLS and 2SLS, the analysis shows that the finding at the county level also stands at the prefectural level. In addition, using multi-level modeling, the analysis shows that provincial government spending on courts also has a significantly positive effect on investors' "confidence in courts" at the prefectural level. Lastly, this chapter tests two alternative explanations: a social capital explanation proposed by Tsai (2007) and a *guanxi*<sup>5</sup> explanation proposed by Wank (1999). The analysis shows that the theory survives against these rival explanations.

Chapter V goes one step backward in the causal chain and asks: when do provincial governments spend money on courts? Analyzing an original time-series cross section data set of provincial court spending in 1995-2006, this chapter shows that the share of foreign direct investment (FDI) from outside the "China circle" in the overall GDP has a significantly positive effect on how much money local governments are willing to spend on courts. By contrast, SOEs, domestic private enterprises, and ethnic Chinese enterprises from within the "China circle" exert a negative pressure on provincial governments' financial assistance to courts. In addition, utilizing the techniques of spatial econometrics, this chapter shows preliminary evidence that provinces in China compete in court spending to prevent capital in their jurisdictions from moving. But competition only exists

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<sup>5</sup>*guanxi* literally means informal social connections in Chinese.

among prosperous provinces; among mid-income and poorly endowed provinces, the competition effect disappears.

Chapter VI concludes with a summary of major findings, major weaknesses, and major contributions of the dissertation.

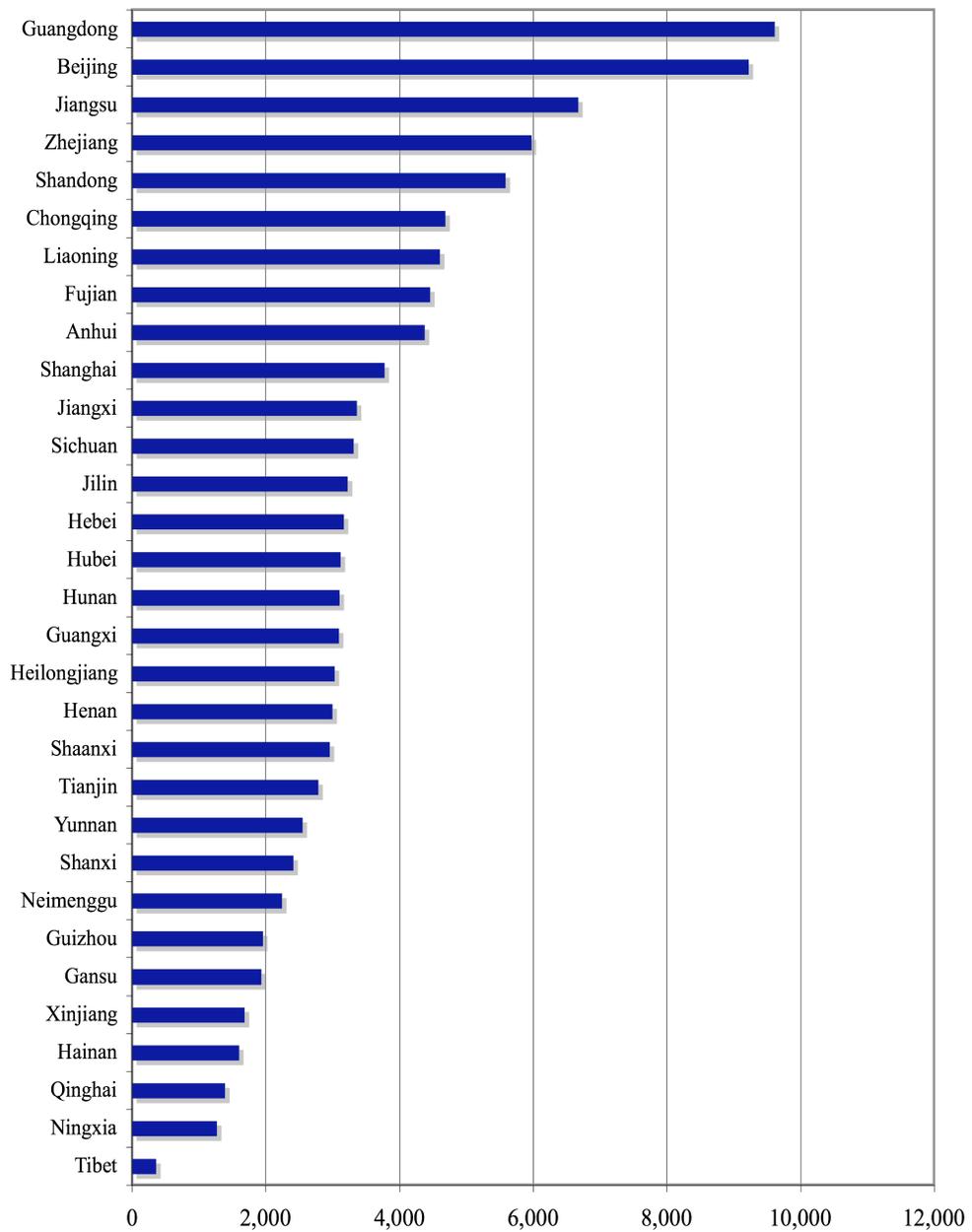


Figure 1.10: Number of Legislation Pieces by Provinces (2005)

Source: Zhu (2007)

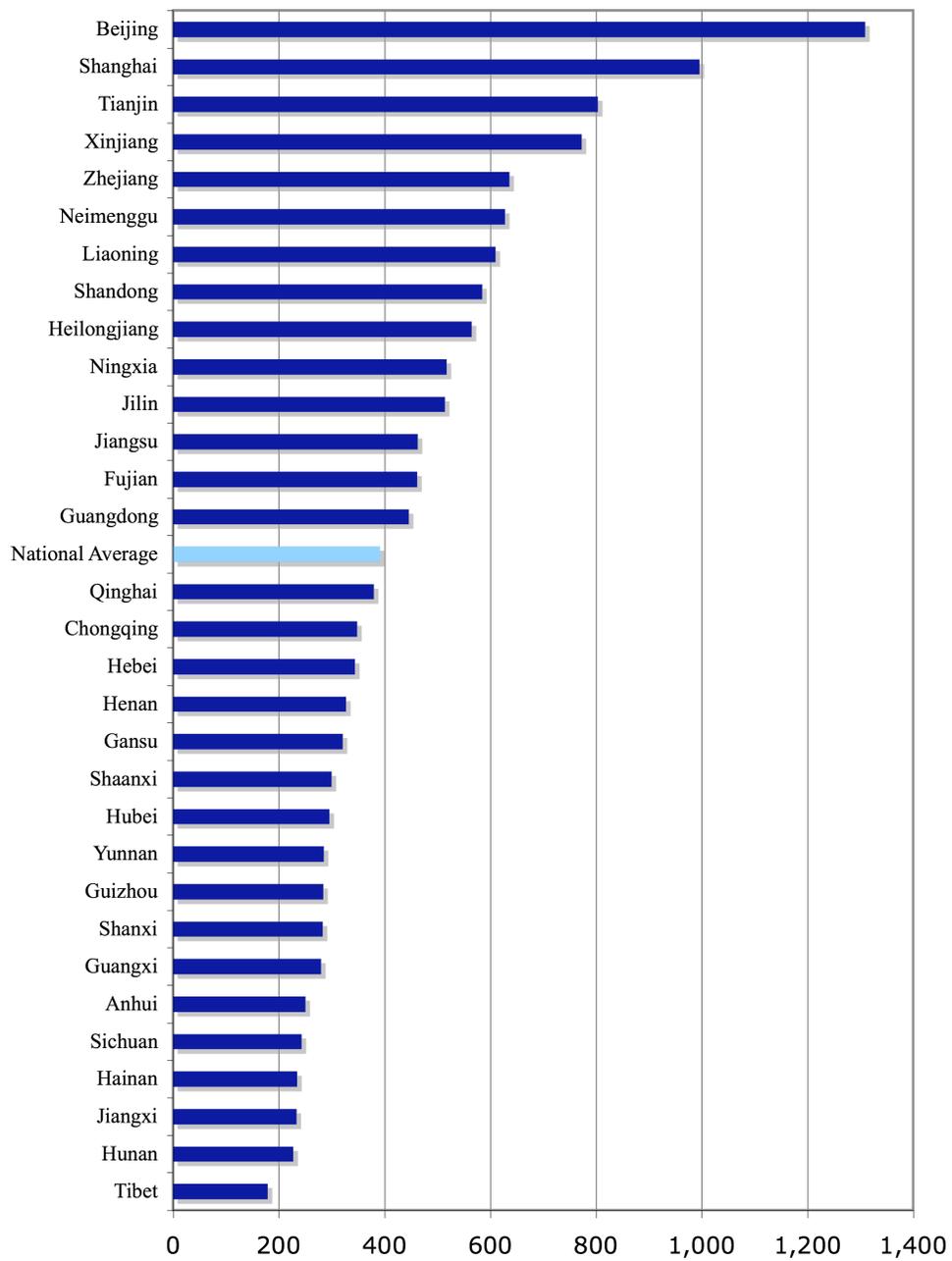


Figure 1.11: Litigation Rate by Provinces (2004)

Source: Zhu (2007)

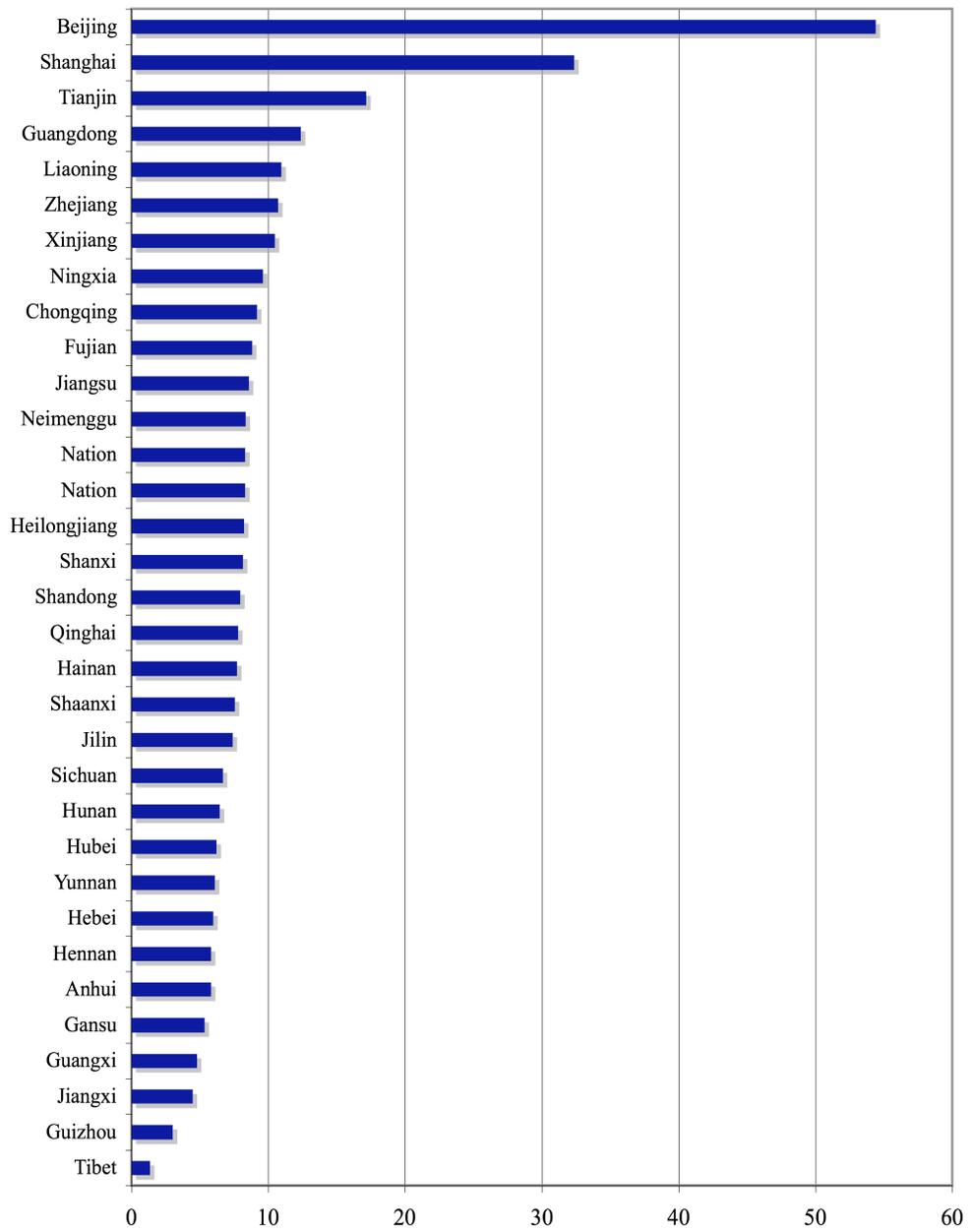


Figure 1.12: Number of Lawyers per 100,000 People Across 31 Provinces (2003)

Source: Zhu (2007)

## CHAPTER II

### Theory

#### 2.1 Introduction

This chapter spells out a theory that explains the occurrence of the rule of law in authoritarian regimes and its application in the context of sub-national China. I argue that the rule of law is more likely to emerge in an authoritarian country when three conditions are met simultaneously: 1. The ruler needs the cooperation of asset holders to maintain power; 2. Asset holders have strong bargaining power vis-à-vis the ruler; 3. Asset holders find legal means the most efficient way to enforce contracts and settle disputes. However, the rule of law emerged in authoritarian regimes is in a limited form. Autocrats seek to build the rule of law in the commercial realm while imposing constraints on citizens' rights to challenge the state in the political and civil realms. Applying the theory, I argue that Chinese local officials are more likely to rely on the rule of law when they rely on foreign capital from outside the "China circle" for government revenue and economic growth. Conversely, Chinese local officials are less likely to rely on the rule of law when they depend on state owned enterprises, domestic private enterprises, and foreign capital from within the "China circle" for revenue and growth. Despite the progress in the commercial arena, the Chinese state has limited the realm where citizens can use law as their weapon to challenge the state. As a consequence,

there is a rise of limited rule of law in sub-national China as more foreign capital from outside the “China circle” are invested in China.

The rest of the chapter is organized as follows: the next section provides a review of the literature on the rule of law and its determinants, the third section outlines the theory of the rule of law in authoritarianism in general, the fourth section examines the Chinese Communist Party and its local agents and discusses why the rule of law in a limited form is relevant to the Party’s survival, the fifth section investigates the ownership structure in the Chinese economy and how it determines local officials’ behaviors, the final section concludes with a summary of the theory.

## **2.2 Literature Review**

### **2.2.1 Conceptualization of The Rule of Law**

The rule of law is one of the most long-lasting and complicated concepts in social sciences. Its origin can be traced back to the thoughts of Plato, Aristotle, Cicero, the Magna Carta, John Stuart Mill, John Locke, Thomas Hobbes, Montesquieu, and The Federalist Papers<sup>1</sup>.

A.V. Dicey in his *Introduction to the Study of The Law of The Constitution* offered the first modern conceptualization and analysis of the rule of law in the context of liberal democracies. For Dicey (1915, 183-191), the rule of law includes three distinct aspects. In the first place, the ruler of law means that “no man is punishable or can be lawfully made to suffer in body or goods except for a distinct breach of law established in the ordinary legal manner before the ordinary Courts of the land.” In the second place, the rule of law is “a characteristic of our country, not only that with us no man is above the law, but (what is a different thing) that here

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<sup>1</sup>For a review of ancient thoughts on the rule of law, please see Tamanaha (2004).

every man, whatever be his rank or condition, is subject to the ordinary law of the realm and amenable to the jurisdiction of the ordinary tribunals." A third sense is that "the 'rule of law or the predominance of the legal spirit may be described as a special attribute of English institutions. We many say that the constitution is pervaded by the rule of law on the ground that the general principles of the constitution (as for example the right to personal liberty, or the right of public meeting) are with us the result of judicial decisions determining the rights of private persons in particular cases brought before the Courts; whereas under many foreign constitution the security (such as it is) given to the rights of individuals results, or appears to result, from the general principles of the constitution."

One of the core spirits of the rule of law for Dicey is the protection of individual liberty against the exercise of discretionary powers by government officials. This idea was also echoed in Hayek's *The Road to Serfdom* where he saw a connection between "the growth of a measure of arbitrary administrative coercion and the progressive destruction of the cherished foundation of British liberty, the Rule of Law." (Hayek, 1994, xliii)

Influenced by Dicey and Hayek, modern political theorists have offered alternative formulations of the rule of law. As Tamanaha (2004, 91-113) reviewed, there are two basic categories: formal versions and substantive versions. Formal theories focus on the proper sources and form of legality, while substantive theories also include requirements about the content of the law. Within each version, there are thinner and thicker formulations. The thinnest formal version of the rule of law is the notion that law is the means by which the state conducts its affairs, "that whatever a government does, it should do through laws." (Reynolds, 1989, 3) A more apt label for this version is "rule *by* law."

Ginsburg and Moustafa (2008) edited a book titled *Rule by Law: The Politics of Courts in Authoritarian Regimes* in which the contributors notice a recent trend in

authoritarian regimes that a form of rule *by* law is emerging where authoritarian rulers are increasingly relying on law, rather than personal will, to rule. But as Tamanaha (2004, 92) argues, the rule of law understood in this way (rule by law) “has no real meaning, for it collapses into the notion of rule by the government.” And as Raz (1979, 2-1-213) argues, “It has been said that the rule of law means that all government action must be authorized by law ... If government is, by definition, government authorized by law the rule of law seems to amount to an empty tautology, not a political ideal.”

A less thinner formal version is formal legality. The most influential formulation of this version was offered by Lon Fuller. In Fuller (1969, 41), he argued that, “At the height of the ascent we are tempted to imagine a utopia of legality in which all rules are perfectly clear, consistent with one another, known to every citizen, and never retrospective. In this utopia the rules remain constant through time, demand only what is possible, and are scrupulously observed by courts, police, and everyone else charged with their administration.”

As Tamanaha (2004, 93) contends, formal legality is also quite compatible with ruthless authoritarian regimes because this formulation imposes no requirements on the content of law. In this sense, the USA adhered to the rule of law even when slavery was legally enforced, and racial segregation legally imposed. What makes this account of the rule of law compatible with evil is the absence of any separate criteria of the good or just with respect to the content of the law.

This dissertation will be based on “formal legality” as a conceptualization of the rule of law. As Raz, Fuller, and Hayek who adopt this version agree, the rule of law in this sense “furthers individual autonomy and dignity by allowing people to plan their activities with advance knowledge of its potential legal implications.” (Tamanaha, 2004, 94) But as Raz (1979, 220-221) argues, “it has no bearing on the existence of spheres of activity free from governmental interference and is compat-

ible with gross violations of human rights.”

### **2.2.2 Determinants of The Rule of Law**

While the literature on what the rule of law could lead to is rich, there are much fewer studies on what lead to the rule of law. It is well established theoretically and empirically that the rule of law is a precondition for protection of human rights, protection of property rights, and economic growth. Empirical studies often link credible rule-of-law institutions with elevated levels of foreign investment, external finance, and higher aggregate levels of economic growth. (Knack and Keefer, 1997; Feld and Voigt, 2003; Davis and Trebilcock, 1999; Ali, 2003; Oliva and Rivera-Batiz, 2002; Barro, 1997; La Porta et al., 1997). The mechanism is that a well-functioning legal system offers fair and efficient dispute settlement and contract enforcement which increase investment confidence.

Most studies on determinants of the rule of law are conducted in the context of liberal democracies. Helmke and Rosenbluth (2009) review the theories that explain judicial independence. There are two types of institutional explanations for judicial independence.

The first type is focused on historical legacy. As La Porta et al. (1998) argue, probably the most popular explanation for why some countries have independent judiciaries focuses on the difference between common law and civil code countries. Common law countries, which also happen to be of Anglo lineage in one way or another, charge courts with developing and interpreting a body of case law that supplements statutory law. Judges are trained to think about, and if necessary to create, the connective tissue between pieces of legislation. The common law judges power to interpret and create law is contrasted with the civil law judges mandate to implement and enforce existing bodies of law. It is believed that judicial independence is high in common law countries on account of this structural difference

in the nature of judicial practice.

The second type is focused on delegative models where politicians tie their hands vis-à-vis an independent judiciary. Landes and Posner (1975) suggest that legislators have an interest to create an independent judiciary that can enforce the deals struck by enacting legislatures, thereby increasing the value of campaign contributions that legislators can extract from contributors on whose behalf they made those deals. The judiciary solves politicians' time inconsistency problem, namely that their short-run interest to sell new deals to the highest bidder undermines the price they are able to get for these deals in the longer run.

Another delegative account of judicial insulation points to politicians' desire to duck blame for unpopular policies. Graber (1993), Salzberger (1993), and Wittington (1999) argue that a legislative majority might want to delegate politically divisive issues to the court, echoing Fiorina (1981)'s blame-avoidance explanation for why politicians might want to delegate to bureaucrats.

A third delegative rationale is supplied by McCubbins and Schwartz (1984), who suggest that an independent judiciary can be useful to the legislature in helping to keep executive agencies from veering from legislative intent. Without wasting resources on monitoring the bureaucracy, Congress can count on unhappy constituents to sue the offending agency in court.

Political insurance against being dominated by a future majority is a fourth delegative explanation for why an incumbent legislative majority might willingly transfer some of its power to the judiciary. A political party expecting to fall into minority status, and expecting at best to alternate in government with another party, might want to lock the door against majority tyranny and throw away the key, so to speak (Ramseyer and Rosenbluth, 1993; Ramseyer and Rasmusen, 1997; Finkel, 2008).

One of the weaknesses of these delegative models, as Helmke and Rosenbluth

(2009) argue, is the ignorance of the fact that courts, like legislators, are strategic actors. For example, in the Landes and Posner (1975)'s model, judges may try to achieve outcomes as close as possible to their own preferences by taking into account the possibility that the incumbent legislature can write new legislation if it is sufficiently unhappy with the court's ruling. Or in the blame-shifting model, strategic courts may have an interest in throwing the matter back rather provoking public wrath themselves.

The literature originated from the democratic settings has influenced the study of courts in authoritarian regimes. Echoing the political insurance argument, Helmke (2002) argues that under certain conditions, for example at the end of weak dictatorships and weak democratic governments, the lack of judicial independence motivates judges to "strategically defect" against the government to insure their status in the new government. Applying McCubbins and Schwartz (1984)'s theory in explaining the enactment of the Administrative Litigation Law in China, Ginsburg (2008) argues that by creating a judicially enforceable procedural right, Chinese central officials decentralize the monitoring function to their constituents, who can bring suits to inform the center of bureaucratic failure to follow instructions.

Another strand of literature on judicial politics in authoritarian regimes emphasizes on the role of authoritarian courts to provide credible commitment to investors. Moustafa (2007) in his study of the Egyptian Supreme Constitutional Court argues that, throughout the 1970s, it was difficult for the Egyptian government to convince investors that their assets would be safe from state seizure or adverse legislation, given the regime's history of nationalizing the vast majority of the private sector. Faced with economic stagnation and escalating pressure from international lenders, Nasser's successor, Anwar Sadat, pinned the regime's survival on attracting foreign direct investment, as well as investment from Egyptian

nationals holding tens of billions of dollars in assets abroad. After a full decade of failed attempts to attract investment without implementing concrete institutional safeguards on property rights, the regime created an institutionally autonomous Supreme Constitutional Court with powers of judicial review. The new court was designed to assuage investor concerns and guarantee institutional constraints on executive actions.

However, Moustafa (2007)'s theory is built on an unfounded assumption that investors prefer the rule of law. As Voigt (1998) argues, interest groups will first of all seek privileges from the government which, if granted, would reduce the degree to which interest groups demand for the rule of law. Moustafa (2007) does not provide a convincing story concerning why foreign investors did not obtain privileges from the Egyptian government who were eager for foreign direct investment.

Moustafa (2007, 6) is right in noticing the unintended consequence of empowering the Constitutional Court that, "Judicial reforms provided institutional openings for political activists to challenge the executive in ways that fundamentally transformed patterns of interaction between the state and society." But he fails to offer any accounts of why the Egyptian government was unable to use the agenda-setting power to impose constraints on the Supreme Constitutional Court to deny citizens' rights.

In Magaloni (2008)'s study of Mexican courts, she discusses how the Mexican autocratic regime solved this dilemma by establishing a procedure for citizens to challenge state abuses before federal courts (the amparo trial) and at the same time giving to these courts very limited "constitutional space" to keep them weak.

This dissertation is inspired by the "credible commitment" argument and offers a theory that is built on the assumption that investors, like any other interest groups, would prefer privileges to the rule of law. But the rule of law becomes the best option when investors are unable to obtain privileges from the ruler given

some externally imposed constraints. I also argue that the rule of law is a double-edged sword in the sense that it will not only provide credible commitment to investors who will potentially help the autocrat remain in power but also provide openings for disgruntled citizens and social groups to challenge the autocratic regime in a way that undermines the autocrat's power. The solution to this dilemma is to build the rule of law in a limited form. In the limited rule of law, autocrats tie their hands in the commercial realm to safeguard the properties of investors, enforce contracts, and settle disputes impartially while imposing constraints on citizens' rights to challenge the state in the political and civil realms.

### **2.3 Asset Holders and The Rule of Law**

I argue that the rule of law will emerge in autocracies only when both the autocrat and asset holders find it in their interests to act according to the law. Autocrats would certainly prefer rule of man to rule of law. In rule of man, a ruler has unlimited power, while in rule of law, governmental powers are bounded by constitutional limits. Society as a whole would prefer a predictable ruler to an arbitrary one. But because of collective action and coordination problems, citizens organized in a decentralized manner are often unable to impose costs when a ruler does not follow the law (Weingast, 1997). Asset holders are in a better position than normal citizens to accomplish this task. The emergence of parliamentary supremacy in England in the 17th century is a consequence of organized assets holders demanding veto powers against the Crown's discretion (North and Weingast, 1989). However, paradoxically, rule of law in which a ruler treats all businesses equally would not be the best case scenario for capital: an investor would obviously prefer a "rule-of-me" situation in which laws and regulations favor herself against her competitors. So when does rule of law, a second-best option for both the autocrat and capital, reach equilibrium?

Autocrats will rely on rule of law when they anticipate that their returns by making their behavior predictable are higher than the returns to making it arbitrary. Autocrats' ultimate goal is to maintain power. To do so, autocrats cannot rely solely on repression; they need cooperation (Wintrobe, 2000). As Holmes (2003, 19) suggests, "governments are driven to make their own behavior predictable for the sake of cooperation." However, an autocrat who must adhere to what laws prescribe has no incentive to cooperate with all social groups. A ruler only needs to cooperate with the organized who can pose a credible threat to her rule and those who control valuable assets that can be mobilized for the ruler's use (Bates and Lien, 1985). Asset holders are such a group of people whose cooperation is most needed by a modern autocrat.

Assets holders, on the other hand, vary on two major dimensions: bargaining power and preference. They can only get what they want by having a strong bargaining power *vis-à-vis* the ruler. Assets holders' power comes from the credible threat to withdraw urgently needed cooperation. The rising merchant class in England was able to force the Crown to cede power to the Parliament mainly because they held mobile assets such as wool. The nature of the assets made it very difficult for the state to tax significantly. This increased the bargaining power of the Parliament where these property holders were represented.

Assets holders also have different preferences for the rule of law. Their preference is a function of their existing (or potential) connections to the ruler. If they could negotiate a better deal with the ruler and guarantee the safety of their properties at a low cost through extralegal means, such as particularistic contracts, personal connections, or patron-client ties, they would not demand the ruler adhere to laws, since a fair legal system would benefit not only themselves but also their competitors. Only when property holders' cost of obtaining the ruler's protection through non-legal means is higher than that through legal means, should they pre-

fer a rule-of-law government through which a formal contract needs to be signed and legally enforced.

I hence argue that the rule of law is more likely to emerge in an autocracy when all of the following three conditions are met simultaneously:

- (1) The ruler needs the cooperation of asset holders to maintain power;
- (2) Asset holders have strong bargaining power vis-à-vis the ruler;
- (3) Asset holders find legal means the most efficient way to enforce contracts and settle disputes.

However, every autocrat will face a dilemma in legal reforms. A strong judiciary is a double-edged sword in the sense that it will not only provide credible commitment to investors who will potentially help the autocrat remain in power but also provide openings for disgruntled citizens and social groups to challenge the autocratic regime in a way that undermines the autocrat's power. The solution to this dilemma is to build the rule of law in a limited form. In the limited rule of law, autocrats tie their hands in the commercial realm to safeguard the properties of investors, enforce contracts, and settle disputes impartially while imposing constraints on citizens' rights to challenge the state in the political and civil realms. Autocrats achieve this through staffing professional judges in commercial courts, prioritizing funding to courts with large number of commercial disputes, or minimizing administrative interference in economic cases while at the same time increasing the costs of filing administrative disputes and lowering the benefits of winning an administrative case against the state.

The following section will apply this insight to explaining sub-national variation of the rule of law in China.

## 2.4 The Chinese Communist Party and Its Local Agents

Under what conditions would Chinese officials need the cooperation of asset holders to maintain power? I argue that the dominant power in China - The Chinese Communist Party - must maintain economic growth at a certain level to survive. The Party's survival depends on, first of all, whether the Party can extract enough resources from its jurisdiction, and secondly, whether the Party can retain the support of its constituency.

The Chinese Communist Party has been the single dominant party in the People's Republic of China for over 60 years since 1949. By 2009, The Party has approximately 77,995,000 members (6% of China's population) and 3,226 committees established at every level of government from the center to street committees and every place from Beijing to remote villages in Tibet<sup>2</sup>. The Party is an elite party which recruits predominantly young professionals, scientists and technicians, and university students. Since late 1990s, facing the emerging private economy, the Party has been encouraging private entrepreneurs, who used to be marginalized from the socialist system, to join the Party. This is considered a tactic of the Party to co-opt the rising and wealthy middle class (Dickson, 2003, 2008).

The Chinese Communist Party is relatively centralized and disciplined compared to political parties in democratic regimes. Ordinary Party members, except advantages in landing jobs and getting promotions in the public sector, have almost no voice in Party affairs. The Party's power lies within the Politburo Standing Committee which now consists of nine men who occupy the most important positions in the government. The Politburo's directives are implemented by Party committees at every level, and all Party members are expected to comply. Failure to do so could cause criticisms and self-criticisms within the committees, and in

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<sup>2</sup>Please see a report by the Central Party Organization Department at [http://news.xinhuanet.com/politics/2010-06/28/c\\_12271914.htm](http://news.xinhuanet.com/politics/2010-06/28/c_12271914.htm).

the most severe situation, termination of Party membership.

The Party has “encompassing interests” in the Chinese society. The first and foremost reason is that the Chinese Communist Party has no exit options; it has to remain in power to survive. Unlike the KMT in Taiwan, the Communist Party has no party assets<sup>3</sup>. The Party’s assets come from the government. Once the Party loses control of the government, it has no funds to operate. In this sense, the Party is a “stationary bandit” who has strong vested interests in the Chinese society (Olson, 2000). As Olson (2000, 9) predicts, a “stationary bandit” has a strong incentive to provide public goods (including economic growth) that benefit her domain. Therefore, to survive, the Party is propelled to increase the wealth of the society from which its assets are drawn.

The Party’s survival also depends on the support of its core constituency. In the selectorate model developed by Bueno de Mesquita, Morrow, Siverson, and Smith, the incumbent ruler needs to distribute public and private goods in such a way as to maintain the support of a sufficient large winning coalition to retain office (Bueno de Mesquita et al., 2003). As the selectorate model predicts, authoritarian regimes like China which have small winning coalitions would not have a strong incentive to promote economic growth because rulers’ survival only hinges on the support of the small winning coalition who are easier satisfied by private goods such as booty and rents (Bueno de Mesquita et al., 2003, 101-102). However, as Clark et al. (2010) show, autocrats with small winning coalitions might as well have an incentive to produce public goods in expectation of reaping a share of a wealthier society tomorrow. This insight echos the predatory theory of the state articulated in Tilly (1992) and Olson (2000).

The Party, which relies on economic growth for survival, faces a principal-agent problem: how to make local agents (local officials) accountable and promote eco-

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<sup>3</sup>Party members pay a small amount of party fee each year, but the amount is far from what the Party needs to consume.

conomic growth as they are expected to? To solve this problem, the Party created formal institutions to incentivize its local agents to comply with the central directives. As shown later, the incentives to promote economic growth are tied to local officials' personal well-beings.

In this research, I assume that *local officials in China are promotion-opportunity maximizers*, that is, they are "political climbers" who are willing to do anything to increase their chances of getting a promotion. Getting a promotion in the bureaucratic hierarchy in China means procuring a higher wage, a bigger house, a more comfortable car, a better health care package, a more luxurious lifestyle, and, above all, access to greater rents.

Like its Soviet counterpart, the Communist Party of China uses a *nomenklatura* system to regulate authority over Party and state "main leading cadres" and other important individuals (Lieberthal, 2004). The Russian term *nomenklatura* generally refers to the lists of offices controlled by the various Party committees (Manion 1985: 212). In this *nomenklatura* system, the appointment, promotion, transfer and removal of leading cadres are based, in principle at least, on officials' qualifications and performance as assessed regularly in the cadre evaluation system (Manion, 1985; Burns, 1994; Huang, 1995; Whiting, 2000, 2004).

I obtained a sample of the cadre evaluation form during field research from the city of Guangzhou in Guangdong province. This is the form used by the Guangzhou Municipal Party Organization Department to evaluate the performance of major Party and government officials at the county level. This is a newly designed evaluation form which became effective in late 2008. This new form reflects the spirit of the Scientific Concept of Development (SCD hereafter) proposed by Chinese president Hu Jintao. The SCD emphasizes quality of development, social equality, environmental protection, and social harmony. The SCD is believed to depart from the previous Party principles which prioritize speed of development

at the expense of income disparity, environmental degradation, and social conflict. Another innovation of the Guangzhou cadre evaluation system is that localities are differentiated by their stages of development and assigned different evaluation forms accordingly. The three categories include central urban districts, new urban districts, and county level cities. The key difference among the evaluation systems in the three types of locality is how measures of economic development are weighted. For example, for central urban districts, index on economic development carries a weight of 30%, whereas new urban districts and county level cities give 31% and 28% respectively to economic development. This reflects the developmental strategies of the Guangdong provincial government to encourage the economic development of new urban districts but put more emphasis on social harmony and environmental protection in central urban districts and county level cities.

What is presented here is the form to evaluate central urban districts in Guangzhou City. As shown in Table 2.1, the first set of indicators in the municipal version of the cadre evaluation forms assigns highest priority (30%) to indicators of economic development, among which the most important indicator is GDP growth rate. The second set of indicators (22%) focuses on measures of social development including social stability, family planing, and school enrollment rates, etc. The third set of indicators covers people's livelihood (23%). The final indicator is quality of ecological environment (25%). Compared to the cadre evaluation forms documented in Whiting (2004) and Landry (2008) <sup>4</sup>, this Guangdong version of the cadre evaluation form under the Hu era gives more weights to quality of economic development, social development, and ecological environment. Other provinces, such as Zhejiang and Hunan, are also considering reconstructing their evaluation systems

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<sup>4</sup>Whiting (2004) documented a cadre evaluation form promulgated in 1989 by Jiangsu province, and Landry (2008) collected a cadre evaluation form from the China Urban Development Research Committee in 2001. All of these forms were designed before Hu Jintao took office.

to assess performance on promoting “scientific development.”<sup>5</sup>

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<sup>5</sup>Please see <http://www.zaobao.com/special/npc/pages3/npc100309d.shtml>.

Table 2.1: A Sample of Cadre Evaluation Form from Guangzhou City, Guangdong Province

Index	Variable	Direction	Weight
	<b>GDP growth rate</b>		
	GDP per capita growth rate/GDP growth rate	+	
	Growth rate of fiscal revenue per capita	+	
	Overhead/Fiscal expenditure	-	
	Growth rate of the private sector	+	30
	Output ratio per unit of land for construction	+	
	Added value of high-tech products/GDP	+	
	Research and development investment/GDP	+	
	Added value of modern service industry/Added value of the service industry	+	
	<b>Social stability index</b>		
	Fiscal expenditures on social programs and public service/Overall fiscal budget	+	
	Area of public cultural facilities per 10,000 persons	+	
	<b>Fertility rate permissible under the family planning policy</b>	+	
	Occurrence of contagious diseases and food poisoning per 100,000 persons	-	
	Index of social safety	+	22
	Index of democracy and rule of law	+	
	Index of informationalization	+	
	Enrollment rate of high school graduates	+	
	Community health services	+	
	Completion rate of “Five-Ones” project <sup>6</sup>	+	
	Unemployment rate	-	
	Social Insurance Coverage	+	
	Growth rate of per capita income/GDP growth rate	+	23
	Correction rate of city environmental management cases	+	
	Households with housing difficulties/All households	-	
	Forestation rate	+	
	Expenditure on environmental protection/Overall fiscal budget	+	
	Area of farmland	+	
	Completion rate of major pollutants emission reduction	+	25
	Completion rate of separation of rain and sewage and removing septic tanks	+	
	Completion rate of comprehensive management of rivers	+	
	Rate of underground wiring in newly constructed and reconstructed roads	+	
	Index of comprehensive evaluation of city appearance and environment	+	

However, Interviews with local officials sent a strong message that, in practice, the application of the evaluation is not so much different from what happened before. A Guangzhou Municipal Party Organization Department official told me that, among the indicators, only three are critical: GDP growth rate, social stability index, and fertility rate. And social stability index and fertility rate only have veto power, that is, they only matter when officials fail on these two aspects. For example, a large scale collective protest or a fertility rate that is higher than the family planning threshold would deny the officials' opportunities of getting a promotion in the subsequent year. But high social stability and low fertility rate will not increase the opportunities. The official also told me that a high GDP growth rate increases an official's probability of getting promoted only when it is exceptional. An official is very likely to be promoted if her locality's GDP growth has been outperforming other localities consecutively for a couple years.<sup>7</sup>

Academic studies on factors that determine Chinese officials' promotion are inconclusive. Landry (2008) shows empirically that GDP growth rate is not a strong predictor of mayors' promotion. Shih, Adolph, and Liu (2010) show that educational qualifications, provincial revenue collection, and factional ties played substantial roles in elite ranking in the reform era, while provincial economic growth did not. Conversely, Guo (2009) finds that county officials strategically increase fiscal spending to stimulate economic growth before they are up for promotion. My findings during field research reconcile this controversy. A general impression is that determinants of political advancement vary across bureaucratic ranks. For county level officials and below, due to their large number and lack of factional ties, performance on economic growth is of critical importance in advancement. On the contrary, for municipal and provincial level cadres, other factors such as factional ties and revenue collection carry more weight.<sup>8</sup>

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<sup>7</sup>Subject #14, interview in Guangzhou, Guangdong province, March 25, 2010.

<sup>8</sup>Subject #16, interview in Guangzhou, Guangdong Province, March 27. Subject #37, interview

The Guangzhou Party Organization Department official told me a story of how promotion works. Each year, if there are some vacancies, the Organization Department will prepare a list of cadres based on their rankings in the evaluation system for the municipal Party secretary to review. But the Party secretary often has her own list. If the cadres who are on the Party secretary's own list are also on the Organization Department's list, then it is fine. The Party secretary will pick some names from the list, and the names include some of her own people and other officials who have exceptional performance. However, if the Party secretary's people are not on the Organization Department's list, the Party secretary would say: "People on this list do not have credentials, give me a new list." Then the job of the Organization Department is to figure out who should be added to the list. Only when the Party secretary's people are listed, then the list becomes "valid."<sup>9</sup> The logic behind this story is that China's cadre advancement is a mixture of meritocracy and factionalism. And, as other interviews indicate, there is more factionalism at higher ranks and more meritocracy at lower ranks.<sup>10</sup>

In addition to affecting advancement opportunities, performance on these criteria is also used to determine the bonuses of state cadres and the total salaries of collective cadres. Therefore, local officials, especially lower ranking officials, seriously take these indicators into their calculus when they make and implement policies.

How can officials maximize their grades? Township and village enterprises (TVEs) and foreign direct investment (FDI) are seen as major driving forces of China's economic growth in the 80s and 90s.<sup>11</sup> In order to attract FDI and promote economic growth, local governments are expected to deliver and maintain

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in Dean, Jiangxi Province, April 8, 2010.

<sup>9</sup>Subject #14, interview in Guangzhou, Guangdong province, March 25, 2010.

<sup>10</sup>Subject #16, interview in Guangzhou, Guangdong Province, March 27. Subject #37, interview in Dean, Jiangxi Province, April 8, 2010.

<sup>11</sup>For the role of TVEs, please see Oi 1992, Walder 1996, Qian 2003; for FDI, please see Gallagher 2002, Zweig 2002, Huang 2003.

consistent policies and put in place a legal environment in which contracts can be enforced and property rights established (Zheng, 2007).

Some scholars believe that the rule of law is the key to economic growth and attracting investment either through protecting property rights (North and Thomas, 1973; Acemoglu, Johnson, and Robinson, 2001) or through increasing policy stability (Henisz, 2000; Feng, 2005). Another school of scholars, however, argues that government's obsession with attracting foreign investments will bring lax regulations. Such claims are based on competitive pressures: The mobility of multi-national corporations (MNCs), coupled with a desire to create jobs, produces incentives for governments to engage in cross-national "races to the bottom" (Drezner, 2001). In addition, the experience of East Asian newly industrialized countries where corruption and rapid growth coexist further casts doubt on the assumed relationship between the rule of law and economic growth (Campos, 2001; Rock and Bonnett, 2004). Yet empirical studies do not lend support to the "racing to the bottom" argument (Wheeler, 2001; Prakash and Potoski, 2006; Mosley and Uno, 2007), and the East Asian paradox only exists at the national level. Once data is disaggregated at the sub-national level, the positive link between the rule of law and economic growth still remains (Zheng, 2007; Huang, 2008).

While the cadre evaluation system provides the incentive structure of local officials in China, it alone cannot explain why some local leaders, similarly obsessed with GDP growth, *do not* rule according to the law. In a comprehensive examination of the cadre evaluation system, Minzner (2009) argues that continued reliance on evaluation systems as a tool of governance raises significant conflicts with the legal reforms that Chinese authorities have pursued since 1978. But as discussed in the next section, whether the evaluation system creates incentives that contradict the rule of law depends on the characteristics of the local economy.

## 2.5 Ownership Structure and Government Incentives

Who are the asset holders that meet all the three conditions in China? A crude categorization of enterprises in China produces state-owned enterprises (SOEs), private enterprises, and foreign invested enterprises (FIEs)<sup>12</sup>. I argue that all the three types meet condition 1: The ruler needs the cooperation of asset holders to maintain power. And SOEs and FIEs meet condition 2: Asset holders have strong bargaining power vis-à-vis the ruler. But only FIEs meet condition 3: Asset holders find legal means the most efficient way to enforce contracts and settle disputes. Therefore, the intersection is FIEs.

The history of reforms in China is the history of diversification of ownership. In mid-1950s, right after the establishment of the PRC, the communist government nationalized all private enterprises that previously existed under the KMT's rule. Throughout the Mao era, there were only two types of ownership in China: SOE and collective enterprise.

Traditional SOEs were integrated into the government bureaucracy under the planned economy before the reforms. The government finance department acted as the financial departments of SOEs, administering their cash flows, revenues, and expenditures and collecting taxes, fees, and profits (Wu, 2005, 141). The SOE managers were themselves government officials governed by the nomenclatura system under various levels of government (Burns, 1989). The SOEs, as “work units (*danwei*)” of employees, also carried the heavy burden of providing basic social welfare such as health care, pension, day care, and housing (Walder, 1988).

Facing increasing competition from township and village enterprises (TVEs) and private enterprises, Chinese government in the 1980s experimented with ways to improve incentives and management capabilities within the state sector (Naughton,

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<sup>12</sup>The actual categories are much more complicated. Lots of firms are mixed in ownership, for example, a foreign firm in a joint venture with an SOE or a private investor being a shareholder in an FIE.

2007). The main theme of SOE reforms can be described as “power-delegating and profit-sharing (*fangquan rangli*).” The components of the reforms include transferring enterprises to governments at lower levels, expanding enterprise autonomy, and the enterprise contracting system (Wu, 2005, 142). The managerial reforms in the state-sector are considered a more desirable alternative to privatization, which is more radical, and hence, more likely to encounter opposition (Qian, 2003). The experimental process focused on a steady shift in emphasis away from plan fulfillment and toward profitability as the most important indicator of enterprise performance (Naughton, 2007).

After the managerial reforms in the 1980s, SOEs’ performance improved. But inefficiency of SOEs gradually manifested as the market reforms went deeper and more foreign invested enterprises and private enterprises entered the competition. From the mid-1990s, Chinese government began to restructure the state sector. The Third Plenary Session of the 14th Chinese Communist Party Congress issued The Decision on Issues Regarding the Establishment of a Socialist Market Economic System, which stated that deepening SOE reform should “emphasize the institutional innovation of enterprises.” This marked a shift in SOE reform strategy from power-delegating and profit-sharing to the institutional innovation of enterprises. One of the significant steps to corporatize SOEs is the enactment of the Company Law of the People’s Republic of China by the National People’s Congress on December 29, 1993. In the Company Law, clearly established property rights, well-defined power and responsibility, separation of enterprise from government, and scientific management became core goals of the SOE corporatization (Wu, 2005, 154-155).

At the same time, the central government decided to be selective in reforming SOEs. At Chinese Communist Party’s 15th Party Congress in 1997, a policy called “grasping the large, letting the small go (*zhuada fangxiao*)” was announced. “Grasp-

ing the large” means that the government should focus on maintaining state control over the largest state-owned enterprises considered vital to the government’s control over the economy. On the other hand, “letting the small go” indicates that the central government should relinquish control over smaller SOEs through various channels including giving local governments authority to restructure the firms, privatizing firms, or closing down unprofitable ones (Naughton, 2007). The consequence of “letting the small go” was a significant downsizing of the state sector. As shown in Figure 2.2, 1997-1998 registered a remarkable drop of SOE employees.

However, some of the goals of SOE corporatization were not achieved. Especially, the original intention to separate the government’s function as the administrator of society and economy and its function as the owner of state assets by establishing the state assets management commissions was not really implemented (Wu, 2005, 158). The remaining large SOEs are still under the firm control of the center and provincial governments. For example, as Wu (2005, 159) observed, “To maintain control by the government, corporatization usually left listed companies dominated by state-owned shares.”

As a consequence, SOEs become allies of the government: SOEs help governments at various levels create tax revenues, maintain social order by co-opting discontented labor, and provide basic necessary of life for SOE employees such as housing and health care. SOEs receive big rewards in return from the government. Figure 2.1 is a photograph that I took in De’an county in Jiangxi province. It is called a “Protection Pad.” It is hung right outside the gate of a Jiangxi state-owned plastic enterprise. The pad was issued by the county Party committee and government. It reads as follows, “Enterprises’ legal rights: Without the permission of the county Party committee and government, no organizations or individuals are allowed to enter this factory to investigate or fine.” I found this pad under the direction of a judge in the county’s court. The judge told me that when he was trying

to investigate a case in this enterprise, he and his colleagues were blocked by this pad<sup>13</sup>. This is just one of many examples where local governments protect SOEs. In a more systematic study by Wang, Wong, and Xia (2008), they show that compared with non-state-owned firms, Chinese state-owned enterprises controlled by various levels of governments are more likely to hire small auditors within the same region. This auditor choice pattern is best explained by SOEs' collusion incentives.



Figure 2.1: Protection Pad

*Translation: "Enterprises' legal rights: Without the permission of the county Party committee and government, no organizations or individuals are allowed to enter this factory to investigate or fine."*

In Kornai (1990)'s typology of post-socialist economic transitions, there are two pure strategies. Strategy A, or the strategy of organic development, emphasizes the creation of favorable conditions for bottom-up development of the private sector.

<sup>13</sup>Subject #34, interview in Jiangxi, April 8, 2010.

Strategy B, or the strategy of accelerated privatization, emphasizes the elimination of state ownership as quickly as possible through speedy privatization of state-owned enterprises. As Wu (2005, XV) argues, "since the beginning of the economic reform the Chinese leadership has been emphasizing SOE reform, which more or less fits Kornai's description of Strategy B; however, the transition itself has followed another path, similar to Kornai's Strategy A." Parallel to the SOE reform in China, the private sector also went through structural changes during the reform era.

The Chinese economy before 1949 was dominated by the private sector. Private businesses accounted for two-thirds of total industrial output and more than 85% of total retail sales (Wu, 2005, 179). In 1955 and 1956, as a way to consolidate the socialist regime, China appropriated all private enterprises. The dominance of the state sector continued until late 1970s. After the Cultural Revolution, it became urgent to find employment for a large number of educated urban youths who had been dispatched to work in rural areas and then returned to cities. In the August 1980 Circular of the Chinese Communist Party Congress on Transmitting the Documents of the National Conference on Labor and Employment, it was stipulated that, "the development of the urban individual business sector be encouraged and fostered." (Wu, 2005, 181-182).

The private sector in China includes two types of entities - self-employed household businesses (*getihu*) and privately run enterprises (*siying qiye*). The regulatory definition of the former is an entity with seven or fewer employees; the definition of the latter is an entity with more than seven employees (Huang, 2008, 22). The private sector developed rapidly in the early 1980s with the green light given by the state. In April 1988, the Seventh National People's Congress passed an amendment to the Constitution of the People's Republic of China, which stated in Article 11 that, "The State permits the private sector to exist and develop within

the limits prescribed by law. The private sector is a supplement to the socialist public sectors. The State protects the lawful rights and interests of the private sector, and exercises guidance, supervision, and control over the private sector.” The legalization of the private sector was finally confirmed by the 15th Chinese Communist Party Congress in 1997. “Keeping public ownership as the mainstay of the economy and allowing diverse forms of ownership to develop side by side” was established as China’s basic economic system for the primary stage of socialism. Nonpublic sectors were acknowledged as “important components of a socialist market economy” (Wu, 2005, 188-189). The private sector then experienced faster growth in late 1990s and has continued to grow in the 21 century <sup>14</sup>. As Figure 2.2 shows, the share of private sector employees kept growing and surpassed that of SOE employees in 2006.

Although the private sector has received *de jure* status in law, private enterprises in practice have a lower political status than SOEs and FIEs. As Huang (2008) argues, in the 1990s the Chinese state systematically favored foreign firms at the expense of indigenous private-sector firms. Small private businesses, for example food and vegetable stalls operated by peasants at the intersections of cities and the countryside, are considered “backward” and therefore, contradict the goal of major Chinese cities to become world-class cities. According to Huang (2008, Chapter4)’s case study of Shanghai, the government imposes many policy restrictions on private businesses. For example, the Shanghai government imposed onerous restrictions on who could start a second job as a private entrepreneur. The government also imposed a registration capital requirement and required entrepreneurs to register the entire amount of the capital requirement on the day of registration. Thus, a potential entrepreneur would have to show the proof of the requisite capital rather than being able to pay in the registered capital

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<sup>14</sup>The Chinese government implemented a crackdown against the private sector after the 1989 Student Movement (Naughton, 2007; Huang, 2008).

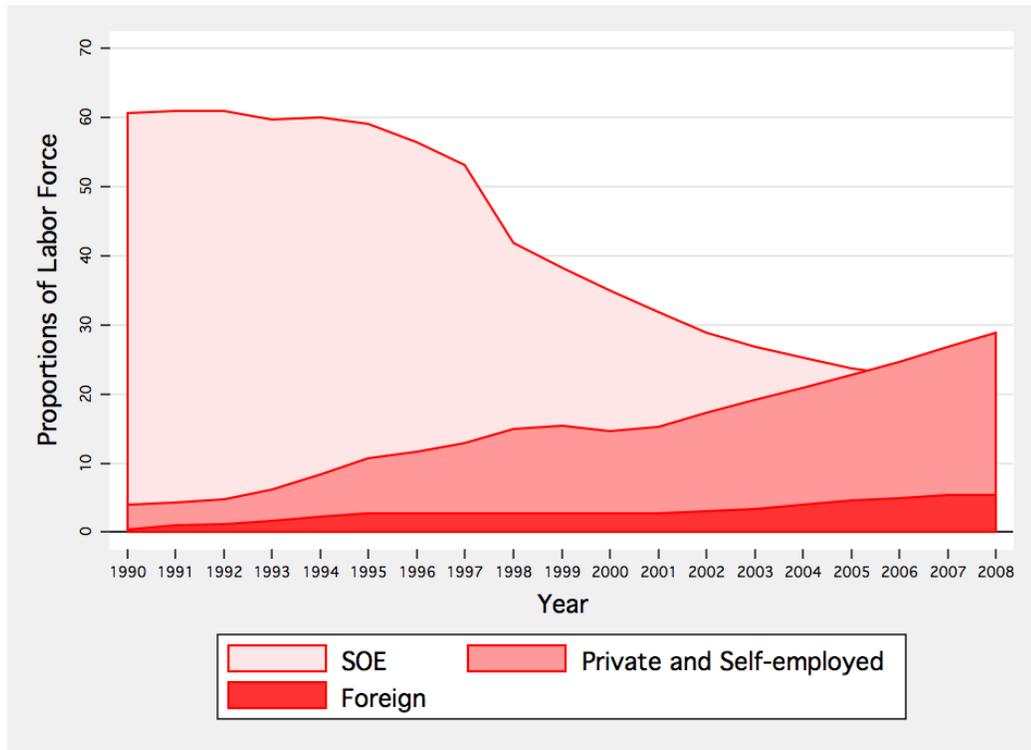


Figure 2.2: Share of Labor in Different Ownerships (1990-2008)

Source: National Bureau of Statistics of People's Republic of China (N.d.)

by installments.

Facing the formal constraints imposed by the state, private entrepreneurs have to rely on political connections to survive and prosper. An informal way to seek political connections is to build clientelistic ties with local officials. As Wank (1999, 68) argues, "Much exchange conducted by private companies is embedded in clientelistic ties with various administrative, policing, distributive, and manufacturing organs of the local state." A more formal way is for private entrepreneurs to join the Chinese Communist Party. It is well documented that the Chinese Communist Party is increasingly integrating itself with the private sector, both by co-opting entrepreneurs into the Party and encouraging current Party members to go into business (Dickson, 2003, 2008). Private entrepreneurs with party membership are

called “red capitalists.” In a systematic study of “red capitalists,” Li et al. (2008) show that the Party membership of private entrepreneurs has a positive effect on the performance of their firms when human capital and other relevant variables are controlled. They further find that Party membership helps private entrepreneurs obtain loans from banks or other state institutions.

In addition to the domestic ownership liberalization, realizing that the nation had been drained of capital and entrepreneurial expertise after the Cultural Revolution, the post-Mao leadership decided to open up to attract foreign investors. The first law on foreign investors was passed by the National People’s Congress in 1979<sup>15</sup>. The law, though pathbreaking, still reflected the cautiousness of the leadership in the sense that it only allowed equity joint ventures (EJVs). Article 1 in the Equity Joint Venture Law in 1979 “permits foreign companies, enterprises, other economic entities, or individuals to incorporate themselves in the territory of China into joint ventures with Chinese companies, enterprises or other economic entities.” Forming a joint venture with a domestic Chinese firm offered foreign investors a sort of protection, since their Chinese partners at this time were mainly state-owned or collective enterprises with close ties with the Chinese government. The Law also stipulated that, “The proportion of the investment contributed by the foreign joint venturer(s) shall generally not be less than 25% of the registered capital of a joint venture.” The 25% threshold is quite high, considering countries in the Organization for Economic Co-operation and Development (OECD) only has a 10% bar.

Special economic zones (SEZs) were then established in Shenzhen, Zhuhai, Shantou, and Xiamen to attract foreign investors. The central government granted the SEZs favorable policies. For example, the enterprise income tax for all types of foreign-invested enterprises in a SEZ was set at a low of 15%, whereas the tax

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<sup>15</sup>For a detailed discussion of evolution of the FDI regulatory framework, please see Fu 2000.

rate for FIEs elsewhere was 24-30%. However, uncertain of China's political and economic environment, investors in the early 80s were mainly from the so-called "China circle" - Hong Kong, Macao, and Taiwan - who had a language advantage and kinship connections with mainland China.

Wholly foreign owned enterprises (WFOEs) were not allowed until 1986 when the Foreign Capital Enterprises Law was passed. Article 1 in the Foreign Capital Enterprises Law "permits foreign enterprises, other foreign economic organizations and individuals to set up enterprises with foreign capital in China and protects the lawful rights and interests of such enterprises." But it took foreign investors a long time to develop confidence in investing in China. Only after 1992, Deng Xiaoping's southern tour, did foreign investors start to invest in China on a large-scale. Figure 2.3 shows the growth of WFOEs as compared to a decline of EJVs. After 2001, the year when China entered the WTO, WFOEs has become the dominant mode of FDI in China.

Another trend of FDI inflow in the 1990s was that investors from outside the "China circle" started to outnumber those from within the "China circle." Before the Asian Financial Crisis in 1997, over half of China's FDI inflows had been from Hong Kong, Macao, and Taiwan - the so called "China circle." This generation of "foreign" investors are ethnic Chinese. They primarily relied on kinship connections to select places for investment because common language and customs made doing business on the mainland easy and cheap (Naughton, 2007, 416-417). The way the investors from the "China circle" interact with Chinese local governments is different from those who came from the "west" (Tsai, 2007a). As a legal scholar who was a practicing lawyer in China in 1980s and 1990s said, those ethnic Chinese investors knew how to conduct business in the "Chinese way:" they just bribe everyone!<sup>16</sup>

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<sup>16</sup>Subject #48, interview in Ann Arbor, Michigan, U.S.A., November 10, 2010.

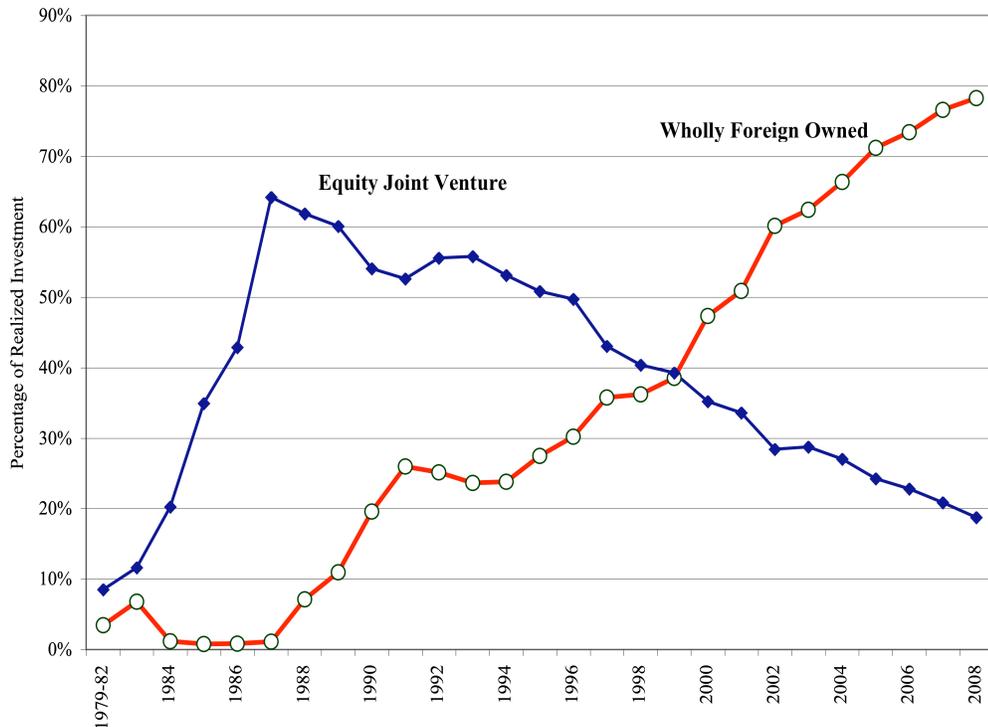


Figure 2.3: Forms of Foreign Direct Investment (1979-2008)

Source: National Bureau of Statistics of People's Republic of China (N.d.)

At the same time, investors from the U.S., European Union, Japan, and other countries were attracted by China's big market. Firms from outside the "China circle" often have technological advantages over Hong Kong and Taiwanese firms. This characteristic of foreign firms became very attractive to Chinese government officials and entrepreneurs who were searching for advanced technologies and know-how in the 1990s. Throughout the 1990s, especially after the Asian Financial Crisis, FDI from outside the "China circle" surged. Figure 2.4 shows the sources of FDI inflow during 1983-2008.

I argue that investors who came from outside the "China circle" have different preferences for the legal institutions from those who were from within the "China circle." Foreign investors from outside the "China circle" have a stronger

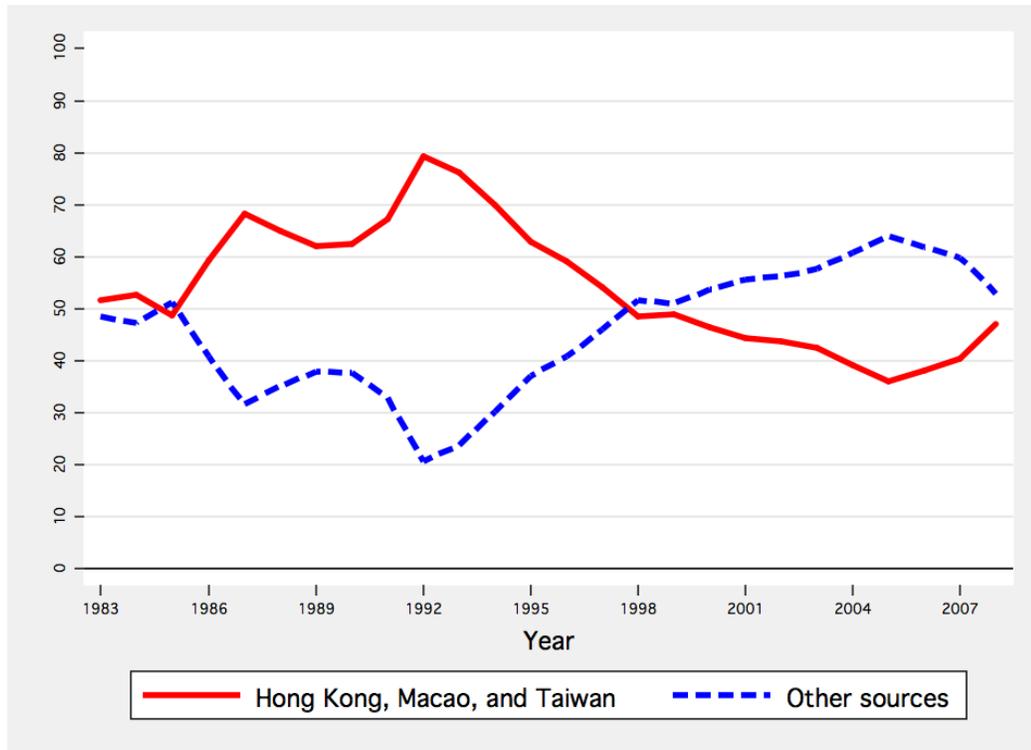


Figure 2.4: Sources of Foreign Direct Investment (1983-2008)

*Source: National Bureau of Statistics of People's Republic of China (N.d.)*

preference for judicial impartiality. The reasons are twofold. Firstly, when foreign investors arrived in China, the market in coastal areas was already occupied by domestic and ethnic Chinese investors who had a language advantage and had already built strong connections with the Chinese government. To have a fair competing environment, foreign investors were more likely to demand that local governments act according to the law. In addition, foreign investors are often subject to stricter internal auditing rules and anti-corruption rules imposed by their mother countries. One recent example is the Sarbanes-Oxley Act (SOX) enacted by the U.S. House in 2002, which set new or enhanced standards for all U.S. public company boards, management, and public accounting firms. A recent study by Arping and Sautner (2010) indicates that, relative to a control sample of comparable firms not

subject to SOX, cross-listed firms became significantly more transparent following SOX. FIEs have to incur higher compliance costs imposed by strict internal rules than domestic firms (Zhang, 2009). Such costs include external auditor fees, directors and officers insurance, board compensation, lost productivity, and legal costs.

Another earlier example is the Foreign Corrupt Practices Act (FCPA) of 1977. Two key sets of provisions in the FCPA are the anti-bribery provisions and the record-keeping provisions. The FCPA's anti-bribery provisions make it unlawful for U.S. persons, U.S. companies and certain foreign issuers listed on U.S. securities exchange to make payments to foreign officials for the purpose of obtaining or retaining business for or with, or directing business to, any person. A simple offer, promise, or authorization of a bribe will trigger a violation of the FCPA (Petersen, 2008). The FCPA's record-keeping and accounting provisions require U.S. corporations to keep books, records and accounts in reasonable detail, in a way that fairly reflects their transactions and the dispositions of their assets. Their purpose is to prevent issuers from concealing bribes and, more specifically, to discourage fraudulent accounting and reporting practices (Petersen 2008). Violations of either the bribery and accounting provisions of the FCPA can subject individuals and/or corporations to both criminal and civil penalties. As Petersen (2008, 35) argues, the FCPA "puts U.S. businesses at a competitive disadvantage compared to their foreign counterparts who are under no such rigorous anti-bribery restrictions as the FCPA." With corporate protests over the FCPA growing, the U.S. Congress directed the executive branch to begin negotiations with the OECD to encourage the major trading partners of the United States to enact laws similar to the FCPA. Members of the Convention were required to implement laws criminalizing the bribery of foreign officials (Petersen, 2008).

As a result, foreign investors have a strong demand for fair legal standards to be applied to all types of firms. This proposition is consistent with some recent

studies on foreign enterprises in China that find that interaction between foreign and Chinese firms increases the use of meritocratic hiring and promotion practices and enhances respect for the rule of law (Rosen, 1999; Guthrie, 1999; Santoro, 2000). However, this does not suggest that foreign investors are better than domestic investors in a moral sense. Foreign investors, similar to domestic investors, are also rational actors whose foremost goal is to maximize profits. It is the institution in which foreign investors are embedded that determines the incentives of foreign investors. It is an unintended consequence for foreign investors to push for the rule of law in China, because only in a fair legal environment could foreign investors best achieve their goal.

A legal scholar who is also a practicing lawyer summarized the situation very clearly:

“Usually, multi-national corporations have to report their financial statements to their mother companies. So multi-national corporations are constrained by two standards: one in the hosting country, the other in their countries of origin. The latter is often stricter than the former. As a consequence, multi-national corporations hope that the hosting country’s standard should also go higher. Otherwise, the competition between them and native companies would be unfair.”<sup>17</sup>

Domestic enterprises, especially private ones, do not suffer similar constraints. As a lawyer bluntly put, “Private firms are very flexible in using their money. They are not susceptible to any auditing: it is the boss’ own money. So they can use it in whichever way they want.”<sup>18</sup> As for Chinese state-owned enterprises (SOEs), studies have shown that local and central SOEs tend to hire small local auditors for opportunistic reasons, with governments using political pressure to coerce small

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<sup>17</sup>Subject #44, interview in Shanghai, April 26, 2010.

<sup>18</sup>Subject #27, interview in Guangzhou, March 31, 2010.

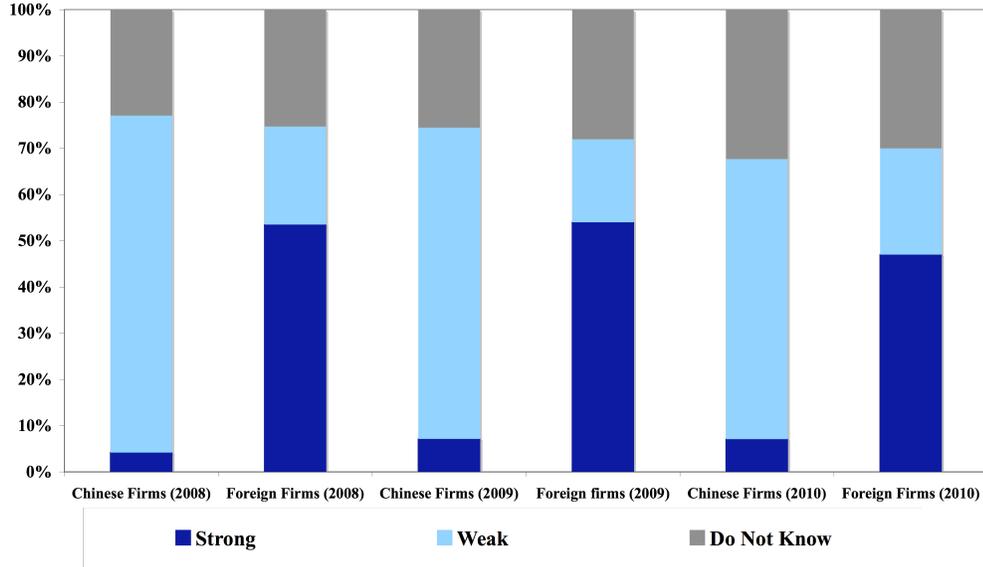
local auditors to collude with their SOEs (Wang, Wong, and Xia, 2008). The lack of fiscal constraints enables domestic firms to build clientelistic ties with local government officials through bribery and other corrupt activities. The gains from clientelistic ties include higher prosperity and loose enforcement of laws (Wank, 1999, 81-83).

Figure 2.5 shows results of the European Chamber Business Confidence Survey which was conducted in China in 2008, 2009, and 2010<sup>19</sup>. The survey interviewed European firms that were investing in China. As shown, most European investors (70% in 2008, 66% in 2009, and 60% in 2010) believed that the enforcement of environmental laws and regulations on Chinese domestic firms was weak, whereas around half of the interviewees believed that the enforcement on foreign firms was strong. To compete fairly, foreign investors certainly prefer a fair legal standard to be applied to all types of firms.

How do foreign asset holders push for the rule of law? “Voice” and “exit” are two key means by which foreign investors push for policy and institutional changes (Hirschman, 1970). A recent example is Google. On January 12, 2010, David Drummond, Google’s corporate development and chief legal officer, posted a statement on Google’s blog saying that they detected a highly sophisticated and targeted attack on Google’s corporate infrastructure originating from China that resulted in the theft of intellectual property from Google. Mr. Drummond also claimed that they had evidence to suggest that a primary goal of the attackers was accessing the Gmail accounts of Chinese human rights activists. He implied that Google would use “voice” to negotiate with the Chinese government: “We have decided we are no longer willing to continue censoring our results on Google.cn, and so over the next few weeks we will be discussing with the Chinese government the basis on which we could operate an unfiltered search engine within the

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<sup>19</sup>The survey data is available online at <http://www.europeanchamber.com.cn>.



N : 2008: 99, 2009: 148, 2010: 376.

Figure 2.5: Perceived Effectiveness of Enforcement of China’s Environmental Laws and Regulations

Source: *European Union Chamber of Commerce in China (2011)*

law, if at all.” He further indicated the possibility of using “exit” if “voice” did not work: “We recognize that this may well mean having to shut down Google.cn, and potentially our offices in China.”<sup>20</sup> On the same day, U.S. Secretary of State Hilary Clinton stated that they looked to the Chinese government “for an explanation.”<sup>21</sup> Three days later, China’s Ministry of Foreign Affairs responded in a press conference, saying “China is regulating the Internet according to the law.”<sup>22</sup> Obviously, the conversations between Google and the Chinese government did not go very

<sup>20</sup>This statement can be found at <http://googleblog.blogspot.com/2010/01/new-approach-to-china.html>.

<sup>21</sup>Clinton’s statement can be found at <http://www.state.gov/secretary/rm/2010/01/135105.htm>.

<sup>22</sup>China’s response can be found at [http://news.xinhuanet.com/fortune/2010-01/15/content\\_12812263.htm](http://news.xinhuanet.com/fortune/2010-01/15/content_12812263.htm).

well. On March 22, 2010, David Drummond posted another statement announcing Google's move from mainland China to Hong Kong<sup>23</sup>. Google is a MNC with highly mobile assets. However, most MNCs are not as mobile as Google. When costs of "exit" are high, most MNCs prefer to use "voice" by openly lobbying the government (Ahlquist and Prakash, 2008).

As a response to foreign investors' pressure, how do local governments in China build the rule of law? China is a single-party authoritarian state. The Chinese Communist Party (CCP) holds sway over every aspects of political life. As shown in Chapter III, the CCP controls the judicial institutions via two major mechanisms. First of all, major court officials are also governed by the *nomenklatura* system, that is, they are appointed and managed by the Party's committee at the same jurisdiction level. For example, the president of a county's basic people's court is appointed and supervised by the county Party committee<sup>24</sup>. Because they are civil servants, officials and judges are also evaluated annually by the Party's organization department. The evaluation index includes measures of virtue, work ethic, and performance, etc. Officials with consistently bad evaluations will be demoted, whereas judges will be deprived of their rights to adjudicate on cases<sup>25</sup>. Secondly, a court's budget completely relies on the local government. All expenditures of the court, including salaries of judges, are paid out of the local government's budget. Hence, a court's "quality" is, to a large extent, determined by the local government. The local government can strengthen the court by staffing professional judges and providing sufficient funds; it can also weaken the court

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<sup>23</sup>Google was not successful at bringing policy changes in China partly because Google's share of market in China was very small, whereas a Chinese domestic firm Baidu occupies almost 70% of China's search engine market.

<sup>24</sup>According the Organic Law of People's Courts, the president of a basic people's court should be nominated by the intermediate people's court and appointed by the county People's Congress. However, in reality, the nomination should be approved by the county Party committee and then automatically passed in the local congress.

<sup>25</sup>Interviews with court officials. Subject #8, Lingao, Hainan province, March 15, 2010. Subject #10, Dongguan, Guangdong province, March 23, 2010.

through nepotistic appointment and insufficient funding.

Meanwhile, Chinese governments at various levels only seek to improve judicial impartiality and judicial efficiency in the commercial realm. Through the *nomenclatura* system and the financial system, the CCP and the Chinese government still hold strong sway over the judiciary to limit ordinary citizens' opportunities to challenge the state in the political and civil realms. As a consequence, the incentive to provide credible commitment to foreign investors from outside the "China circle" contributes to the rise of a limited form of the rule of law where commercial disputes are settled in an increasingly fair fashion whereas judicial unfairness is still prevalent in cases involving ordinary citizens.

## 2.6 Conclusion

As this chapter points out, autocrats cannot solely rule by use of political repression; they also need people's loyalty. And the common way to create loyalty is to stimulate economic growth. Economic stagnancy destabilizes dictatorships (Przeworski et al., 2000). It hurts dictators either through reducing the amount of private goods allocated to their winning coalitions (Bueno de Mesquita et al., 2003) or through empowering their opponents and making opponents easier to coordinate (Acemoglu and Robinson, 2005). In the case of China, economic stagnancy may ruin local leaders' political career by failing them on the cadre evaluation system. Therefore, to stimulate economic growth and remain in power, Chinese officials need cooperation of asset holders.

However, asset holders vary on two major dimensions: bargaining power and preference. They can only obtain what they want by having strong bargaining power *vis-à-vis* the ruler. Asset holders' power comes from the credible threat of withdrawing urgently needed cooperation. Asset holders also have different preferences for the rule of law. Their preference is a function of their existing (or

potential) connections to the ruler and their internal rules. If they could negotiate a better deal with the ruler and guarantee the safety of their properties at a low cost through extralegal means, such as particularistic contracts, personal connections, or patron-client ties, they would not demand that the ruler adheres to the law, since a fair legal system would benefit not only themselves, but also their competitors. Property holders prefer a reliable legal system through which a formal contract needs to be signed and fairly enforced when the cost of obtaining the ruler's protection through non-legal means is higher than accomplishing the same through legal means. In addition, when an asset holder has strict and transparent internal auditing and operational rules, she would certainly want her competitors to stick to the same rules, since otherwise, the asset holder will incur a higher cost of compliance.

I argue that local Chinese officials' incentive to promote the rule of law comes from their need to prevent the outflow of foreign investors from outside the "China circle." Foreign investors have two characteristics that qualify them to push the rule of law in China. First of all, they are in a better position than domestic investors to bargain with the government. Secondly, foreign investors from outside the "China circle" have a stronger preference for judicial impartiality. So we expect to observe more "rule-of-law" in places where are large shares of foreign capital from outside the "China circle."

Instead, domestic investors and ethnic Chinese investors prefer administrative channels in enforcing contracts and settling disputes. The lack of fiscal constraints enables domestic firms to build clientelistic ties with local government officials through bribery and other corrupt activities. Therefore, we expect to observe less "rule-of-law" in places where there are large shares of SOEs, domestic private enterprises, and enterprises from within the "China circle."

I also argue that Chinese governments at various levels only seek to improve

judicial impartiality and judicial efficiency in the commercial realm. Through the *nomenclatura* system and the financial system, the CCP and the Chinese government still hold strong sway over the judiciary to limit ordinary citizens' opportunities to challenge the state in the political and civil realms. As a consequence, the incentive to provide credible commitment to foreign investors from outside the "China circle" contributes to the rise of a limited form of the rule of law where commercial disputes are settled in an increasingly fair fashion whereas judicial unfairness is still prevalent in cases involving ordinary citizens.

## CHAPTER III

# The Chinese Judiciary

### 3.1 Introduction

Drawing from qualitative interviews, laws and regulations, and government documents, this chapter provides a detailed account of the setup of China's judicial system, the configurations of Chinese local courts as a legal organization and a bureaucratic organization, the formal and informal rules embedded in courts, the political environment of local courts, and the roles that courts have played in promoting economic development and maintaining social stability.

As discussed in this chapter, legal reforms in China have not led to judicial impartiality in the political and civil realms. Citizens' legal rights, although protected by "law in book," are not protected by "law in action." The CCP and government organizations rely on their hegemonic power on the personnel system and financial system to set the agenda for China's legal reforms, which frequently deny citizens' pursuit of their legal rights in the political and civil realms.

The chapter is organized as follows: the next section gives a snapshot of the Chinese judicial system, the third section then specifies the dual natures of Chinese courts both as a legal institution and a bureaucratic institution, the fourth section examines the external political environment in which a local court is embedded, the fifth section discusses what role courts have played in promoting economic

growth and maintaining social stability, and the final section concludes with major findings and a theoretical contribution of the research.

### 3.2 An Overview of China's Judicial System

As stipulated in Article 123 of the Constitution of the People's Republic of China, "The people's courts of the People's Republic of China are the judicial organs of the state." The People's Republic of China establishes the Supreme People's Court and the people's courts at various local levels, and also military courts and other special people's courts.

China has a four-level judicial system as shown in Figure 3.1. The system includes the Supreme People's Court and local people's courts. The local people's courts at various levels are divided into basic people's courts, intermediate people's courts, and higher people's courts. Military courts, railway transport courts, and maritime courts are special courts which are in independent judicial systems separate from the "mainstream" judicial system.

Basic people's courts are county-level courts, which include (1) county people's courts and municipal people's courts, (2) people's courts of autonomous counties, and (3) people's courts of municipal districts<sup>1</sup>. A basic people's court adjudicates criminal and civil cases of first instance. When a basic people's court considers that a criminal or civil case it is handling is of major importance and requires trial by the people's court at a higher level, it may request that the case be transferred to that court for trial<sup>2</sup>. As stipulated by the Organic Law of People's Courts of the People's Republic of China (the Organic Law hereafter), a basic people's court may set up a number of people's tribunals according to the conditions of the locality, population, and cases. A people's tribunal is a component of the basic people's

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<sup>1</sup>The Organic Law Article 18.

<sup>2</sup>The Organic Law Article 20.

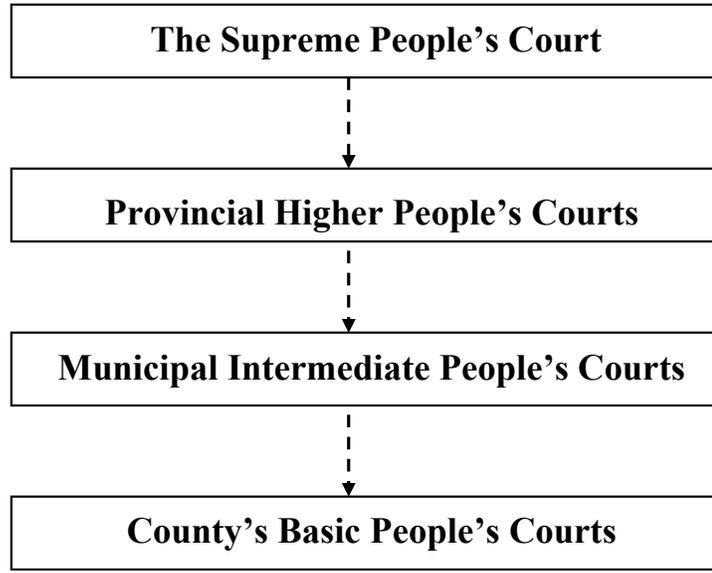


Figure 3.1: Hierarchy of China's Judicial System

court, and its judgments and orders are judgments and orders of the basic people's courts (Article 20).

Intermediate people's courts are prefectural level courts, which include (1) intermediate people's courts established in prefectures of a province or autonomous region, (2) intermediate people's courts established in municipalities directly under the central government, (3) intermediate people's courts of municipalities directly under the jurisdiction of a province or autonomous region, and (4) intermediate people's courts of autonomous prefectures<sup>3</sup>. As stipulated by the Organic Law, an intermediate people's court handles the following cases: (1) cases of first instance assigned by laws and decrees to their jurisdiction, (2) cases of first instance transferred from the basic people's courts, (3) cases of appeals and of protests lodged against judgments and orders of the basic people's courts, and (4) cases of protests lodged by the people's procuratorates in accordance with the procedures of judicial supervision (Article 25). The Organic Law also stipulates that when an

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<sup>3</sup>The Organic Law Article 23.

intermediate people's court considers that a criminal or civil case it is handling is of major importance and requires trial by the people's court at a higher level, it may request that the case be transferred to that court for trial (Article 25).

Higher people's courts are provincial level courts, which include (1) higher people's courts of provinces, (2) higher people's courts of autonomous regions, (3) higher people's courts of municipalities directly under the central government<sup>4</sup>. A higher people's court handles the following cases: (1) cases of first instance assigned by laws and decrees to their jurisdiction, (2) cases of first instance transferred from people's courts at lower levels, (3) cases of appeals and of protests lodged against judgments and orders of people's courts at lower levels, and (4) cases of protests lodged by people's procuratorates in accordance with the procedures of judicial supervision<sup>5</sup>.

The Supreme People's Court is the highest judicial organ of the state. The Supreme People's Court supervises the administration of justice by the local people's courts at various levels and by the special people's courts<sup>6</sup>. The Supreme People's Court handles the following cases: (1) cases of first instance assigned by laws and decrees to its jurisdiction and which it considers should itself try, (2) cases of appeals and of protests lodged against judgments and orders of higher people's courts and special people's courts, and (3) cases of protests lodged by the Supreme People's Procuratorate in accordance with the procedures of judicial supervision<sup>7</sup>. As stipulated by the Organic Law, The Supreme People's Court also gives interpretation on questions concerning specific application of laws and decrees in judicial proceeding (Article 33).

The people's courts adopt the system whereby the second instance is the last instance. It works in the following way: From a judgment or orders of first instance

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<sup>4</sup>The Organic Law Article 26

<sup>5</sup>The Organic Law Article 28.

<sup>6</sup>The Organic Law Article 30.

<sup>7</sup>The Organic Law Article 32.

of a local people's court, a party may bring an appeal to the people's court at the next higher level in accordance with the procedure prescribed by law, and the people's procuratorate may present a protest to the people's court at the next higher level in accordance with the procedure prescribed by law. Judgments and orders of first instance of the local people's courts at various levels become legally effective judgments and orders if, within the period for appeal, none of the parties has appealed and the procuratorate has not protested. The Organic law also says that judgments and orders of second instance of intermediate courts, higher people's courts and the Supreme People's Court and judgments and orders of first instance of the Supreme People's Court are all judgments and orders of last instance, that is, legally effective judgments and orders (Article 12).

China now has 32 higher people's court (including 1 military court), 409 intermediate people's courts, and 3,117 basic people's courts. There are over 190,000 judges, among which 7,000 judges are in higher people's courts, 36,000 in intermediate courts, and 146,000 in basic people's courts<sup>8</sup>.

### **3.3 A Basic People's Court as a Legal Organization and a Bureaucratic Organization**

Most basic people's courts were established around 1949 when the People's Republic was founded. Some of them date back to 1934 when the Nationalist Party was still in power, whereas some were established as late as 1961 (Landry, 2011). Basic people's courts are at the lowest ladder of the judicial system, but they handle the majority of cases. According to a report, in 2008, courts at various levels in Jiangsu province accepted 882,352 cases, among which the higher people's court accepted 8,135 cases (1%), intermediate people's courts 66,826 cases (7.5%), and

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<sup>8</sup>See <http://www.court.gov.cn/jgsz/rmfyjj/>.

basic people's courts 807,391 cases (91.5%)<sup>9</sup>.

As Su (2000) argues, a Chinese court has two functions: legal adjudication and administrative management. A court is, therefore, a legal organization and a bureaucratic organization. As a legal organization, a basic court has a very clear division of labor. As required by the Organic Law, a basic people's court is composed of a president, vice-presidents, and judges. In law, the president, vice-presidents, division chief judges, division associate judges, and ordinary judges are all judges with the same duties and responsibilities<sup>10</sup>. So as a legal organization, a court is a flat organization where all judges have equal powers.

A basic people's court may set up a criminal division, a civil division, and an economic division, each with a chief judge and associate chief judges (Article 19). In practice, some basic courts combine the civic division and the economic division. In developed areas, some courts have more than one civil division to meet high societal demands. For example, the first basic people's court in Dongguan city has 4 civic divisions<sup>11</sup>. A typical basic court has one criminal division, one or two civil divisions, at most one economic division, and one administrative division. Another important function of basic courts is enforcement of court judgments. Every basic court has an enforcement bureau (*zhixing ju*)<sup>12</sup>. The enforcement bureau is not a designated organization in the Organic Law, so the legal status of enforcement bureaus is unspecified in law. In some places, there is an enforcement division under an enforcement bureau. The rank of an enforcement bureau head is often higher than a division head<sup>13</sup>.

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<sup>9</sup>Please see "Too Many Cases, Too Few Judges: Problems of and Solutions to Basic Courts (*Jiceng fayuan anduo renshao de kunjing yu chulu*)" at <http://www.dffy.com/faxuejieti/ss/200906/20090608160101.htm>.

<sup>10</sup>The Organic Law Article 6.

<sup>11</sup>Please see <http://dyfy.dg.gov.cn/fyjy/fywz/2010/01/08145748734.html>.

<sup>12</sup>Enforcement bureaus were established after the National People's Congress Standing Committee issued a decision on revising the Civil Procedure Law in 2007. Please see [http://news.xinhuanet.com/legal/2008-11/03/content\\_10298227.htm](http://news.xinhuanet.com/legal/2008-11/03/content_10298227.htm).

<sup>13</sup>For a discussion of the status of the enforcement division, please see the following statement issued by the National People's Congress Standing Committee <http://www.npc.gov.cn/npc/>

Most cases are adjudicated by a collegial panel of judges (*heyi ting*). Only simple civil cases and minor criminal cases are tried by a single judge<sup>14</sup>. There is a presiding judge (*heyiting shenpanzhang*) in each collegial panel. The responsibility of the presiding judge is not specified in the Organic Law.

In addition, as the Organic Law (Article 11) requires, each court also establishes a judicial committee to discuss *important* (*zhongda*) and *difficult* (*yinan*) cases. A basic court judicial committee is usually composed of the president, vice-presidents, chief judges of major divisions. The size of a judicial committee is between 9 to 11. The Organic Law stipulates that the presidents of the people's courts preside over meetings of judicial committees. All cases can enter the judicial committee. As Su (2000, 104-105) observes, very few civil cases enter the judicial committee, 10%-15% of criminal cases enter the judicial committee, and most administrative cases enter the judicial committee. Su (2000, 104-105) argues that only "difficult" cases are discussed in the judicial committee, which include (1) cases with significant social influences and reactions, (2) cases interfered by congress, government or other government organizations, and (3) cases hard to define in law.

As Su (2000, 103) summarizes, the procedure of cases entering the judicial committee works in the following way. If the case is adjudicated by a single judge, and the judge is not sure about the nature of the case or what law to apply, the judge should report the case to the chief judge of her division. If the chief judge agrees with the judge's opinion, a judicial decision can be made; if there is a disagreement, the chief judge should report to a vice president. If the vice president cannot make a decision, the vice president should report the case to the president, and then the case enters the judicial committee. If the case is adjudicated by a collegial panel, and the opinion of the panel contradicts that of the division chief judge, the chief judge reports the case to a vice president. The vice president proposes her

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xinwen/lfgz/xwdf/2005-07/08/content\_363220.htm.

<sup>14</sup>The Organic Law Article 10.

opinion, and the panel discusses the case again. If there is still a disagreement, the vice president reports the case to the president, and then the case enters the judicial committee.

Figure 3.2 summarizes the structure of a basic court as a legal organization.

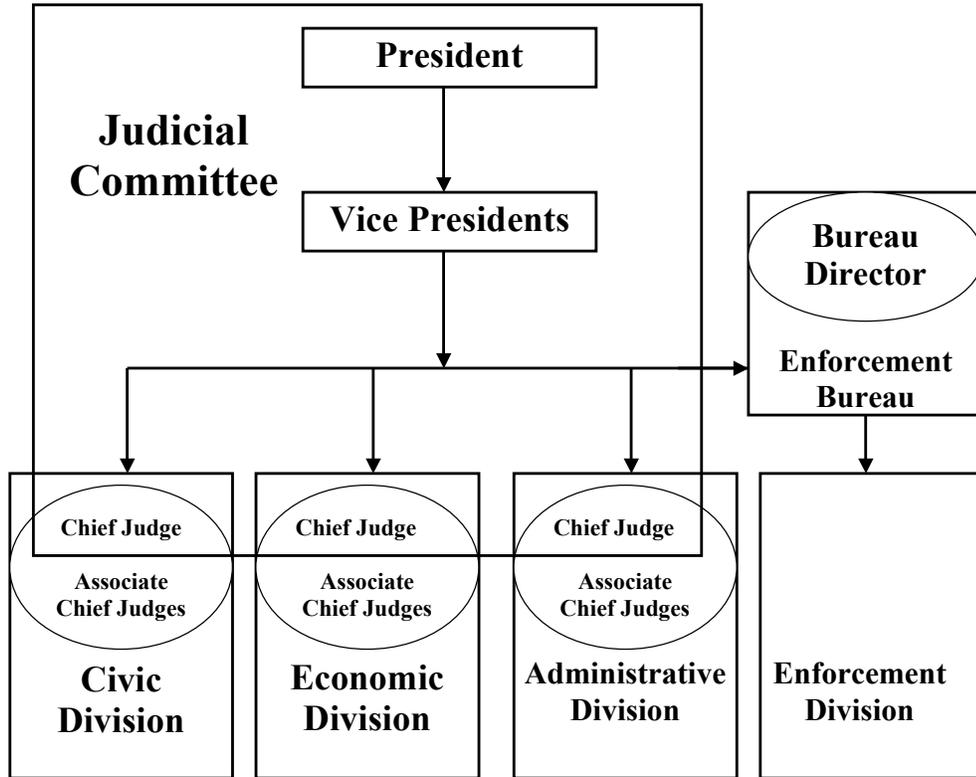


Figure 3.2: Court as a Legal Organization

At the same time, a basic court is also a bureaucratic organization. As a bureaucratic organization, a court is a hierarchical organization where judges and staff members have different ranks and powers associated with their ranks.

In addition to those functional departments in a basic court, there are also several administrative organs. Among them, the most important organ is the Party committee. According to the Constitution of the Chinese Communist Party, "Primary Party organizations are formed in ... basic units, where there are at least three full Party members." (Article 29) Every court in China has a Party commit-

tee. And in most cases, the president is also the Party secretary of the court, and vice presidents are also Party committee members<sup>15</sup>.

A typical basic court also has an administrative office (*bangong shi*), a political work department (*zhenggong ke*), a disciplinary department (*jijian shi*), a research department (*yanjiu shi*), and a legal police department (*fajing dadui*). They are at the same rank as a division.

This hierarchy operates according to certain rules that keep the court running. The foremost rule is that the power of a court lies in the Party committee; and the power of the Party committee lies in the Party secretary<sup>16</sup>. The Party committee is composed of the president (also the Party secretary), vice presidents, and sometimes heads of the political work department and disciplinary department. The Party committee meets very frequently to discuss major issues in the court, and decides on major administrative issues, such as personnel decisions (e.g. appointment, promotion, and dismissal of judges and staff members) and monetary decisions (e.g. salary structure and budget). Below are the major rules for the Party committee meetings in a basic court<sup>17</sup>:

- The Party committee meets twice a month. Additional meetings will be convened if necessary;
- The Party secretary sets the agenda of the meetings. Committee members can make proposals for the Party secretary to decide;
- Party committee meetings are convened by the Party secretary. If the Party secretary is absent, the Party secretary designates a committee member to preside;

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<sup>15</sup>Subject#8, interview with a basic court president, Lingao county, Hainan province, March 15, 2010.

<sup>16</sup>It is hard to distinguish whether this is a formal rule or an informal rule. According to the Constitution of the PRC, the basic tasks of the nation should be achieved “under the leadership of the Communist Party of China,” and one of the tasks is to “improve the socialist legal system” (Preamble). In this sense, the Party leadership in courts is a formal rule. But none of the other laws, including the Organic Law and procedural laws, is explicit in the Party’s leadership. In this sense, this is also an informal rule.

<sup>17</sup>These are informal rules. These rules are printed on a framed paper which hangs on the wall of a meeting room of a basic court that I visited. These rules are not stipulated in any formal laws. The rules may vary in different courts.

- Representatives from other government departments can sit in committee meetings if necessary;
- More than half of the committee members should be present to run the meetings. For meetings on personnel decisions, more than two thirds committee members should be present;
- Party committee members should have adequate discussions before making a personnel decision. If the committee cannot reach a consensus, the decision should be postponed. But once the committee makes a decision, the committee must comply;
- In emergent situations, the Party secretary or committee members can make decisions without convening a committee meeting. But the committee should hear the report afterwards;
- Any documents issued in the name of the Party committee should be signed by the Party secretary or a committee member designated by the Party secretary.

There are also written rules for Party committee members to follow<sup>18</sup>:

- Party committee members are assistants to, in charge of certain issues under the leadership of, and responsible to the Party secretary;
- Party committee members should report major issues to and seek suggestions from the Party secretary;
- Party committee members can suggest or keep disagreements for the Party secretary's decisions; Party committee member can also report disagreements to a higher ranking official. But committee members must comply with the Party secretary's orders;
- Party committee members should communicate with the Party secretary frequently and support the Party secretary.

As a consequence, the hierarchical nature often triumphs the egalitarian nature. Judges hold different powers according to their administrative posts. The most powerful person in a basic court is the president who is also the Party secretary. Granted by the Organic Law, the president presides over meetings of judicial committees<sup>19</sup>. As Su (2000, 105) observes, during judicial committee meetings, the

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<sup>18</sup>These are also informal rules.

<sup>19</sup>The Organic Law Article 11.

president usually does not reveal her opinion at the beginning. After listening to other committee members, the president will conclude and say her own opinion. In this way, the president can make sure that her opinion is always the right one. But sometimes, if the president really wants to influence a case, she will reveal her opinion first and impose it on other members<sup>20</sup>.

Division chief judges are also more powerful than ordinary judges. The Organic Law stipulates that the chief judge of a division can appoint one of the judges to act as the presiding judge of the collegial panel. And when the chief judge of a division participates in the judicial proceedings, she acts as the presiding judge<sup>21</sup>. By selecting the presiding judge, a chief judge can largely influence the decision of a case. Another way chief judges influence judicial decisions is through *division affairs meetings (tingwu hui)*. Su (2000, 79) observes that, sometimes, division chief judges convene division affairs meetings to discuss difficult and complicated cases. All judges in the division should participate. The chief judge's opinion is often influential over other judges.

Figure 3.3 summarizes the structure of a basic court as a bureaucratic organization.

### **3.4 Appointment, Removal, Dismissal, and Evaluation of Judges**

The Judges Law is the *formal* rule to regulate appointment and removal of judges. However, in practice, the informal rules subvert the formal rules in personnel affairs. The key difference between the formal rules and the informal rules is who has the power to appoint and remove judges. For the formal rules, the power lies in the legislative body, whereas for the informal rules the power lies in the Party organizations. The following paragraphs specify the appointment and

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<sup>20</sup>Subject #10, interview with a judge, Guangdong, March 23, 2010

<sup>21</sup>The Organic Law Article 10.

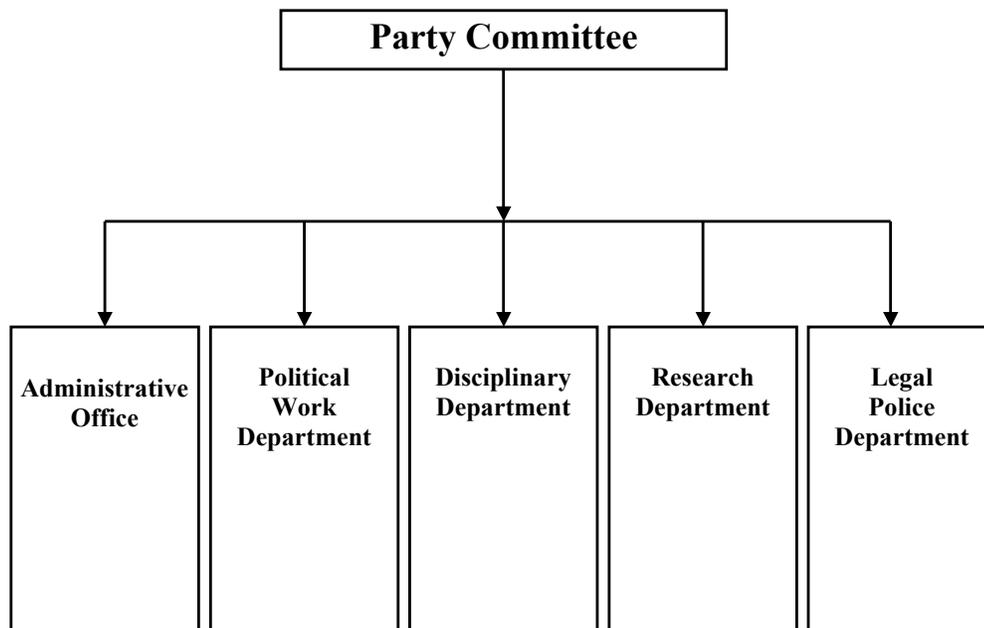


Figure 3.3: Court as a Bureaucratic Organization

removal procedures of major posts in a basic court: the president, vice-presidents, judicial committee members, division chief judges, division associate judges, and ordinary judges.

### 3.4.1 Appointment

The Judges Law stipulates that, “The presidents of the local people’s courts at various levels shall be elected or removed by the local people’s congresses at various levels. The vice-presidents, members of the judicial committees, chief judges and associate chief judges of divisions and judges shall be appointed or removed by the standing committees of the corresponding levels upon the suggestions of the presidents of those courts.” (Article 11) The term of the presidency post is 5 years. A president can be reelected only once.

However, in practice, people's congresses only have the power to confirm nominations. The elections in congresses are not competitive, hence, not meaningful, since congresses rarely veto a nomination<sup>22</sup>. The appointment procedures for the major posts work in the following way<sup>23</sup>:

The candidate of the president of a basic court is nominated jointly by the Party committee and court at a higher territorial level, and this nomination will be done in consultation with the county Party committee. If there is an agreement, the nomination will be passed by the county people's congress. For example, if the county is directly under a municipal city, the municipal Party committee and the city intermediate court will jointly nominate a candidate. Then the county Party committee will discuss this nomination. If there is an agreement, the county people's congress will pass this nomination. If there is a disagreement, the municipal Party committee and the intermediate court should nominate a new candidate, or the county Party committee can make a recommendation. The rule of thumb is that there should be a consensus among all the three organizations: the municipal Party committee, the intermediate court, and the county Party committee.

Both the Judges Law and the Organic Law are very vague in the qualifications of a court president. The Judges Law stipulates that, "Persons to be appointed presidents or vice-presidents of People's Courts shall be selected from among the best judges and other people who are best qualified for the post." (Article 12) The Organic Law says that, "Citizens who have the right to vote and to stand for election and have reached the age of 23 are eligible to be elected presidents of people's courts ...; but persons who have ever been deprived of political rights are excluded. Judicial personnel of people's courts must have an adequate knowledge of the law." (Article 34) It is difficult to define what constitutes an "adequate knowledge of

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<sup>22</sup>Subject #2, interview with a police school chancellor, Hainan province, March 8, 2010.

<sup>23</sup>Interviews with subject #8 (a basic court president in Hainan province) and subject #10 (a political work department director in a basic court in Guangdong province).

the law.” There are no systematic data on qualifications of basic court presidents; among the courts that I visited, at least half of the court presidents do not have professional legal training, for example, degrees from law schools. According to a news report, 14 out of the 30 higher court presidents do not have any legal training and have never worked in a law-related profession<sup>24</sup>. And ironically, the current Chief Justice in the Supreme People’s Court Wang Shengjun himself was a history major in college and never was a practicing lawyer or a judge<sup>25</sup>. Court presidents having no legal training has its advantages and disadvantages. Since courts in China are not independent, a court president who previously had a political career outside the legal system can help the court secure funding from the government, communicate with the Party committee, and coordinate with other government organs<sup>26</sup>. But since the court Party committee also makes judicial decisions, a president without legal training usually politicizes cases.

The candidates for vice-presidents of a basic court are nominated by the county Party committee standing committee and then passed by the county people’s congress standing committee. There is no term limits for vice-presidents. According to my observation, vice-presidents are mostly professional judges. Since vice-presidents are also judicial committee members, the professionalization of vice-presidents complement the weaknesses of the president.

Judicial committee members, chief judges and associate judges of divisions are nominated by the court Party committee, approved by the county Party committee standing committee, and then passed by the county people’s congress standing committee.

Ordinary judges are appointed by the court president, but this appointment must be approved by a higher level court, for example, the intermediate court. As

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<sup>24</sup>Please see <http://www.infzm.com/content/31840>.

<sup>25</sup>Justice Wang’s CV can be found here [http://news.xinhuanet.com/misc/2008-03/16/content\\_7799618.htm](http://news.xinhuanet.com/misc/2008-03/16/content_7799618.htm).

<sup>26</sup>Subject #35, interview with a division chief judge, Jiangxi, April 8, 2010.

for qualifications of judges to be appointed for the first time (*churen faguan*), the Judges Law stipulates that, “Persons to be appointed judges for the first time shall be selected, through strict examination and appraisal, from among those who have passed the uniform national judicial examination and who are the best qualified for the post, in conformity with the standards of having both ability and political integrity.” (Article 12) However, in practice, as He (1998) observes, a large number of first time appointed judges are retired military officers who have basically no legal training and experiences in the legal profession. My impression during the fieldwork is that the situation is much better than what He observed in late 1990s. The bar for becoming a judge is set higher, and judges in local courts are much more professionalized. To become a judge, one must go through the following three steps: (1) take the civil service examination (*gongwuyuan kaoshi*), and obtain the qualification; (2) pass the national judicial examination (*guojia sifa kaoshi*); and (3) participate in a training session in the Supreme People’s Court and receive a certificate.

It is noteworthy that all judges in China are also civil servants. So they all need to take the civil service examination and obtain the qualification. As civil servants, all judges are also managed by the Party organization departments at the same territorial level.

### **3.4.2 Removal and Dismissal**

Chinese judges do not have tenure; they can be removed or dismissed. Removal (*lizhi*) means leaving the current position, and dismissal (*citui*) means being discharged from the current position. Therefore removal contains dismissal. The Judges Law has different stipulations on who should be removed or dismissed.

Article 13 stipulates that, “If a judge is found to be in any of the following circumstances, a suggestion shall be submitted according to law for his or her re-

removal from the post: (1) having forfeited the nationality of the People's Republic of China; (2) having been transferred out of a court; (3) having no need to maintain his or her original post after a change of post; (4) being determined to be incompetent in the post through appraisal; (5) being unable to perform the functions and duties of a judge for a long period of time due to poor health; (6) having retired from the post; (7) having resigned the post, or having been dismissed; or (8) being disqualified from continuing to hold the post because of violation of discipline or law or commission of a crime."

Article 40 stipulates that, "A judge shall be dismissed if he or she is found to be in any of the following circumstances: (1) to be confirmed by annual appraisal as being incompetent for two successive years; (2) to be unqualified for the present post and decline to accept other assignments; (3) to refuse to accept reasonable transfer, which is necessitated by restructuring of the judicial organ or reduction of the size of the size of the staff; (4) to have stayed away from work without leave or to have overstayed his or her leave without good reason for fifteen days or more in succession, or for thirty days or more in a year aggregated; or (5) to fail to perform a judge's duty, and make no rectification after criticism."

There is no systematic data on how many judges are removed or dismissed every year. A judge told me that it is very rare for a basic court judge to be promoted to a higher level court, say, an intermediate court. The vertical mobility within the judicial system is very limited<sup>27</sup>.

### **3.4.3 Evaluation**

There are two evaluation systems for judges: one in the judicial system, the other in the bureaucratic system. The judicial evaluation assesses judges' performance as judges, whereas the bureaucratic evaluation assesses judges' perfor-

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<sup>27</sup>Subject #28, interview with a judge, Guangdong province, March 31, 2010.

Table 3.1: External Judicial Evaluation Form (Adjudication Category)

Indicator	Direction
1. Total number of cases ( <i>zong anjian</i> )	+
2. Total number of complete cases ( <i>zong jian</i> )	+
3. Number of mediated cases ( <i>tiaojie</i> )	+
4. Number of withdrawn cases ( <i>chesu</i> )	+
5. Number of mediated and withdrawn cases ( <i>tiaocheng zongshu</i> )	+
6. Number of appeals ( <i>shangsu</i> )	-
7. Quality of adjudication ( <i>zhiliang</i> )	+
8. Completion rate ( <i>jian lu</i> )	+
9. Mediation and withdrawal rate ( <i>tiaocheng lu</i> )	+
10. Appeal rate ( <i>shangsu lu</i> )	-
11. Correction rate ( <i>gaipan lu</i> )	-
12. Complaint rate ( <i>shensu lu</i> )	-

mance as civil servants. This section examines the judge evaluation system in a basic court in Dongguan City, Guangdong province<sup>28</sup>.

There are external and internal judicial evaluations. The external judicial evaluation is carried out by a higher level court. For example, judges in a basic court are evaluated annually by an intermediate court.

The external judicial evaluation has two categories of indicators: adjudication and enforcement. The adjudication category includes indicators in Table 3.1.

A first glance at the indicators shows that the evaluation form emphasizes *quantity* rather than *quality*. This emphasis has some unintended consequences on judges' incentives. For example, complete cases are cases that have been adjudicated. And completion rate is calculated by the number of complete cases being divided by all accepted cases by the end of the year. This indicator was designed to increase efficiency of judges; however, in practice, courts are often reluctant to accept cases towards the end of the year to decrease the denominator<sup>29</sup>. The bottom

<sup>28</sup>The judge evaluation system is informed by subject #10, a political work department director in a basic court, Guangdong province, March 23, 2010.

<sup>29</sup>This practice is quite common among basic courts across the country. Please see a discussion at <http://court.gmw.cn/html/article/201101/05/484.shtml>. The Supreme People's Court is thinking of revising this indicator. Please see <http://www.chinacourt.org/html/>

line of completion rate for basic courts is 91%, and 88% for intermediate courts. But most basic courts cannot achieve this goal. According to a report, the average completion rate of basic courts in city X in 2008 is 87.86%, and 89.32% in 2009<sup>30</sup>. Another way to increase completion rate is to encourage plaintiffs to withdraw their cases, for withdrawn cases will not be included in the denominator. Number of withdrawn cases and withdrawal rate are other indicators on which judges are evaluated. It is in judges' strong interests to press plaintiffs to withdraw.

The indicators that directly or indirectly tap quality of adjudications include the number of appeals, quality of adjudication, appeal rate, correction rate, and complaint rate. To some extent, these indicators play important roles in pressing judges to make a fair judgement. But judges have ways to circumvent them. For example, to avoid appeals, judges are inclined to mediate a case rather than to adjudicate. The result is a compromise between the two parties, so either side is less likely to appeal to a higher level court. In addition, correction of judgements of first instance cases are made by a higher level court. For example, an intermediate court can correct the judgement made by a basic court if either side appeals. However, in reality, the intermediate court rarely corrects a basic court judgement. As an intermediate court judge told me, "We do our best to respect basic courts' decisions. We do not correct if it is a borderline case unless there is a fatal mistake."<sup>31</sup>

In addition to adjudication, judges in the enforcement bureau are also evaluated on their performance on enforcement of court judgements. The enforcement category includes indicators in Table 3.2.

Enforcement of judicial decisions has long been a headache for Chinese courts (*zhixing nan*). In addition to some obvious reasons such as costly process and limited resources, the foremost obstacle is government intervention. Below is the

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article/201012/20/439196.shtml.

<sup>30</sup>Please see <http://court.gmw.cn/html/article/201101/05/484.shtml>.

<sup>31</sup>Subject #28, interview with a judge, Guangdong province, March 31, 2010.

Table 3.2: External Judicial Evaluation Form (Enforcement Category)

Indicator	Direction
1. Total number of cases ( <i>zong anjian</i> )	+
2. Total number of complete cases ( <i>zong jiean</i> )	+
3. Number of compromised cases ( <i>hejie anjian</i> )	+
4. Number of documented cases ( <i>yiguidang anjian</i> )	+
5. Average enforcement length ( <i>pingjun zhixing tianshu</i> )	-
6. Completion rate ( <i>jiean shu</i> )	+
7. Compromise rate ( <i>hejie lu</i> )	+
8. Appeal rate ( <i>shangsu lu</i> )	-
9. Documentation rate ( <i>guidang lu</i> )	+
10. Rate of disbursement ( <i>zijin daoweilv</i> )	+
11. Ranking of completion rate ( <i>jieanshu paiming</i> )	+
12. Ranking of disbursement rate ( <i>zijin daoweilu paiming</i> )	+
13. Ranking of enforcement termination rate ( <i>zhongzhi zhixing lu</i> )	-

conversation I had with a judge who works in the enforcement bureau in a basic court<sup>32</sup>:

Me: Why is enforcement so difficult?

The judge: The foremost reason is government intervention. For example, enterprises are attracted by the county government. If the court enforces a judgement that harms the enterprise, the county government will say this is like “killing chickens for eggs.” To attract investors is already hard; investors who are already here need to be protected. To enforce according to the law will set bad examples for other enterprises that are thinking about moving here. ... Here in this place, there is a saying, “No matter if it is a black firm or a white firm; as long as it pays tax, it is a good firm.”

And the judge told me that the *actual* completion rate for his court is only around 50%. But they have alternative ways to calculate. For example, they can claim that the enforcement process is terminated for inevitable reasons, such as

<sup>32</sup>Subject #33, interview with a judge, Jiangxi province, April 8, 2010.

Table 3.3: Internal Judicial Evaluation Form

Indicator	Direction
1. Rate of change of registration category ( <i>lian biangeng lu</i> )	-
2. Rate of first instance cases with juries ( <i>yishen anjian peishen lu</i> )	+
3. Rate of correction in appeals ( <i>shangsu gaipan lv</i> )	-
4. Rate of remand for new trial after appeal ( <i>shangsu fahui chongshen lu</i> )	-
5. Quality of paper of judgement ( <i>panjue wenshu zhiliang</i> )	+
6. Completion rate ( <i>jiean lu</i> )	+
7. Number of complete cases ( <i>jiean shu</i> )	+
8. Stability of completion rates throughout the year ( <i>jiean junhengdu</i> )	+
9. Mediation rate of first instance civil cases ( <i>minshi yishen anjian tiaojie lu</i> )	+
10. Withdraw rate of first instance civil cases ( <i>minshi yishen anjian chesu lu</i> )	+
11. Appeal rate ( <i>shangsu lu</i> )	-
12. Rate of complaints through petitions ( <i>xinfang tousu lu</i> )	-
13. Rate of second trial ( <i>zaishen lu</i> )	-
14. Rate of cases actually enforced ( <i>shiji zhijie lu</i> )	+
15. Rate of disbursement of enforced cases ( <i>zhixing biaodi daowei lv</i> )	+

death of a party or one side applying for an adjournment. Although this will increase the enforcement termination rate, completion rate will be higher<sup>33</sup>. Another way to increase the completion rate is for judges to encourage the two parties to make a compromise. A compromise is less costly and is considered a complete case.

Besides the external evaluation conducted by a higher authority, a court also conducts an internal judicial evaluation. The political work department is in charge of the evaluation. The internal judicial evaluation includes the indicators in Table 3.3.

As shown in Table 3.3, the internal evaluation has more detailed indicators. But since the internal evaluation is conducted by the court itself, the impartiality of assessment is often violated.

Although the judge evaluation system can be easily manipulated, the results are important for a judge's career and well-being. As the Judges Law stipulates,

<sup>33</sup>Subject #33, interview with a judge, Jiangxi province, April 8, 2010.

“The results of the annual appraisal shall fall into three grades: excellent, competent and incompetent. The results of appraisal shall be taken as the basis for award, punishment, training, removal or dismissal of a judge, and for readjustment of his or her grade and salary. ” (Article 24) For example, as said in the Judges Law, “The salary of a judge who has been confirmed through appraisal as being excellent or competent may be raised in accordance with regulations” (Article 37). And as discussed previously, a judge will be dismissed if her annual evaluation ends up being incompetent for two successive years.

As civil servants, judges are also subject to a bureaucratic evaluation. The indicators in the bureaucratic evaluation are more general and hard to operationalize. It evaluates judges on four major dimensions: virtue (*de*), ability (*neng*), diligence (*qin*), and performance (*ji*). This evaluation is conducted by the Party organization department at the same territorial level. This evaluation is less important than the judicial evaluation and only used as a reference to assess a judge.

The judge evaluation system has become an effective instrument for higher authorities to incentivize judges for some desirable outcomes. During the period when I conducted my fieldwork, mediation rates carry a heavy weight in the evaluation system. This is because the current CCP general secretary Hu Jintao advocates a “harmonious society” idea which emphasizes avoiding litigation and minimizing possibilities of social conflicts. This Party principle is realized in the judge evaluation system through emphasizing mediation rather than adjudication. However, as a consequence, judges had an incentive to make up fake numbers for the mediation rate<sup>34</sup>.

It is important to note that not every basic court has a quantitative evaluation system as discussed in this section. The evaluation process consumes human and technical resources. The president of a basic court in Hainan province told me

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<sup>34</sup>Subject #30, interview with a judge, Jiangxi province, April 7, 2010.

that his court had not implemented an evaluation system. But he was considering establishing the evaluation system in his court, which he claimed to be the first basic court to have a quantitative evaluation system in Hainan<sup>35</sup>.

### 3.5 Court in a Political Environment

The current (2004) version of the Constitution guarantees judicial independence: “The people’s courts exercise judicial power independently, in accordance with the provisions of the law, and are not subject to interference by any administrative organ, public organization or individual.” (Article 126) However, this is not always the case. During the Cultural Revolution (1966-1976), the 1975 Constitution did not respect the independence of the judiciary. Instead, the 1975 Constitution stipulated that the “masses” should be involved in the judicial process: “The mass line must be applied in procuratorial work and in trying cases. In major counter-revolutionary criminal cases the masses should be mobilized for discussion and criticism.” (Article 25) This article remained in the 1978 Constitution with minor revisions<sup>36</sup>. The 1982 Constitution deleted this article and reemphasized judicial independence. But, as shown in the following discussion, this principle has never been realized.

The Chinese judiciary is not an independent branch. Chinese courts are embedded in and, therefore, constrained by various Party and government organizations. This section examines the external environment in which a Chinese basic court is embedded. The external environment is comprised of the Party committee, the political and legal committee, the government, the local congress, the intermediate court, and the procuratorate.

According to the Constitution, the basic people’s court is at the same rank as

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<sup>35</sup>Subject #8, interview with a basic court president, Hainan province, March 15, 2010.

<sup>36</sup>Article 41 in the 1978 Constitution: “With regard to major counter-revolutionary or criminal cases, the masses should be drawn in for discussion and suggestions.”

the county government, since they are all elected by the county people's congress. However, in reality, because of the fiscal dependence of courts on the government, the court is merely considered a functional department under the government.

The county Party committee is the principal of the county basic court. As discussed in the previous section, the nomination of the court president needs to be approved by the county Party committee. The county Party committee micro-manages the county basic court through the court Party committee. As a basic court president (also Party secretary) commented, "The leadership of the Communist Party is realized through the Party committee in the court. The court Party committee is an agency of the county Party committee and, therefore, is under the leadership of the county Party committee. The court Party committee needs to understand and implement the decisions of the county Party committee."<sup>37</sup> The county Party committee only provides guidelines for the basic court and rarely intervenes in individual cases unless the case is especially politically sensitive, such as corruption cases or cases that can potentially provoke social unrest. It is worthwhile to note that the basic court president rarely sits in the county Party committee standing committee. This means that the court president is not in the core decision-making organ of the county and is usually not informed of the Party committee decisions beforehand.

The county political and legal committee (*zhengfa wei*) is the supervisor of the basic court. The county political and legal committee is first of all a branch of the county Party committee. The secretary of the political and legal committee is a member in the county Party committee standing committee. The secretary is usually also the director of the county police department<sup>38</sup>. The county polit-

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<sup>37</sup>Subject #8, interview with a basic court president, Hainan province, March 15, 2010.

<sup>38</sup>As commented by a police school chancellor (Subject #2, Hainan province, March 8, 2010), county court presidents used to chair the political and legal committee. But several years ago, a central Party document requires that county police department directors chair the political and legal committees. However, the chancellor also noted that this requirement is not completely enforced. In some places, court presidents still chair the political and legal committees, whereas some

ical and legal committee's work is to coordinate all formal legal organizations in the county, which include the police department, the court, the procuratorate, and the legal bureau (*sifa ju*). A concrete example is the so-called "three-heads meeting" (*sanzhang huiyi*). The political and legal committee secretary convenes the court president, the procuratorate president, and the police department director for "three-heads meetings" if a case meets one of the following four conditions<sup>39</sup>: (1) the case potentially provokes collective protests, (2) the case has great social influences, (3) the case has great influences on the economic development of the locality, and (4) the case involves vicious crimes (such as serial murders). During the meetings, the three or four heads come up with a plan. The political and legal committee secretary sets the tone and principles, and the three organizations implement. The political and legal committee does not intervene in ordinary cases. A court president also commented that it is important for the three heads to reach a consensus for important cases. The meetings coordinate the actions of the three organizations. A situation where the police department arrests, but the procuratorate does not sue and the court does not sentence should be avoided. In these cases, the court should be involved before the case is filed at the court<sup>40</sup>.

The county government is the "purse" of the basic court. The county government finances the basic court. Courts depend on local governments for basic necessities, including judges' salaries and bonuses, office supplies, vehicles, court buildings, etc. As discussed in details in Chapter V, before 2008, local court expenditures completely depend on local budgets. Each year, the basic court prepares a budget submitted to the county government, and the county government allocates a certain proportion of the budget to the court. This proportion varies across space.

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counties have full-time political and legal committee secretaries. I am unable to identify this central Party document.

<sup>39</sup>Subject #5, interview with a county political and legal committee secretary, Hainan province, March 15, 2010.

<sup>40</sup>Subject #8, Hainan province, March 15, 2010.

As shown in Chapter V, in economically developed areas, the court funds are guaranteed, whereas in underdeveloped areas the funds are often delayed or reduced and, therefore, are not adequate to run the court properly. The county government also intervenes in individual cases if the case involves a local enterprise. As discussed in the previous section, if the court enforces a court decision that harms a local enterprise, the county government often intervenes to protect the local enterprise for the sake of maintaining economic development and tax revenues.

The county people's congress is the *de jure* principal of the county court. This is reflected in three aspects:

1. All the major positions (such as president, vice-presidents, judicial committee members, chief judges and associate judges of divisions) are appointed by the county congress or the congress standing committee;
2. The county court is responsible and accountable to the county congress. Each year, the court president reports to the county congress. And the report is subject to a vote by the representatives;
3. The county congress supervises the county court.

But in practice, as discussed in the previous section, all the major positions are appointed by Party committees at various levels. The county congress only needs to pass the nominations. And the local congresses rarely veto the court reports and practice supervisions over courts. This situation has been changing in the last two decades. As Cho (2003) argues, legislative supervision over courts has been strengthened since the 1990s. The supervisory measures include appraisal (*pingyi*) of judicial officers and work, individual case supervision (*gean jiandu*) and the system of investigating the responsibility for misjudged cases (*cuoan zeren zhuijiuzhi*). As documented in Cho (2003, 1073-1074), people's congresses in Henan investigated 27,964 cases of economic disputes handled by courts, and thoroughly ap-

praised 3,055 selected cases in 1999. They also forced courts to redress problems and punish related personnel after the supervision. For individual case supervision, people's congresses first carefully select targets among public complaints and cases identified through other forms of supervision. Then people's congresses investigate the cases. Finally, they require courts to correct problems within a certain time, and punish related persons, for instance by dismissal (Cho, 2003, 1074). As Cho (2003, 1074) argues, "Courts generally accept the demands of people's congresses when these demands are based on evidence obtained through intensive investigation. So the supervision is evaluated as the most effective measure of dealing with courts." However, during my interviews, a legal work committee<sup>41</sup> director in a county people's congress commented that it is very hard for congresses to supervise courts because of lack of human resources, financial resources, and legal knowledge<sup>42</sup>. And also, most local congresses terminated supervision of individual cases after The Supervision Law of Standing Committees of People's Congresses at Various Levels (The Supervision Law hereafter) became effective on January 1, 2007<sup>43</sup>. The Supervision Law does not grant congresses the authority to supervise individual cases.

Cho (2003) argues that the legislative supervision matters; for example, people's congresses have dismissed more and more judicial officers after supervision. For example, in 2000 alone, people's congresses in Huaihua city of Hunan discharged three judges. People's congresses can also veto the work reports delivered by court presidents as a criticism. In 2001, the people's congress in Shenyang city, Liaoning province, vetoed the work report delivered by the president of Shenyang intermediate court. In 2007, the people's congress in Hengyang city, Hunan province, vetoed the work report delivered by the president of the

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<sup>41</sup>The legal work committee (*fagong wei*) in congresses are responsible for supervising courts.

<sup>42</sup>Subject #31, interview with a county congress official, Jiangxi province, April 7, 2010.

<sup>43</sup>Please see an example in Wenzhou's congress at [http://www.wenzhou.gov.cn/art/2009/6/1/art\\_6942\\_584.html](http://www.wenzhou.gov.cn/art/2009/6/1/art_6942_584.html).

Hengyang intermediate court.<sup>44</sup>

The intermediate court is the professional leader of the basic court. This means that the intermediate court and the basic court are in a *professional (yewu)* relationship in which the intermediate court cannot issue binding orders to the basic court (Lieberthal, 2004, Chapter 6). The intermediate court has three ways to control the basic court: (1) The intermediate court, with the municipal Party committee, nominates a candidate for the president of the basic court; (2) The intermediate court conducts judicial evaluations of basic courts; (3) The intermediate corrects misjudged cases after appeal. Evaluation and correction of misjudged cases are two critical instruments to monitor basic courts. So although the intermediate court cannot issue binding orders to the basic court, the basic court often respects the suggestions from the intermediate court.<sup>45</sup>

The county people's procuratorate is the collaborator of the basic court. The people's procuratorate is the public procurator. The procuratorate monitors the court in two ways: (1) The chief procurators of the people's procuratorates at the corresponding levels may attend judicial committee meetings without voting rights<sup>46</sup>; (2) If the Supreme People's Procuratorate finds some definite error in a legally effective judgment or order of a people's court at any level or if the people's procuratorate at a higher level finds such error in a legally effective judgment or order of any people's court at a lower level, it has the authority to lodge a protest (*kangsu*) in accordance with the procedure of judicial supervision.<sup>47</sup> But, in practice, this protest authority is rarely practiced. According to a report, during the period of 2003-2008, the second procuratorate of Beijing only protested 89 out of

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<sup>44</sup>Please see <http://www.rdyj.com.cn/inc/ShowArticle.asp?artid=1849&catid=16> for a discussion of the two cases.

<sup>45</sup>Subject #13, interview with a basic court political work department director, Guangdong province, March 24, 2010.

<sup>46</sup>The Organic Law Article 11

<sup>47</sup>The Organic Law Article 14.

more than 50,000 criminal cases (0.178%)<sup>48</sup>.

In general, the basic court is embedded in a power network where the Party committees and governments hold strong sway over courts and other *de jure* organizations, such as people's congresses and procuratorates, are gaining *de facto* powers very slowly.

### **3.6 Court, Economic Development, and Social Stability**

As discussed in the theory chapter, local officials in China have two major goals: promoting economic growth and maintaining social stability. Since local courts are controlled by Party committees and governments at various levels, courts are expected to help local officials fulfill these two goals. This section draws on several cases to illustrate how courts assist local governments in developing local economy and maintaining social stability.

#### **3.6.1 Economic Development**

Courts are becoming a major avenue of dispute resolution and contract enforcement in China. A strand of literature in Chinese politics argues that China is able to achieve a high growth rate without a strong legal system because the cadre evaluation system (Clarke, Murrell, and Whiting, 2008) and the decentralized fiscal system (Oi, 1992) incentivize local officials to protect local businesses. Unlike the existing literature, I argue that courts play an important role in protecting local firms which contributes to China's rapid economic growth. However, legal protection is exclusive to businesses that contribute to local tax revenue or have political connections. Legal means of favoring local firms include making unfair adjudications or postponing/expediting case proceedings.

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<sup>48</sup>Please see <http://www.criminallawbnu.cn/criminal/Info/showpage.asp?pkID=22640>.

A county political and legal committee secretary told me a story about how he instructed the county court to favor an incoming business<sup>49</sup>:

Several years ago, an oil and gas exploration company came to the county to explore. During that period, the workers of the exploration company had some conflicts with the local villagers, and five villagers were beaten to death by the workers. The political and legal committee immediately convened a “three-heads meeting” to discuss this case. The conclusion was that if the court made a harsh judgement against the workers according to the law, it would hurt the exploration company. And if the company could explore oil and gas in the county, it was conducive to the long-term economic development of the county. And also, if the court made a harsh judgement (e.g. death penalty), the villagers’ families would not be compensated. So the “three-heads meeting” set a tone that the court judgement should be lenient. After the case was transferred to the court, the defendants (the workers) were only sentenced a 3-year prison term, and the sentence was suspended. The principle of dealing with this sort of cases is that if a court judgement is detrimental to economic development of the county (for example, the defendant is a local firm), the sentence should be lenient; if a case has provoked significant social reactions, the sentence should be harsh. However, this principle should be carried out in accordance with the law, and this principle is consistent with the Party spirit.

Obviously, receiving merely a 3-year prison term after beating five people to death is not “in accordance with the law.” To attract a potential “tax payer,” the county officials colluded to force the court to make an unfair adjudication. An-

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<sup>49</sup>Subject #5, interview with a political and legal committee secretary, Hainan province, March 15, 2010.

other way to protect local businesses is to postpone case proceedings if the case is detrimental to local firms, and to expedite them if they are beneficial to local firms.

A lawyer commented on a case involving Hisense-Kelon. Hisense-Kelon is a domestic electrical company located in Guangdong. The company produces home appliances such as refrigerators, air-conditioners, and TVs. Several years ago, lots of small stock holders sued Hisense-Kelon for hiding information on the stock market. The lawsuit was accepted by a court in Foshan city. To protect the interests of Hisense-Kelon, the local court postponed the case for a long time until the small stock holders agreed to compromise with Hisense-Kelon outside the court. The lawyer remarked that this is very common, because companies all have tricks to deal with lawsuits. The lawyer also said that there is an internal court document that spells out the principles of dealing with this sort of sensitive case: “accept but do not hear the case, hear but do not decide the case, decide but do not enforce the case (*lian bu kaiting, kaiting bu panjue, panjue bu zhixing*).”<sup>50</sup>

Local protectionism (*difang baohu zhuyi*) is particularly strong when exit of businesses constitutes a threat to the revenue base of local governments. During the financial crisis in 2008 and 2009, many small manufacturing firms went bankrupt in Guangdong province. At the same time, because of the newly enacted Labor Contract Law, employees started to use their legal weapons to demand better labor protection and welfare benefits. Local courts, however, were instructed to favor local firms rather than the employees, which violated the spirit of the new Labor Contract Law.

A judge told me about a case where three people lost their lives because of a minor labor dispute. A Taiwanese or Hong Kong firm delayed the salaries of the workers. A worker sued the firm in the local court for a compensation of 10,000 yuan (about 1,400 dollars). After the court leadership’s intervention, the court

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<sup>50</sup>Subject #20, interview with a practicing lawyer, Guangdong, March 29, 2010.

judged against the workers. The firm was informed of this decision before the judgement was even announced. The firm managers showed off this case everywhere. After losing the case, the workers found a gun somewhere and killed two firm managers, and they were sentenced to death penalty. The judge remarked that, "because of merely 10,000 yuan, three people lost their lives; it is really not worth it. This is completely because of judicial unfairness. The court judgement is directed by the court president to protect the interests of local businesses rather than the interests of workers. For the firm managers, they didn't care about the money; they wanted to highlight this case to prevent other workers from suing the firm." The judge also commented that there are some informal rules in courts to limit workers' ability to pursue their own interests through legal means. For example, for this sort of labor dispute, some courts set a 10% correction bar, that is to say, an intermediate court only corrects up to 10% of the cases appealed from basic courts. For most cases, if one side (usually the employees) is unsatisfied with the first instance judgement, she can appeal, but few are corrected. Most second instance judgements keep the original judgements to protect the employers' interests.<sup>51</sup>

Local favoritism has become an informal rule that was prevalent during the economic crisis. A lawyer told me that he, through some informal channels, obtained a copy of the internal meeting minutes of an intermediate court. The minutes implicitly state that the court should favor the employers when adjudicating labor disputes. The lawyer remarked that there are two considerations for the court: first of all, if the court decides that the employees win, more employees will follow the precedent to sue their employers, and the many lawsuits burden the court; secondly, courts do this to protect local firms, and courts can list this as one

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<sup>51</sup>Subject #19, interview with a judge, Guangdong province, March 28, 2010. The 10% correction bar is also verified by subject #22, interview with a lawyer, Guangdong province, March 29, 2010.

of their achievements when they report to congresses.<sup>52</sup>

The rationale of protecting local firms is beyond the consideration of economic development; it is also related to maintaining social stability. A judge in an intermediate court revealed her opinion on the new Labor Contract Law. She said that,

“After the new Labor Contract Law became effective, many lawyers urged workers to sue their employers. For example, now there were many cases that involved situations where workers asked for compensation and overtime pay when a formal labor contract is not signed<sup>53</sup>. Lawyers often encouraged workers to file lawsuits. And because the new Labor Contract Law gives a 2-year term limit for this sort of disputes, many workers sued on their previous cases. And during the economic crisis, many firms were on the brink of bankruptcy, employees took this advantage to ask for compensation of overtime pay. Lawyers made lots of money by taking these cases. And under the persuasion of lawyers, workers usually did not accept mediation; many of them then appealed. For this type of case, the court’s principle is to expedite adjudication and mediate before the trial. Previously (before the economic crisis), courts tended to protect the interests of laborers; but during the economic crisis, we must take firms’ interests into account. For example, if a firm pays its employees well above the minimum wage, even if the workers do not get overtime pay, the workers already make enough money. The court usually does not accept this type of case. In addition, we need to consider the financial resources of a firm. We cannot make a firm bankrupt because of several workers. And if the

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<sup>52</sup>Subject #22, interview with a lawyer, Guangdong province, March 29, 2010.

<sup>53</sup>The new Labor Contract Law stipulates that employees should receive double overtime pay if a formal labor contract is not signed.

firm went bankrupt, many more workers will be unemployed, and this would cause social unrest.”<sup>54</sup>

In addition to legal favoritism, courts also provide regular legal services to local firms to reassure that the court will be helpful when the firm has a dispute. An economic division chief judge in a basic court said that his court often visits local enterprises located in the industrial park to provide legal service and consultancy. He told me that if the court serves well, the firms will add a term when they sign contracts with firms outside the county: “Should a dispute occur in the future, we agree to settle it in the county basic people’s court.” Firms are reluctant to settle a dispute in the court that is on the other’s side, because of local protectionism.<sup>55</sup>

These cases suggest that there is legal protection of properties in China, even though the protection is selective and exclusive.

### 3.6.2 Social Stability

A natural question to ask after considering the cases discussed above is how to repress social discontent with such a degree of judicial unfairness? The following paragraphs discuss ways in which local governments, along with legal institutions, control social discontent created by the unfair judiciary.

First of all, the Chinese Communist Party established new institutions to channel social discontent. For example, during the economic crisis in 2008 and 2009, because of large number of labor disputes, Guangdong province established the “Office of Comprehensive Management, Letters and Visits, and Maintaining Social Stability (*Zongzhi xinfang weiwen bangongshi* or *Zongzhi ban*)” at the township level (including street committees in urban areas) to handle minor disputes. Other provinces, such as Zhejiang, also established similar organizations. *Zongzhi ban*

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<sup>54</sup>Subject #28, interview with a judge, Guangdong province, March 31, 2010.

<sup>55</sup>Subject #35, interview with a division chief judge, Jiangxi, April 8, 2010.

is composed of people from the local police departments, labor bureaus, offices of letters and visits (*xinfang ban*), and legal bureaus. If a dispute occurs, *Zongzhi ban* is the primary channel. Usually, people do not go to court directly, because litigation is costly and time consuming. Settling a dispute in *Zongzhi ban* is free, and because *Zongzhi ban* is a governmental organization, it is easier to enforce a settlement when coordinating within the government.<sup>56</sup>

As shown in the theory chapter, local officials' careers are tied to the degree of social stability of their jurisdictions. The central government sets several "fire alarms" to monitor local societal problems, such as letters and visits (*xinfang*). By writing letters to and visiting the local offices of letters and visits (*xinfang ban*), citizens can express their grievances caused by unjust government actions or judicial decisions. However, because of collusion of governmental organizations, the local offices of letters and visits have neither incentives nor capabilities to help the grieved citizens secure their rights against the government. Many petitioners have to skip levels to petition (*yueji shangfang*), and some of them go directly to Beijing to complain to the central government, for they believe that central leaders are more benevolent than local leaders (Li, 2004).

A political and legal committee official told me that judicial favoritism and corruption have created a significant amount of letters and visits, which call attention to the center. As a consequence, governments at all levels are concerned with letters and visits and try everything to block petitioners. This is due to the consideration of maintaining social stability. The center has issued a document which stipulates that if the number of letters and visits surpasses a certain threshold in a locality, the local officials cannot be promoted. But this type of constraint cannot really reduce judicial unfairness for two reasons. First of all, judicial unfairness is very difficult to uncover; most unfair cases are covered up at the local level. In ad-

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<sup>56</sup>Subject #18, interview with a political and legal committee official, Guangdong province, March 28, 2010.

dition, local governments have ways to prevent petitioners from going to Beijing. For example, one of the important tasks of local police is to catch the petitioners (*jiefang*). There is a police office besides the State Bureau for Letters and Visits (*Guojia xinfang ju*). All local governments need to please the police officers there, because they have the information on the petitioners. Local governments manage to track the information from the police officers and capture the petitioners.<sup>57</sup>

I myself overheard one of these “catching” actions when I had lunch with a county police department director. It was during the period of “two conferences” (*lianghui*): the annual conferences of The National People’s Congress (NPC) and The Chinese People’s Political Consultative Conferences (CPPCC). During the “two conferences,” people’s representatives from all over the country go to Beijing along with thousands of journalists. This is the best time of the year for petitioners to get heard. There were two petitioners from the county who went to Beijing to petition. The police department director got a call during lunch learning this news, and he immediately ordered five policemen to travel to Beijing to catch the petitioners. Several days later, I interviewed the associate director who was sent to Beijing for the task. He said that, “To hide from the police, the two petitioners took a train to Baoding city, Hebei province, and then they took a long-distance bus to Beijing. We took an airplane. We went to the State Bureau for Letters and Visits and Tiananmen Square to search for them. Finally, we found them in a hotel near Tiananmen Square. The petitioners were surprised when caught, saying ‘how could you find us in such a large city?’” I asked the associate director how they tracked the petitioners, and he said the police department had its own tactics.

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Non-governmental organizations, such as law firms, are also mobilized to main-

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<sup>57</sup>Subject #18, interview with a political and legal committee official, Guangdong province, March 28, 2010.

<sup>58</sup>Subject #6, interview with a police department associate director, Hainan province, March 15, 2010.

tain social stability. A lawyer told me that to avoid collective unrest caused by judicial unfairness, the government establishes several “fire alarm” mechanisms. One of them is that if a lawyer takes a labor dispute case that involves more than 10 plaintiffs, the lawyer should report this case to the local legal bureau. The judicial decision on this type of case might be different from other cases that only involve a small number of people.<sup>59</sup>

Another way to cover judicial unfairness is through emphasizing procedural justice. A legal scholar told me that if a judge must make a biased judgement, she usually follows the legal procedure very strictly so that, if the case is appealed, the judge can claim that her legal knowledge or skills are not adequate or she did not fully apprehend the nature of the case, so nobody can punish her for lack of legal professionalism. But actually the judge made an unfair judgement intentionally.<sup>60</sup>

This is further verified by a conversation that I had with another judge. During the economic crisis, the judge’s court accepted a lot of labor disputes. Following the guidelines from the local government, the court adjudicated all the cases in a way that favored the employers. Below is our conversation<sup>61</sup>:

Me: Do you fear provoking collective protests if your court always favors the employers when adjudicating labor disputes?

The judge: In this case, we must follow the legal procedure very strictly.

We need to find enough evidence!

The material I have presented here all suggest that social stability is a concern for local officials and judges, but social stability is not maintained through achieving judicial fairness. Judicial fairness is not a necessary condition for pacifying

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<sup>59</sup>Subject #22, interview with a lawyer, Guangdong, March 29, 2010.

<sup>60</sup>Subject #27, interview with a legal scholar, Guangdong province, March 31, 2010.

<sup>61</sup>Subject # 28, interview with a judge, Guangdong province, March 31, 2010.

litigation-related social unrest. Social stability is maintained through the repressive apparatus.

### **3.7 Concluding Remarks**

Drawing from qualitative interviews, laws and regulations, and government documents, this chapter spells out the setup of China's judicial system, the institutional details of Chinese local courts as a legal organization and a bureaucratic organization, the formal and informal rules embedded in courts, the political environment of local courts, and the roles that courts have played in promoting economic development and maintaining social stability. The major findings of this chapter can be summarized in the following several statements:

- The Chinese judicial system is highly decentralized; local courts depend on local Party committees and governments. The center has ineffective mechanisms in monitoring local courts;
- Court as a legal institution is egalitarian in the sense that all judges have equal authority, whereas the court as a bureaucratic organization is hierarchical, where judges with administrative posts exert significant influence on ordinary judges. The bureaucratic nature triumphs the legal nature;
- Informal rules subvert formal rules in major aspects of running a court: appointment, removal and dismissal, and evaluation of judges, Party leadership in judicial affairs, and government interposition in individual cases;
- Courts lack fiscal autonomy; Local court funding almost completely depends on local governments;
- Courts selectively protect properties of local firms;

- Judicial unfairness and corruption has been a major reason for social unrest, but it is very hard for the center to detect it because of local repression.

One contribution this chapter makes to the Chinese politics literature is that, unlike the existing literature which emphasizes bureaucratic protection of properties, it shows that Chinese courts do protect properties, even though this protection is selective. Scholars who seek to explain the puzzle of China's economic growth assume that formal legal institutions are universally weak (Clarke, Murrell, and Whiting, 2008). However, as this chapter shows, courts in China have played an important role in protecting the interests of businesses.

This paper also casts doubts on the argument that the judiciary has become an effective mechanism for the central government to monitor their local agents (Ginsburg (2008)). As shown in the discussion, local courts often collude with local governments in denying citizens' legal rights. And some of the "fire alarms" set by the center such as "letters and visits" are ineffective because of repression of local governments.

## CHAPTER IV

# When Do Authoritarian Rulers Build Less Corrupt Courts: Sub-National Evidence from China

### 4.1 Introduction

This chapter tests one observable implication of the theory: foreign capital reduces judicial corruption.

I argue that foreign capital's influence is a major factor that contributes to building clean courts in China. Foreign invested enterprises (FIEs) have a stronger preference for judicial fairness compared to domestic enterprises because 1) FIEs are not as competitive as domestic enterprises in seeking government protection of property rights; 2) FIEs are subject to stricter and more transparent internal auditing and operating rules imposed by their countries of origin. Hence, foreign investors exert stronger pressure than domestic investors for a fair and reliable legal system. Local governments, relying on FIEs for promoting economic growth, are likely to respond to foreign investors' call by strengthening local courts. This chapter tests this hypothesis quantitatively using two data sets compiled from survey data and government released yearbooks at the county level and prefectural level respectively.

This chapter has six sections. The next section tests the theory using an origi-

nal cross-sectional data set of 102 randomly selected Chinese counties. Using OLS and 2SLS regressions, the analysis shows that the weight of foreign capital in the local economy has a significantly positive effect on enhancing judicial integrity. The subsequent section verifies the findings analyzing a cross-sectional data set of 120 Chinese cities. Using World Bank's survey data, the analysis shows that the positive effect of foreign capital also exists at the prefectural level. In addition, multi-level statistical analysis shows that provincial court spending also has a significantly positive effect on investors' confidence in courts at the prefectural level. The fourth section tests two rival explanations: a social capital explanation and a *guanxi* explanation. The final section then concludes with a summary of findings and broader significance of the research.

## **4.2 Empirical Evidence from County-Level Data**

This section tests the theory using county-level data. In the following, I will derive one testable hypothesis, introduce the dataset, and propose potential ways to measure key variables in the model. Two key variables wait to be measured: degree of judicial corruption and foreign capital. The unit of analysis is county, county level districts, or county level cities.

### **4.2.1 One Testable Hypothesis**

Based on theoretical discussions in the theory chapter, one hypothesis is generated:

*Hypothesis 4.1: Foreign capital reduces corruption in local courts. As the weight of foreign capital increases in local economy, the degree of corruption in local courts decreases, ceteris paribus.*

## 4.2.2 Data and Measurement

The quantitative data used in this chapter is drawn from a survey of the Institutionalization of Legal Reforms in China (ILRC) 2003, conducted by the Research Center of Contemporary China (RCCC) at Peking University. This survey interviewed a national probability sample of 7,714 respondents (i.e., completed interviews) on a wide range of items related to their attitudes and behavior in dispute resolution. All respondents are Chinese adult citizens among which 79.3% are rural citizens<sup>1</sup> and 20.7% are urban citizens.

The ILRC survey employed spatial sampling technique to draw a national sample of Chinese adults in 2003<sup>2</sup>. The primary sampling units (PSUs) of the sample were counties and county level units (county-level cities or urban districts). Using provinces as strata, 102 PSUs were selected by PPS (probability of selection proportional to measure of size, i.e. population), and within each county, two townships were also drawn by PPS. Tertiary sampling units (TSU) are cells of spatial grids drawn for each township, namely a half square minute of latitude and longitude. This method is based on population density rather than population size. To be specific, the sample space (township) was divided into a GIS (geographic information system) grid that linked specific cells to the boundary map of the township. TSUs were drawn by PPS technique. Figure 4.1 and 4.2 show examples of spatial sampling units in an urban area and a rural area respectively. Trained surveyors equipped with GPS receivers were then sent to locate and enumerate the sampled “spatial square seconds,” or SSS. In order to maintain equal probabilities of selection across households, all dwellings enumerated in the SSSs were included in the sample. Respondents were selected from each dwelling using the Kish grid

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<sup>1</sup>Rural citizens do not necessarily live in rural areas. It just means they are registered in rural areas (or have a rural *hukou*)

<sup>2</sup>For more details about spatial sampling technique used in the ILRC survey, please see Yan, Landry, and Ren (2009). For a general introduction of the spatial sampling, please see Landry and Shen (2005).

method<sup>3</sup>. The advantage of using spatial sampling is to overcome coverage problems in sample frames based on formal household registration (*hukou*), since 11.1% of the total population in China are migrants who are not registered.



Figure 4.1: Example of Spatial Sampling Units in an Urban Area

*Source: Landry (2010b)*

There are 102 counties in total, across all 31 provinces and provincial level units of the country, and from the coastline areas to the remote western regions. Figure 4.3 shows the locations of the samples. They vary a great deal in terms of level of economic prosperity and fiscal condition. I compiled a unique cross-sectional data set using the survey data and data collected from various sources ranging from yearbooks to government websites.<sup>4</sup> All variables in the data set are measured in

<sup>3</sup>Please see Kish (1965, 398-399).

<sup>4</sup>Data sources include the University of Michigan's China Data Center <http://chinadataonline.org/>, 2003 Statistics Report on Finance in All Chinese Counties edited by the Ministry of Finance, and China Statistics Yearbooks published by the National Bureau of Statistics.

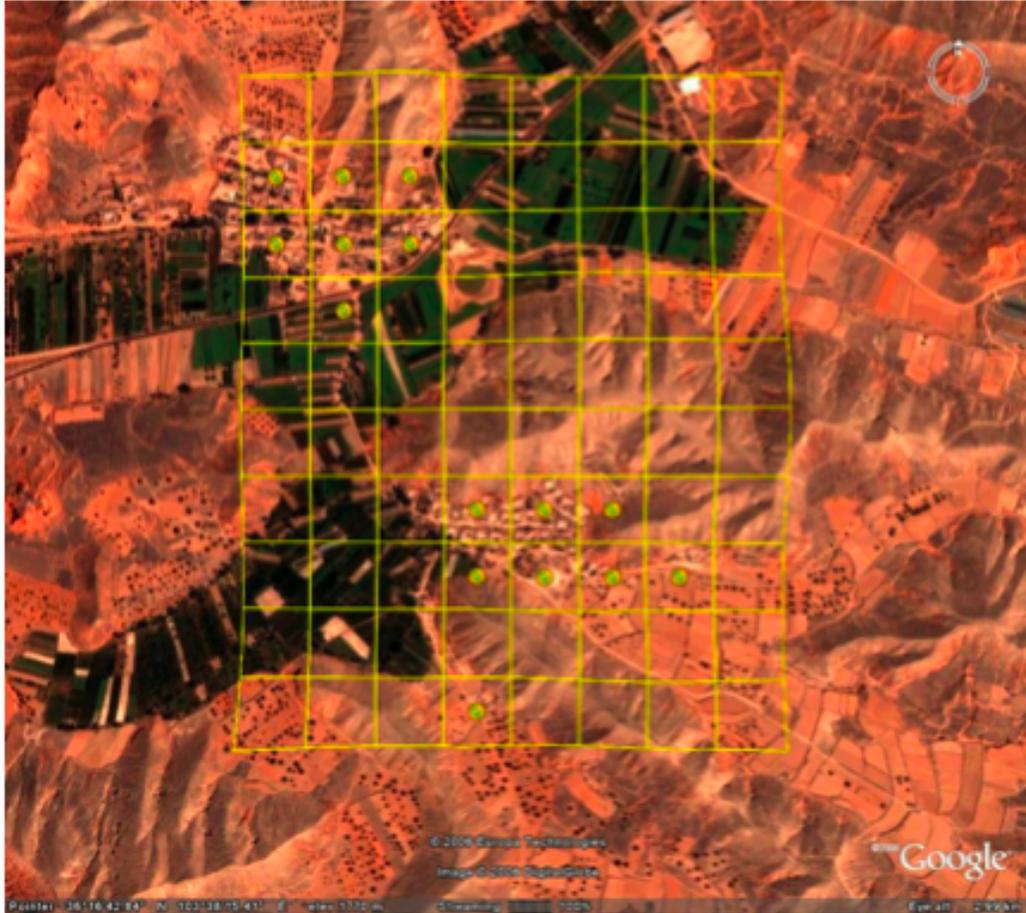


Figure 4.2: Example of Spatial Sampling Units in a Rural Area

Source: Landry (2010b)

2003.

Corruption is broadly defined as the abuse of public power for private gain (Bardhan, 1997). Li (2010, 198) distinguishes judicial corruption into three types. Type A involves cases where corrupt judges have physically abused litigants, illegally seizing and detaining them by force. Type B represents corrupt conduct without exchange between the judge and litigants, such as embezzlement, misappropriation of assets, swindling litigants, and serious negligence. Type C represents mainly bribery and favoritism. Although this research cannot make this distinction due to data limitations, I assume that it is the third type that was re-

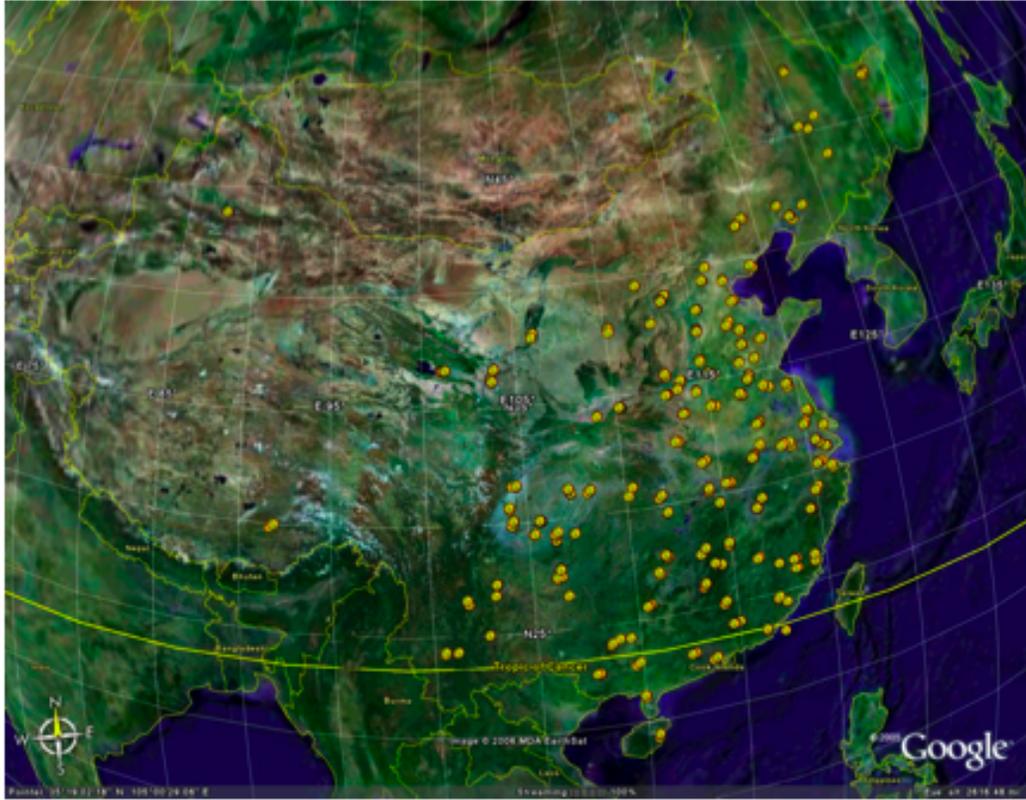


Figure 4.3: Locations of Counties in the Sample

*Source: Landry (2010b)*

flected in respondents' minds, since the former two types of corruption cannot be observed by the public.

This chapter uses respondents' subjective evaluation of basic people's courts to measure the degree of judicial corruption<sup>5</sup>. I use basic people's courts as the focus of this study because they are the first ladder in the Chinese legal system which the majority of the litigants need to go through. Most legal cases in China are dealt

<sup>5</sup>Most existing measures of corruption are subjective. Two indexes of perceived corruption have become the most commonly used in empirical work - the Corruption Perceptions Index (CPI) constructed by Transparency International (TI) and a rating of control of corruption published by a team led by Daniel Kaufmann at the World Bank (WB). A third cross-national corruption rating produced by the firm Political Risk Services (PRS), based on evaluations by its network of experts and published in its International Country Risk Guide (ICRG). All three of these measures are based on the subjective evaluations of experts or survey respondents of how widespread or costly corruption is in particular countries. For a review of ratings of corruption, please see Treisman (2007).

with daily by over 3,000 basic people's courts all over the country. While people might feel the Supreme Court in Beijing is far away, they probably would feel that the basic people's court located at the center of their county is very familiar and, therefore, are well-informed about it.

I admit that the public's view of local legal environment might be different from investors' views, for example, the public might have more positive or more negative evaluations of the local courts compared to investors. The next section will use business survey data to verify the findings in this section.

Since very few respondents (9% in civil disputes, 7% in economic disputes, and 7% in administrative disputes) had ever encountered a dispute of any kind, the survey questionnaire includes three vignettes, as shown below, tapping respectively three types of disputes to solicit respondents' evaluation of local courts.

### **Three Vignettes Tapping Three Types of Disputes**

#### Civil dispute

*Since you have not had such experiences, let's use a hypothetical case to understand your views. The labor contractor of a construction site has been embezzling the workers' wages, and the workers were denied their demands for payment numerous times. If you are one of the workers, what would you do? Would you take action to settle the dispute, or would you not do anything?*

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#### Economic dispute

*Since you have not had such experiences, let's use a hypothetical case to understand your views. To help a township business through some financial difficulties, a township government borrows 100,000 yuan from villager Wang Lin. The agreement lays down that this amount should be repaid in two years. But two years go by, and the amount has still not been repaid. If you are Wang Lin, what will you do? Would you take action to settle the dispute, or would you not do anything?*

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#### Administrative dispute

*Since you have not had such experiences, let's use a hypothetical case to understand your views. Zhang Jie is an individual industrial household with a license to set up his stall. But the relevant authority found his stall detrimental to aesthetic of the city, and thus confiscated his goods and fined him. If you were Zhang Jie, what would you do? Would you take action to settle the*

*dispute, or would you not do anything?*

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Most respondents (76% in civil dispute, 78% in economic dispute, and 60% in administrative dispute) chose to take actions if they confronted with any of these three situations. They are then offered up to three options to settle the dispute: mediation, administrative arbitration, and legal litigation. As far as this research is concerned, only a minority (35% civil, 30% economic, and 28% administrative) chose to go to court.

The dependent variable is constructed using answers given by respondents who did *not* choose to go to court.<sup>6</sup> The survey asked these respondents why they chose not to go to court, and they could choose up to 11 reasons.<sup>7</sup> One quantity pertinent to our interests is calculated: the proportions of respondents in each county who chose “Courts are corrupt” ( $P_c$ ).<sup>8</sup> A variable “*corruption*” is constructed by adding up proportions of respondents who chose “Court is corrupt” in three types of disputes and then normalizing to 1:

$$corruption = \frac{P_{c*civildispute} + P_{c*economicdispute} + P_{c*administrativedispute}}{3} \times 100\%$$

There is an advantage of using survey data to measure judicial corruption: since respondents were firstly put in the context of three hypothetical cases, the sensitivity of these questions are much toned down, and thus the validity of the questions are enhanced. However, there are several potential challenges to the validity of the measure. First of all, respondents’ evaluations might simply be the

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<sup>6</sup>I only selected respondents who chose not to go to court because they are the majority and therefore are more representative of the population. In contrast, respondents who chose litigation are too few (around 20% of the sample) and therefore underrepresent the population.

<sup>7</sup>The options include: 1. Fees were too high; 2. In this locality, we don’t have the practice of going to court; 3. Too unkind to go to court; 4. Court is corrupt; 5. Was not aware that one could go to court for these matters; 6. Should not go to court for these matters; 7. The process is too complicated and troublesome; 8. Uses too much time; 9. Courts side with the government (*only asked in administrative dispute*); 10. The dispute was already settled; 11. Other.

<sup>8</sup>The data is weighted by taking into account sampling design effects.

results of media influence. One instance could be that if more corrupt cases were uncovered by the public media, respondents would be more likely to feel that their local courts were corrupt; the other instance is that respondents have confidence in local courts because of positive media propaganda. A second challenge to validity is social desirability. After all, questions about corruption are sensitive. And saying "court is corrupt" to an interviewer from outside might give the outsider a bad impression of the county. If this is the case, respondents who grew up in that locality are more likely to "save face" by not saying "court is corrupt" than respondents who came to that locality from outside.

To validate the measure of judicial corruption using survey data, I examine individual level characteristics that could potentially influence respondents' evaluations of courts. The two potential challenges discussed above can be phrased into two null hypotheses:

*Null Hypothesis 4.2: Respondents' exposure to public media is correlated (positively or negatively) with their evaluations of judicial corruption in local courts, ceteris paribus.*

*Null Hypothesis 4.3: Respondents who grew up in the locality are less likely to say "court is corrupt" than those who came from outside, ceteris paribus.*

For the measure to be valid, both null hypothesis 4.2 and null hypothesis 4.3 should be rejected.

Using *individual level* data collected in the same survey, I estimate a model to test these two null hypotheses. I coded the dependent variable "**perceived corruption**" as a dichotomous variable which equals 1 if the respondent chose "court is corrupt" in any of the three hypothetical cases and 0 otherwise. An explanatory variable "**media exposure**" is the sum of a battery of ordinal scales measuring respondents' usage of various media outlets including newspaper, magazine,

TV, and radio. Higher values mean more media exposure. To capture whether a respondent was interested in political and legal issues covered by public media specifically, two other variables are constructed. One dichotomous variable “**attention**” was coded 1 if the respondent chose “current issues” or “legal issues” as one of her top three attended topics in media and 0 otherwise<sup>9</sup>. Another variable “**interest**” measures respondents’ interest in politics. It is in ordinal scale with larger values meaning more interest<sup>10</sup>. A dichotomous variable “**local**” equals 1 if the respondent grew up in that locality and 0 otherwise. Controls include respondents’ party membership, satisfaction with their local leaders<sup>11</sup>, trust in courts, connections with officials in the police department, procurator, and court. Demographic variables include age, gender, and education.

An econometric model is specified as follows:

$$\begin{aligned} \text{perceived corruption} = & \beta_1 + \beta_2 \text{media} + \beta_3 \text{attention} \\ & + \beta_4 \text{interest} + \beta_5 \text{local} + X' \beta + \epsilon \end{aligned} \quad (4.1)$$

Table 4.1 reports results of the logistic regression. As shown, none of the media related variables (media, attention, and interest) are significant either individually or jointly ( $F_{(3,2273)} = 0.86, p = 0.46$ ). This rejects null hypothesis 4.2. This finding suggests that respondents’ evaluations of judicial corruption were not influenced by the public media. In addition, the variable “local” has a significantly positive effect, which means that respondents who grew up in the locality were more likely to say “court is corrupt” than those who came from outside. This rejects null hy-

<sup>9</sup>The original question was “Among the types of information provided by these various media, which three are you most concerned with?” Options include: current issues, economy, culture and sports, life, education, society, legal issues, technology, health, and others.

<sup>10</sup>The original question was “Some people care deeply about the affairs of the government, while others are not too interested. With regards to affairs of the government, are you very concerned, somewhat concerned, not very concerned, or not concerned at all?”

<sup>11</sup>The question was “In general, are you satisfied with the leadership of this village or this unit?”

Table 4.1: Who Said “Court Is Corrupt:” Complex Survey Design Effects Logistic Regression

Variable	Coefficient	(Std. Err.)
age	-0.124**	(0.061)
age <sup>2</sup>	0.002**	(0.001)
sex	0.067	(0.280)
edu	-0.106	(0.154)
ccp member	0.714	(0.470)
media exposure	-0.057	(0.069)
attention	0.316	(0.272)
interest in politics	0.089	(0.152)
local	1.214**	(0.478)
connection	0.928***	(0.303)
satisfaction	-0.567***	(0.154)
trust in courts	-0.679***	(0.196)
Intercept	1.335	(1.825)
<hr/>		
N	2276	
Population size	2.640e+08	
Design df	2275	
F (12,2275)	4.925	

\* $p < .1$ , \*\* $p < .05$ , \*\*\* $p < .01$

pothesis 4.3. This suggests that respondents were not trying to save face for the local court when asked about judicial corruption. In sum, there is no empirical evidence showing that respondents' subjective evaluations were biased by media influence or social desirability.

Data on foreign capital at the county level is very scarce, which does not allow me to fully test the theory by disaggregating sources of FDI ("China circle" v.s. foreign). Foreign direct investment (FDI) would be an ideal measure of foreign capital, but the data is also not available at the county level. I then use "foreign capital actually used" as a proxy. Foreign capital actually used includes FDI and foreign loans. Foreign loans usually have a small proportion whereas the majority of foreign capital is in the form of FDI. Since what matters for local officials is the importance of foreign capital in the local economy, I use the percentage of "foreign capital actually used" in the overall GDP to measure the weight of *foreign capital*. The variable is collected using sources provided by the University of Michigan's China Data Center.

A court's performance depends to a large extent on what resources it has. In China, a court's income completely relies on the local government's budget. According to the fiscal rules, local courts should hand in all litigation fees to the local government that they collect. And in each fiscal year, the local government appropriates certain amounts of funds to the court. How much the local government expends on the court should be independent of how much the court collects. But in reality, most local governments in China are in difficult financial situations. In many places, government expenditure on a court is linked to how much that court can earn. When facing budget constraints, local courts have to seek more cases to make money. In some courts, judges' wages also hinge on how many cases they can find. As a result, judges need to keep informal ties with all intermediaries of litigation, including lawyers, corporate managers, and officials in the local legal

bureau, etc.<sup>12</sup>. Corruption often occurs in the process of transactions between cases and money.

A variable “*finances*” is constructed to measure how much financial support a court obtains from the local government. The 2003 Statistics Report on Finance in All Chinese Counties edited by the Ministry of Finance provides data on how much each county government spends on the police, the procurator, the court, and the legal bureau as an aggregate. “Finance” is calculated as the proportion of expenditures on the police, the procurator, the court, and the legal bureau in the overall government budget. It is not a perfect measure, since no disaggregated data exists. But it provides a measure of the priority local governments give to legal affairs.

As a developing country, China still has remarkable rural-urban divide. I expect to discover different degrees of judicial corruption in rural and urban areas. In a recent study of judicial corruption by Ling Li, she finds that corruption is mostly prevalent in civil (especially commercial) cases, followed by criminal cases, and rare in administrative cases (Li, 2010). Since commercial cases happen more frequently in urban areas than in rural areas, I expect to see more corruption in urban areas. A variable “*rural*” is constructed using the proportion of agricultural products in the overall GDP to measure the “ruralness” of the county.

As modernization theorists would predict, a rule-of-law regime should emerge as a country becomes economically well-off. A recent study by Michelson and Read shows that court performance improves with economic development (Michelson and Read forthcoming). Is it simply a matter of development? To test this hypothesis, I included a log transformed GDP per capita (*logGDPpc*) in the model.

All variables in the data set are measured at the county level in 2003. Table 4.2

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<sup>12</sup>Subject #11, court official, Dongguan, Guangdong province, March 23, 2010. Subject #26, government official, Guangzhou, Guangdong province, March 30, 2010. Subject #27, legal scholar, Guangzhou, Guangdong province, March 31, 2010. Subject #29, court official, Gongqingcheng, Jiangxi province, April 2, 2010. Subject # 32, court official, Dean, Jiangxi province, April 8, 2010.

shows basic statistics of these variables.

Table 4.2: Summary Statistics

Variable	Mean	Std. Dev.	Min.	Max.	N
corruption	6.782	7.241	0	43.532	102
foreign capital	3.193	5.583	0	35.409	101
finances	5.962	2.617	1.8	18.04	102
rural	23.131	15.349	0	57.041	96
gdp pc (logged)	8.895	0.836	7.322	10.784	101

Figure 4.4 graphs “corruption” against county GDP per capita. It is interesting to see that there is an “lower triangular” pattern, which implies the level of economic development is a sufficient but unnecessary condition for judicial integrity.

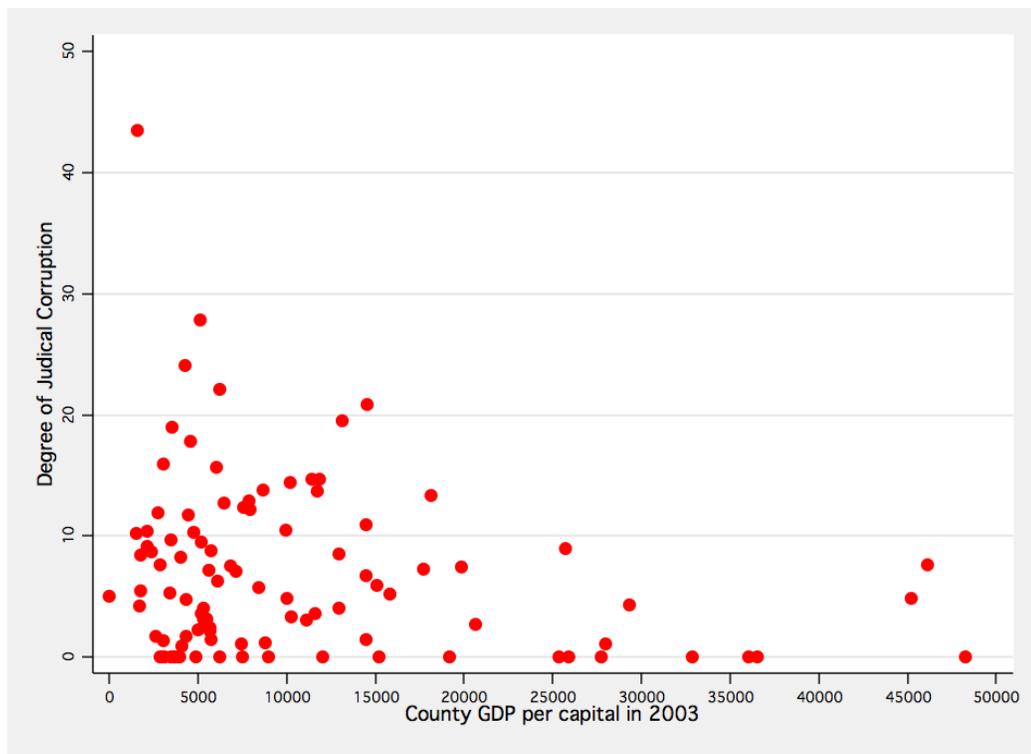


Figure 4.4: Judicial Corruption across Chinese Counties

### 4.2.3 Analysis and Results

Using the data set I compiled, this section tests the theory empirically. The observations are 102 randomly sampled Chinese counties. Based on the hypothesis, a benchmark model is specified as follows:

$$\begin{aligned} \text{corruption} = & \beta_1 + \beta_2 \text{foreign capital} + \beta_3 \text{finances} \\ & + \beta_4 \text{rural} + \beta_5 \log \text{GDPpc} + \epsilon \end{aligned} \quad (4.2)$$

where  $\beta_2$  is expected to be negative since it is the marginal effect of foreign capital, which should reduce corruption.  $\beta_3$  is expected to be negative: it is the marginal effect of government financial support, which should also reduce corruption.  $\beta_4$  is expected to be negative for corruption should be more rampant in urban areas than in rural areas.  $\beta_5$  is expected to be negative too since corruption should become less frequent as the economy develops.

Prior to estimating the model, I carried out a diagnosis using Cook's methods (Cook, 1977) to identify highly influential cases. Two observations are highly influential and therefore dropped in the following analysis. In addition, Cameron and Trivedi's decomposition of IM-test rejects the null hypothesis of homoskedasticity ( $\chi^2 = 21.9, p < .1$ ). Thus, robust standard errors are estimated in the regression analysis.

Table 4.3 shows regression estimates of model (4.2). The first column is the OLS regression results. Foreign capital has a negative effect, and the effect is distinguishable from zero. Comparative statics shows that a one percent increase of foreign capital in the overall GDP will bring a 0.565% decrease of people who think the local court is corrupt. Government financial support has a significantly negative effect. Comparative statics shows that a one percent increase in the proportion of government legal expenditures in the overall fiscal budget will bring a 0.488%

Table 4.3: Regression Results (DV=corruption)

Variable	OLS	2SLS
	Coefficient (Robust Std. Err.)	Coefficient (Robust Std. Err.)
foreign capital	-.565*** (.131)	-.504** (.240)
finances	-.488** (.220)	-.492** (.217)
rural	-.210*** (.052)	-.205*** (.054)
gdp pc (logged)	-2.080** (.889)	-2.116** (.893)
Intercept	34.201*** (8.967)	34.265*** (8.876)
N	94	94
R <sup>2</sup>	.215	.214
F	7.00***	4.76***
Durbin-Wu-Hausman $\chi^2$ test:		$\chi^2=0.054, p = 0.816$

\* $p < .1$ , \*\* $p < .05$ , \*\*\* $p < .01$

decrease of people who think the local court is corrupt. The magnitude of the agricultural industry has a negative sign too and passes the .01 level of significance. Comparative statics shows that a one percent increase in the weight of agriculture in the overall economy will bring a 0.210% decrease of people who think the local court is corrupt. Lastly, the level of economic development has a significantly negative impact too, which is consistent with modernization theoretical predictions.

There is a possible endogeneity problem with the model estimated: foreign capital might be endogenous to judicial corruption. It might be argued that foreign asset holders would take into account the quality of local legal systems when they choose a location of investment. There is a historical fact that rules out this possibility. During the Cultural Revolution, the whole legal systems, including legislatures and courts at various levels, were completely abolished. So at the be-

ginning of the reform era, the quality of local courts were equally poor. Initial attractions for investors were mainly kinship connections, proximity to raw products and markets, cheap labor costs, and favorable policies. That is why the five SEZs<sup>13</sup> and the fourteen “Coastal Open Cities” (COCs)<sup>14</sup> are concentrated in coastal areas that are close to Hongkong, Maucou, and Taiwan. The quality of legal systems carried little weight in the selection of these hot spots of investment. And also, China’s FDI inflow started in mid-1980s, but development of the formal legal institutions mainly happened in the 1990s. As Clarke, Murrell, and Whiting (2008, 399) argue,

“China experienced very rapid growth throughout its reform period, but it was only in the 1990s that legal developments began to catch up with changes in the way that the economy was functioning and in the roles that economic agents were dening for themselves. Indeed, ‘The Development of Law during the Era of Economic Reform’ contains more evidence for the proposition that economic change spurred legal change than for the opposite relation.”

There is an interesting paradox in the relationship between FDI and the rule of law in China; that is, the rule of law seems to play a trivial role in attracting investors in the early period of the reforms, while in the later period, especially in the last 15 years, a favorable legal environmental has become a major concern for foreign investors. Figure 4.5 shows the survey results of European Chamber Business Confidence Survey. The most important reason for European firms to invest in China is “close to the market/better market access.” 76% firms chose this as the most important criteria to decide on mainland China headquarter location. How-

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<sup>13</sup>The first four SEZs established in 1980 are Shenzhen, Zhuhai, Shantou, and Xiamen. Hainan province was added to this list in 1988.

<sup>14</sup>COCs were established in 1994 and include Dalian, Qinhuangdao, Tianjin, Yantai, Qingdao, Weihai, Lianyungang, Nantong, Shanghai, Ningbo, Wenzhou, Guangzhou, Zhanjiang, and Beihai.

ever, none of them considered “relatively more transparent legal environment” as their criteria for choosing investment location. Figure 4.6 shows the firms’ views on regulatory obstacles when doing business in mainland China. While legal environment was not a concern for investors when deciding investment location, “discretionary enforcement of laws and regulations” became the most mentioned (39%) obstacle when actually doing business in China. These empirical evidence corroborates the statement made by Clarke, Murrell, and Whiting (2008) that legal reforms occurred *after* the inflow of FDI.

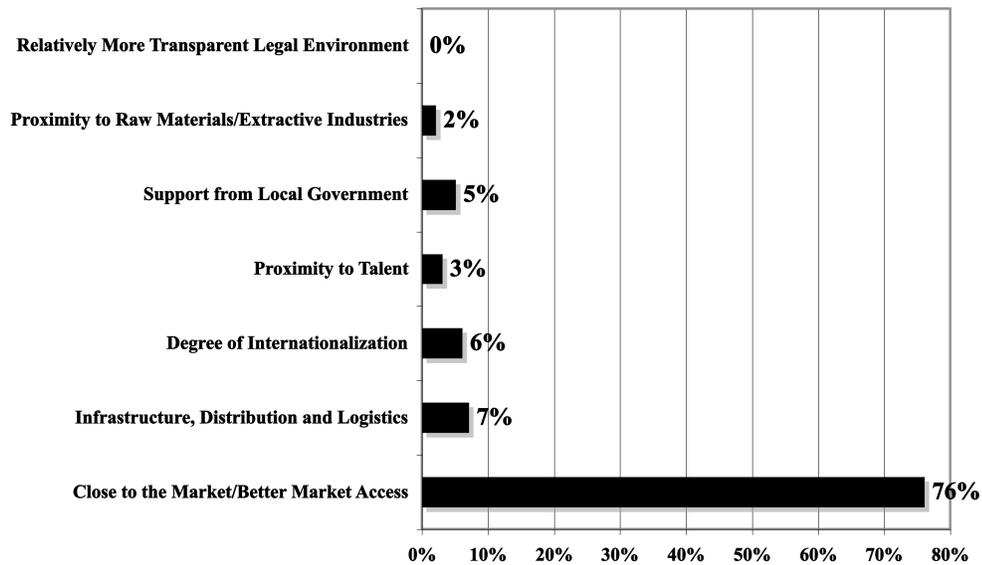


Figure 4.5: Most Important Criteria to Decide on Mainland China Headquarters Location

Source: *European Union Chamber of Commerce in China (2011)*

To verify this proposition empirically, I carry out two-stage least squares (2SLS) regressions. I use two instrumental variables. One (**distance**) is the distance to the

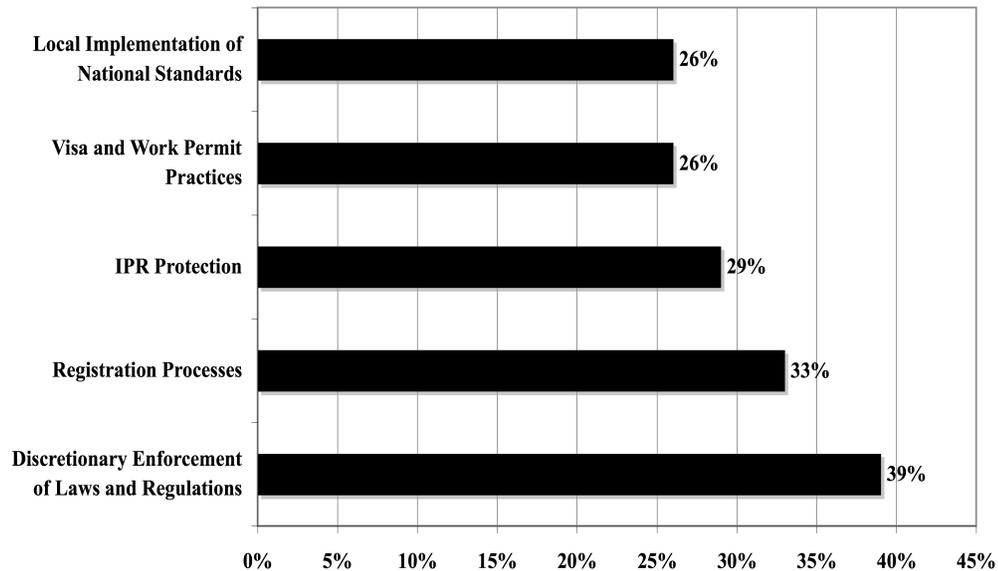


Figure 4.6: Regulatory Obstacles When Doing Business in Mainland China

Source: European Union Chamber of Commerce in China (2011)

nearest SEZs or COCs. The distance is calculated using Google Map’s “get direction” function. It gives the distance in kilometers from the observations to their nearest SEZs or COCs. For example, the closest SEZ or COC to Shenze county in Hebei province is Tianjin city, and the distance is 284 km. The rationale of using “distance” as an instrument is that China’s opening up is very much policy-oriented: the first few open areas were deliberately selected by the national government and were given special tax and tariff policies. These open areas, such as Guangdong and Shanghai, later played significant roles in stimulating FDI inflows and economic development in neighboring areas. So the closer to these open zones inland areas are, the more likely they would attract investors<sup>15</sup>. The second instru-

<sup>15</sup>The use of geographical variables to instrument FDI is also seen in Larrain and Tavares (2004).

mental variable (**migrant population**) is measured by a county's migrant population as a percentage of the whole population. The data was drawn from the fifth census carried out by China's Bureau of Statistics in 2000. The census measured the number of people who migrated into this area from other counties in the same province and the number of people who migrated from other provinces. The variable "migrant population" is measured by the percentage of whole population that is migrant. The rationale of using it is that China's development in FDI is labor-intensive. So the more free labor an area is endowed with, the more likely it would attract investors. These two variables constitute strong instruments because we do not have theoretical and empirical reasons to believe that they directly affect judicial corruption.<sup>16</sup>

Column 2 in Table 4.3 shows the results of 2SLS. As is shown, after instrumented by two exogenous variables, the effect of foreign capital is still significantly negative. And the magnitude of the effect has not changed very much. The Hausman test shows that  $\chi^2 = 0.054$ ,  $p = 0.816$ . This suggests that the null hypothesis that "foreign capital" is exogenous cannot be rejected, that is to say, there is no endogeneity in the OLS model.

### 4.3 Empirical Evidence from Prefectural-Level Data

The previous section has shown empirical support for hypothesis 4.1 using county-level data. However, as discussed before, survey of ordinary citizens might not directly tap the dimension that this research is concerned with: business-related legal affairs. The perception of judicial corruption from the public's view might differ significantly from the business's view. A court that is fair and efficient to businesses might be the exact same court that takes bribes from ordinary citizens

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<sup>16</sup>These two variables have significant effects on foreign capital in regression analysis and explain 28 percent of the variation of foreign capital.

or violate citizens' civil rights in favor of the government. To tackle this problem, this section tests the theory using data from a business survey of China's 120 cities.

A survey on "Competitiveness Enhancements for 120 Cities in China" was designed and implemented by World Bank in 2005<sup>17</sup>. The 120 cities are included from all provinces in mainland China except Tibet. For each province, the capital city is included. The inclusion of additional cities for a particular province depends on provincial GDP. The 120 cities included in this survey account for 70-80% of China's GDP. The most valuable feature of the survey is that it collected firm-level data. For all but the four provincial-level cities, the survey sampled 100 firms. For each of the four provincial-level cities (Beijing, Tianjin, Shanghai, and Chongqing), the survey sampled 200 firms. Thus, the sample includes 12,400 firms. Of these, 8% are registered as majority state-owned, 28% foreign-invested, and 64% domestic non-state.

All firms are from industry. This is intended to promote consistency since some services (e.g., financial services) are prone to greater regulation and the inclusion of higher numbers of such service businesses in some cities (e.g., Beijing, Shenzhen, and Shanghai) could distort survey results. For each city, the top 10 industries in terms of sales revenue are drawn. For each industry, all firms in the sample universe are divided into large, middle, and small firms, each accounting for 1/3 of total industry revenue. Then from each of three types of firms, an equal number of firms are drawn.<sup>18</sup> Firms are required to have a minimum of 10 employees. As shown, the firms are not a random sample. So the results in this section are not generalizable to the nation.

The World Bank's report does not provide information on who in the firms received the survey and how the survey was conducted (e.g. through face-to-face

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<sup>17</sup>For details of the survey, please see a downloadable report at <http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/EASTASIAPACIFICEXT/CHINAEXTN/0,,contentMDK:21124378~pagePK:141137~piPK:141127~theSitePK:318950,00.html>.

<sup>18</sup>comments on sampling techniques.

or telephone interviews). The survey questionnaire focuses on the relationship between the total factor productivity or foreign ownership of firms and various investment climate factors.

A question in the questionnaire asked the firms: “Do you expect that the courts will protect legitimate property and contract rights?” World Bank’s report does not provide information on how the answer is scaled (e.g. ordinal or interval). A continuous variable - *confidence in courts* is constructed based on firms’ answers. It is a percentage measure ranging from 27%-98%. Table 4.4 shows all the cities in the sample, their provinces, and their “confidence-in-courts” scores .

Figure 4.7 graphs a scatterplot of cities’ “confidence in courts” scores and GDP per capita. As shown, the pattern does not follow the prediction of modernization theory that economic prosperity brings stronger property rights protection. Instead, there is a large variation of “confidence in courts” among underdeveloped cities.

To verify the empirical finding in the previous section, I use a similar set of explanatory variables to explain the variation of “confidence in courts” among Chinese cities. Again, the key independent variable is “*foreign capital*.” It is constructed using the proportion of “foreign capital actually used” in the overall municipal GDP in 2005. Unfortunately, data availability at the prefectural-level does not allow me to distinguish foreign capital from outside or within the “China circle.” So the measure is still a sum of all foreign capital in that city. A variable “*finances*” is constructed to measure how much financial support a court obtains from the local government. The 2005 Statistics Report on Finance in All Chinese Prefectures, Cities, and Counties edited by the Ministry of Finance provides data on how much each municipal government spends on the police, the procurator, the court, and the legal bureau as an aggregate. “Finances” is calculated as the

Table 4.4: List of 120 Cities

<i>Id</i>	<i>City</i>	<i>Province</i>	<i>Confidence in Courts</i>	<i>Id</i>	<i>City</i>	<i>Province</i>	<i>Confidence in Courts</i>
1	Beijing	Beijing	43	61	Zibo	Shandong	86
2	Tianjin	Tianjin	61	62	Yantai	Shandong	83
3	Shijiazhuang	Hebei	79	63	Weifang	Shandong	75
4	Tangshan	Hebei	52	64	Jining	Shandong	85
5	Qinhuangdao	Hebei	68	65	Taian	Shandong	78
6	Handan	Hebei	41	66	Weihai	Shandong	83
7	Baoding	Hebei	71	67	Linyi	Shandong	71
8	Zhangjiakou	Hebei	67	68	Zhengzhou	Henan	75
9	Cangzhou	Hebei	47	69	Luoyang	Henan	48
10	Langfang	Hebei	74	70	Xinxiang	Henan	40
11	Taiyuan	Shanxi	69	71	Xuchang	Henan	57
12	Datong	Shanxi	30	72	Nanyang	Henan	56
13	Yuncheng	Shanxi	77	73	Zhoukou	Henan	93
14	Huhehaote	Neimenggu	27	74	Shangqiu	Henan	87
15	Baotou	Neimenggu	42	75	Wuhan	Hubei	63
16	Shenyang	Liaoning	54	76	Yichang	Hubei	84
17	Dalian	Liaoning	65	77	Jingmen	Hubei	70
18	Anshan	Liaoning	67	78	Xiaogan	Hubei	79
19	Fushun	Liaoning	40	79	Xiangfan	Hubei	40
20	Benxi	Liaoning	55	80	Jingzhou	Hubei	55
21	Jinzhou	Liaoning	79	81	Huanggang	Hubei	70
22	Changchun	Jilin	70	82	Changsha	Hunan	65
23	Jilin	Jilin	65	83	Zhuzhou	Hunan	36
24	Haerbin	Heilongjiang	50	84	Yueyang	Hunan	62
25	Qiqihaer	Heilongjiang	54	85	Changde	Hunan	41
26	Daqing	Heilongjiang	37	86	Chenzhou	Hunan	81
27	Shanghai	Shanghai	45	87	Hengyang	Hunan	39
28	Nanjing	Jiangsu	62	88	Guangzhou	Guangdong	61
29	Wuxi	Jiangsu	48	89	Shenzhen	Guangdong	74
30	Xuzhou	Jiangsu	61	90	Zhuhai	Guangdong	68
31	Changzhou	Jiangsu	66	91	Shantou	Guangdong	96
32	Suzhou	Jiangsu	93	92	Foshan	Guangdong	53
33	Nantong	Jiangsu	75	93	Jiangmen	Guangdong	94
34	Lianyungang	Jiangsu	70	94	Maoming	Guangdong	71
35	Yancheng	Jiangsu	54	95	Huizhou	Guangdong	75
36	Yangzhou	Jiangsu	70	96	Dongguan	Guangdong	39
37	Hangzhou	Zhejiang	98	97	Nanning	Guangxi	36
38	Ningbo	Zhejiang	76	98	Liuzhou	Guangxi	67
39	Wenzhou	Zhejiang	44	99	Guilin	Guangxi	72
40	Jiaxing	Zhejiang	79	100	Haikou	Hainan	47
41	Huzhou	Zhejiang	63	101	Chongqing	Chongqing	71
42	Shaoxing	Zhejiang	78	102	Chengdu	Sichuan	72
43	Jinhua	Zhejiang	66	103	Deyang	Sichuan	83
44	Taizhou	Zhejiang	40	104	Mianyang	Sichuan	69
45	Hefei	Anhui	54	105	Leshan	Sichuan	70
46	Wuhu	Anhui	83	106	Yibin	Sichuan	56
47	Anqing	Anhui	81	107	Guiyang	Guizhou	47
48	Chuzhou	Anhui	78	108	Zunyi	Guizhou	43
49	Fuzhou	Fujian	76	109	Kunming	Yunnan	43
50	Xiamen	Fujian	83	110	Qujing	Yunnan	65
51	Sanming	Fujian	79	111	Yuxi	Yunnan	73
52	Quanzhou	Fujian	78	112	Xian	Shaanxi	42
53	Zhangzhou	Fujian	69	113	Baoji	Shaanxi	61
54	Nanchang	Jiangxi	75	114	Xianyang	Shaanxi	51
55	Jiujiang	Jiangxi	88	115	Lanzhou	Gansu	38
56	Shangrao	Jiangxi	95	116	Tianshui	Gansu	45
57	Yichun	Jiangxi	70	117	Xining	Qinghai	36
58	Ganzhou	Jiangxi	56	118	Yinchuan	Ningxia	53
59	Jinan	Shandong	56	119	Wuzhong	Ningxia	39
60	Qingdao	Shandong	95	120	Wulumuqi	Xinjiang	50

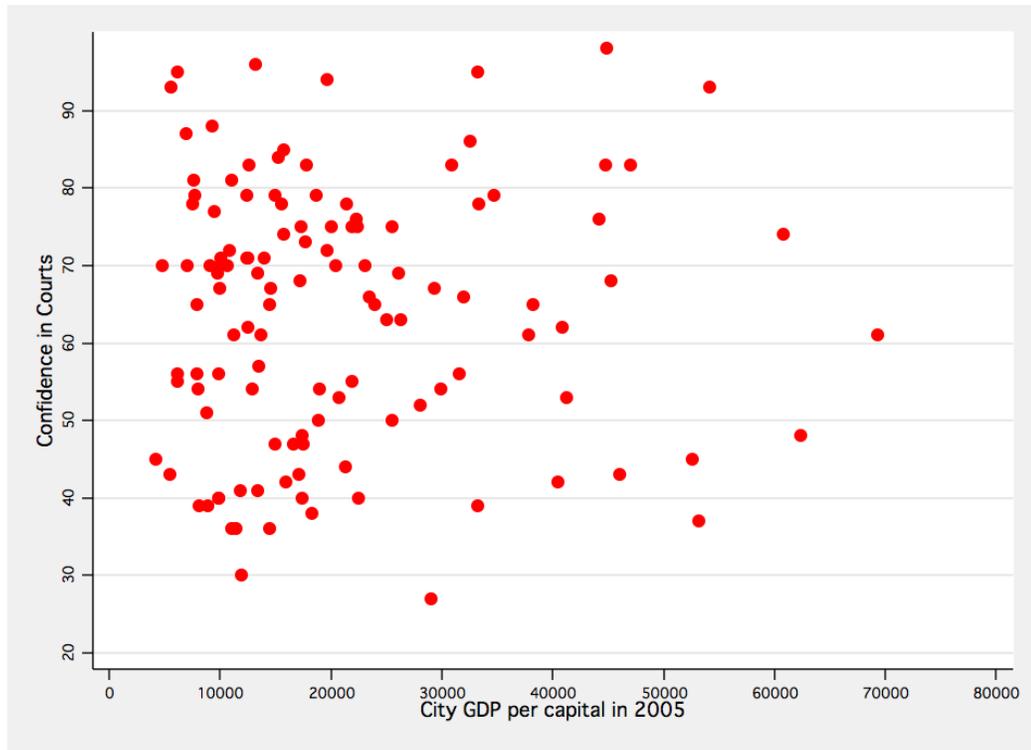


Figure 4.7: Confidence in Courts and GDP per capita Among the 120 Cities

proportion of expenditures on the police, the procurator, the court, and the legal bureau in the overall government budget. It is not a perfect measure, since no disaggregated data exists. But it provides a measure of the priority local governments give to legal affairs. Next, a log transformed GDP per capita (*gdp pc*) is included in the model to control for level of economic development. To take into account of the overall economic structure of the locale, a variable "*service*," which measures the weight of service industry in the overall GDP, is listed on the right-hand side. In addition, GDP growth rate - "*growth*" - and proportion of urban population in the overall population - "*urban*" - are also included. Since there are 4 provincial-level cities and 116 prefectural-level cities in the sample, a dichotomous variable "*level*" is included to distinguish the cities' administrative levels (1=provincial-level and 0=prefectural-level). All variables are measured in 2005.

To examine the role of government funding more closely, a provincial-level

variable “*provincial court spending*” is included in the model. The data is made available by the Ministry of Finance in the Statistics Report on Local Finance. The report has breakdowns in government spending on courts *per se*. Unlike the aggregate data for all legal-related departments at the municipal level, “provincial court spending” measures the financial priority that provincial governments give to courts in the overall fiscal budget. It is a percentage measure.

Table 4.5 shows the summary statistics of the major variables in the model.

Table 4.5: Summary Statistics

Variable	Mean	Std. Dev.	Min.	Max.	N
confidence in courts	63.75	16.812	27	98	120
foreign capital	0.419	0.383	0.007	1.5	118
finances	7.54	1.932	3.321	15.061	120
gdp pc (logged)	9.752	0.624	8.34	11.146	120
service	38.207	8.707	11.092	70.019	120
growth	14.658	4.004	1.6	29.4	107
urban	135.73	62.761	59.57	329.078	107
level	0.292	0.456	0	1	120
provincial court spending	0.893	0.125	0.599	1.099	120

Based on theoretical discussions in the preceding section, one hypothesis is generated:

*Hypothesis 4.4: Foreign capital enhances quality of courts. As the weight of foreign capital increases in local economy, the business’ confidence in courts increases, ceteris paribus.*

A benchmark model is specified as follows:

$$\begin{aligned}
 \text{confidence in courts} = & \beta_1 + \beta_2 \text{foreign capital} + \beta_3 \text{finances} \\
 & + \beta_4 \text{gdppc} + \beta_5 \text{service} + \beta_6 \text{growth} \\
 & + \beta_7 \text{urban} + \beta_8 \text{level} + \epsilon
 \end{aligned} \tag{4.3}$$

where  $\beta_2$  is expected to be positive since it is the marginal effect of foreign capital, which should enhance confidence in courts.  $\beta_3$  is expected to be positive: it is the marginal effect of government financial support, which should also enhance confidence in courts.  $\beta_4$  is expected to be positive too since confidence in courts should increase as the economy develops.  $\beta_5$  is hard to predict as the theory does not imply direct link between a locale's industrial structure and its court quality.  $\beta_6$  is expected to be positive as economic growth brings more economic activities which press courts to improve.  $\beta_7$  is expected to be positive as confidence in courts should be higher in urban areas than in rural areas. Lastly,  $\beta_8$  should be positive since provincial-level cities are expected to have better overall governance than prefectural-level cities.

Again, prior to estimating the model, I carried out a diagnosis using Cook's methods to identify highly influential cases. Two observations (Shantou and Dongguan) are highly influential and therefore dropped in the following analysis. In addition, Cameron and Trivedi's decomposition of IM-test rejects the null hypothesis of homoskedasticity. Thus, robust standard errors are estimated in the regression analysis.

Column 1 in Table 4.6 shows OLS estimates of model (4.3). Foreign capital has a positive effect, and the effect is distinguishable from zero. Comparative statics shows that a 1% increase of foreign capital in the overall GDP will bring a 11% increase of confidence in courts. Government financial support has a positive effect, but the effect is indistinguishable from 0. This is different from the findings in the county-level regressions. One potential reason is that the spending combines expenditures on the police department, the procuratorate, the court, and the legal bureau, which does not directly reflect government's spending on courts. GDP per capita has a positive sign but does not pass hypothesis testing at any conventional level of significance. Weight of service industry is negative and sig-

nificant. This might be because the service industry in China is mainly composed of private enterprises, which according to the theory undermine judicial fairness. Economic growth, surprisingly, has a negative sign. But the effect is very small and not significant. "Urban" has a significantly positive effect as expected. Lastly, provincial-level cities have higher confidence in courts than prefectural-level cities as expected, but this difference is not significant.

Table 4.6: Determinants of “Confidence in Courts” in 120 Cities

Variable	Single-Level OLS Coefficient (robust S.E)	Single-Level 2SLS Coefficient (robust S.E)	Multi-Level MLE1 Coefficient (S.E)	Multi-Level MLE2 Coefficient (S.E)
foreign capital	11.326 (4.218) ***	7.874 (9.427)	9.079 (3.708) **	16.451 (4.824) ***
finances	0.354 (0.784)	0.400 (0.790)	-	-1.102 (0.855)
gdp pc (logged)	1.091 (3.786)	2.463 (5.151) **	-	1.154 (3.815)
service	-0.653 (0.223) ***	-0.665 (0.222) ***	-	-0.611 (0.258) **
growth	-0.071 (0.419)	-0.047 (0.435)	-	-0.794 (0.479) *
urban	0.069 (0.030) **	0.074 (0.033) **	-	-0.139 (0.169)
level	3.011 (4.431)	3.553 (4.580)	-	2.404 (4.060)
provincial court spending	-	-	52.485 (13.192) ***	42.033 (12.812) ***
Intercept	62.358 (35.571) *	49.339 (49.352)	12.883 (11.779)	59.865 (37.091)
N	104	104	117	105
R <sup>2</sup>	0.265	0.261	-	-
F	7.23	4.56	-	-
log-likelihood	-	-	-474.6	-409.4
Durbin-Wu-Hausman $\chi^2$	-	0.078	-	-

\* $p < .1$ , \*\* $p < .05$ , \*\*\* $p < .01$

Similarly, there is a potential endogeneity problem with the model estimated: foreign capital might be endogenous to confidence in courts. It might be argued that foreign asset holders only invest in places with high confidence in courts. Again, I carry out two-stage least squares (2SLS) regressions. I use the same instrumental variables. “**Distance**” is the distance to the nearest SEZs or COCs. The distance is calculated using Google Map’s “get direction” function. It gives the distance in kilometers from the observations to their nearest SEZs or COCs. The second instrumental variable (**migrants**) is measured by a city’s migrant population as a percentage of the whole population. The data was drawn from the fifth census carried out by China’s Bureau of Statistics in 2000.

Column 2 in Table 4.6 shows the results of 2SLS. As is shown, after instrumented by two exogenous variables, the effect of foreign capital is still positive. But the effect fails to pass hypothesis testing at any conventional level of significance. This is partly due to the inflated standard error caused by 2SLS. The standard error of  $\beta_1$  in 2SLS more than double what is estimated in OLS. This is a typical problem with 2SLS in finite sample<sup>19</sup>. The Hausman test shows that  $\chi^2 = 0.078$ ,  $p = 0.780$ . This suggests that the 2SLS estimate of  $\beta_1$  is not significantly different from the OLS estimate, this might be also because of the inflated standard error.

To test whether provincial government spending on courts has an effect on confidence in courts at the prefectural-level, a *varying-intercept model* is specified as follows:

$$confidence\ in\ courts_{ij} = \beta_{1j} + \beta_{2j} foreign\ capital + \epsilon_{ij} \quad (4.4)$$

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<sup>19</sup>IV estimators are biased, and their finite-sample properties are often problematic. Most of the justification for the use of IV is asymptotic; performance in small samples may be poor (Please see a discussion in Cameron and Trivedi, 2005, 103-109).

$$\beta_{1j} = \gamma_{11} + \gamma_{12} \text{provincial court spending} + \mu_{1j} \quad (4.5)$$

To simplify the model specification, all the controls are omitted in model (4.4). Model (4.4) is the usual linear model,  $\beta_{1j}$  is the usual intercept,  $\beta_{2j}$  is the usual regression coefficient for the explanatory variable “foreign capital,” and  $\epsilon_{ij}$  is the usual residual error term. The subscript  $j$  is for the provinces ( $j = 1 \dots 31$ ) and the subscript  $i$  is for individual cities ( $i = 1 \dots 120$ ). The difference with the usual regression model is that each province has a different intercept coefficient  $\beta_{1j}$ . The residual errors  $\epsilon_{ij}$  are assumed to have a mean of zero, and a variance to be estimated. It is assumed that the variance of the residual errors is the same in all provinces. Across all provinces, the intercept coefficient  $\beta_{1j}$  has a distribution with a mean and a variance.

As specified in model (4.5), the variation of  $\beta_{1j}$  can be explained by a provincial-level variable “provincial court spending.” Equation (4.5) predicts the average “confidence in courts” in a province (the intercept  $\beta_{1j}$ ) by provincial government spending on courts. Thus,  $\gamma_{12}$  is expected to be positive because the average “confidence in courts” should be higher in a province where the government provides more financial support to courts than a province with limited financial support to courts. I assume that provincial governments’ behaviors will trickle down to municipal governments.

Column 3 in Table 4.6 shows results of maximum-likelihood estimation (MLE) of model (4.4). The marginal effect of “foreign capital” is still significantly positive. Especially, the provincial-level variable “provincial court spending” has a positive effect on “confidence in courts,” and the effect is distinguishable from 0. This confirms the finding from the county-level data that government financial support enhances court quality. And interestingly, provincial governments’ focus on courts will trickle down to the municipal level. Column 4 shows the results

with other controls. As shown, the inclusion of other controls does not alter the results, except that the magnitude of the effect of “provincial court spending” is smaller.

A closer look at the results reveals that the magnitude of the effect of “provincial court spending” is quite large (52 without controls and 42 with controls). But the range of the variable “provincial court spending” is [.599, 1.099], thus in reality, a usual change, say 0.1% increase in the budget, will bring about 4% increase in “confidence in courts.”

In sum, empirical evidence from prefectural-level business survey data reconfirm those from county-level survey data. And interestingly, using multi-level modeling, this section finds that provincial government spending on courts also has a significantly positive effect on quality of courts at the prefectural-level.

## **4.4 Alternative Explanations**

Does this political economic explanation fare better than other explanations? In this section I will test, using the county level data, two alternative explanations: a social capital explanation and a “*guanxi*” explanation.

### **4.4.1 A Social Capital Explanation?**

Since Putnam (1993)’s seminal work on institutional performance in Italy, social capital has been considered a prominent factor in determining the performance of institutions. In Tsai (2007*b*)’s application of the social capital theory in China, she successfully explained the variation of public goods provision of Chinese villages. In Tsai’s story of local government performance, formal institutions (e.g. democratic elections in villages) have limited impact on local officials’ behavior; instead, Tsai (2007*b*, 120) argues that, “in political systems with weak formal institutions of

accountability, localities with encompassing and embedding solidary groups are likely to have better local governmental provision of public goods than localities without these groups, all other things being equal.” And Tsai (2007*b*, 123) considers village temples to qualify as “encompassing and embedding solidary groups” whereas “village church institutions are associated with dangerous connections to foreign actors and the undermining of state authority.” Therefore, she hypothesizes that village temples should have positive impact on public goods provisions whereas village church institutions should have no or a negative effect on public goods provision.

One weakness of Tsai’s theory of institutional performance is, while she was successful at explaining the performance of the lowest level of government,<sup>20</sup> the applicability of the theory to higher levels of government is in question. This flaw is especially troublesome in China because county governments are the major public goods providers. According to a World Bank report in 2001, county and township governments paid for 70% of budgetary expenditures for education and about 55 percent of budgetary expenditures for public health (World Bank, 2001). As far as the rule of law is concerned, the lowest level of formal legal institutions, including basic courts and local legislatures, are also located at the county level.

In addition, the dynamics of everyday life in Chinese localities further cast doubt on Tsai’s theory in the sense that the causal mechanism that works in Tsai’s story might not work in higher levels of government. In her words, the mechanism that links village temples and public goods provision is moral standing: “solidary groups make the awarding of moral standing possible, first, by establishing a set of shared moral and ethical standards, and, second, by providing opportunities for members to demonstrate their adherence to these standards publicly.” (Tsai, 2007*b*, 113) While “the awarding of moral standing” has strong power in villages where

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<sup>20</sup>Constitutionally village committees are not a level of formal government in China, but they carry heavy burdens of implementing government policies.

village officials interact with villagers frequently, it is hard to extend this power to higher levels of administration in China where government officials rarely interact with the masses on a daily basis.

Based on the two reasons reviewed above, I propose that 1) existence of solidary groups has no effect on judicial integrity at the county level, and 2) adding variables measuring solidary groups will not change the original results. Validation of these two propositions will not make Tsai's theory less plausible though, since she used different dependent variables; it will only prove the "political economic model" more robust.

Ideally I should use Tsai's data to test these two propositions, but the unit of analysis in her study is village, and there are no questions tapping rule of law in her survey. Therefore I add two variables measuring existence of solidary groups to my county-level data set: **temple** and **church**. The survey on the Institutionalization of Legal Reforms in China does not have direct measures of religious groups, so I use respondents' religious activities as a proxy for the existence of religious groups.<sup>21</sup> "Temple" is a dichotomous variable with value of 1 if both of the following conditions are met: a) There is at least one Buddhist residing in the county and b) The Buddhist(s) should attend some religious activities each year. My rationale of using this proxy is that if there is a Buddhist in the county and she attends some religious activities, then I can infer that there probably is a temple located in that county. As a result, "temple" equals 0 when a) there is no Buddhist in the county or b) There is at least one Buddhist, but she never attend religious activities. The variable "church" is constructed in the same way. "Church" equals 1 when both of the following conditions are met: 1) There is at least one Protestant

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<sup>21</sup>Tsai's original measures are also indirect. She uses two indicators to measure village temple groups: the existence of a formal temple manager; and the percentage of households that have participated in village temple reconstruction projects by donating money, labor, or materials since the beginning of the reform. Two similar measures are used for village church groups: the existence of a state-approved Protestant minister or Catholic priest who organizes church services and activities; and the existence of a church that has been renovated or rebuilt in the reform period.

or one Catholic resided in the county and 2) She attends some religious activities each year. “Church” equals 0 when either of the conditions above is not met.

Table 4.7 shows estimation of the model with the two “solidary groups” variables. The first column shows the OLS results whereas the second column shows the 2SLS results<sup>22</sup>. As is shown, first of all, both “temple” and “church” do not have any significant effect on corruption. Secondly, adding the two variables does not change the original results.<sup>23</sup> Generally speaking, the “political economic model” survives a test versus the “social capital” explanation.

#### 4.4.2 A *guanxi* Explanation?

Is formal legal protection a unique means to protect property rights and attract investors? Students of Chinese political economy have long been arguing that business and the state has strong patron-client ties (*guanxi*) through which private firms are protected (Wank, 1999). Oi (1992) has argued that the impressive growth of collective rural industrial output between 1978 and 1988 is in large measure a result of local government entrepreneurship. Fiscal reform has assigned local governments property rights over increased income and has created strong incentives for local officials to pursue local economic development. In the process, local governments have taken on many characteristics of a business corporation, with officials acting as the equivalent of a board of directors. This merger of state and economy characterizes a new institutional development that Oi labels local state corporatism. Wank (1999, 68), in a more blunt way, argues that “[m]uch exchange conducted by private companies is embedded in clientelistic ties with various administrative, policing, distributive, and manufacturing organs of the local state.

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<sup>22</sup>The Hausman test shows that  $\chi^2 = 0.002$ ,  $p = 0.960$ . This suggests that the null hypothesis that “foreign capital” is exogenous cannot be rejected, that is to say, there is no endogeneity in the OLS model.

<sup>23</sup>The marginal effect of foreign capital is in the same magnitude and significant at a similar range.

Table 4.7: Estimation of Solidarity Group Explanations (DV=corruption)

Variable	OLS	2SLS
	Coefficient (Robust Std. Err.)	Coefficient (Robust Std. Err.)
foreign capital	-.559*** (.133)	-.548** (.242)
finances	-.526** (.238)	-.527** (.235)
rural	-.208*** (.051)	-.207*** (.054)
gdp pc (logged)	-2.357** (.966)	-2.365** (.966)
church	1.393 (1.387)	1.396 (1.388)
temple	.747 (1.309)	0.748 (1.306)
Intercept	35.839*** (9.326)	35.854*** (9.295)
N	94	94
R <sup>2</sup>	.229	0.229
F	4.69***	3.31***
Durbin-Wu-Hausman $\chi^2$ test		$\chi^2 = 0.002, p = 0.96$

\* $p < .1$ , \*\* $p < .05$ , \*\*\* $p < .01$

These ties are symbiotic transactions of commercial wealth for political power.” The “developmental state” literature has also noted the importance of administrative protection of business in East Asian economies (Evans, 1995; Johnson, 1982; Woo-Cumings, 1999; Kohli, 2004). Meanwhile these scholars have also observed massive corruption in “transactions of commercial wealth for political power” that Kang (2004) terms “crony capitalism.”

Under the pressure to stimulate economic growth, have Chinese local state agents relied on “*guanxi*” (informal ties) to protect foreign asset holders? If this *guanxi* story had some explanatory power, we would expect to observe more *government* corruption in places where foreign capital is important in local economy and less *government* corruption in places with little foreign capital.

To measure government corruption I again use the county survey data. A variable “**govcorruption**” is constructed in the same way that legal corruption is calculated. Respondents were asked whether they would choose to go to the government if they confronted with three types of disputes. And for those who chose no, we asked why. One of the reasons given in the questionnaire is “Government is corrupt.” The variable “**govcorruption**” is constructed by adding up proportions of respondents who chose “Government is corrupt” in three types of disputes and then normalizing to 1:

$$govcorruption = \frac{P_{g*civildispute} + P_{g*economicdispute} + P_{g*administrativedispute}}{3} \times 100\%$$

Table 4.8 shows estimates of the model with “govcorruption” as the dependent variable using both OLS and 2SLS. If the alternative explanation is plausible, we would expect that the effect of foreign capital on government corruption is significantly positive, all else being equal. However, empirical results do not corroborate this proposition. The effect of foreign capital on government corruption is signifi-

Table 4.8: Estimation of the *guanxi* Explanation (DV=govcorruption)

Variable	OLS	2SLS
	Coefficient (Robust Std. Err.)	Coefficient (Robust Std. Err.)
foreign capital	-.633** (.282)	-.061 (.621)
rural	-.045 (.139)	.006 (.151)
gdp pc (logged)	2.710 (2.428)	2.372 (2.425)
Intercept	-2.071 (24.029)	-1.803 (24.376)
N	94	94
R <sup>2</sup>	.056	.027
F	2.28*	.58
Durbin-Wu-Hausman $\chi^2$ test		$\chi^2 = 0.989, p = 0.320$

\* $p < .1$ , \*\* $p < .05$ , \*\*\* $p < .01$

cant but negative in the OLS results, which suggests that foreign capital decreases government corruption. It becomes insignificant in the 2SLS results but still remains negative<sup>24</sup>. Overall, competition for foreign capital has not made Chinese local governments more corrupt but cleaner.

The political economic explanation performs better than the social capital explanation and the “*guanxi*” explanation. The tests further add robustness to the model.

## 4.5 Concluding Remarks

This chapter tests the theory by explaining the variation of the degree of judicial corruption at the county level and confidence in courts at the prefectural level in

<sup>24</sup>The Hausman test shows that  $\chi^2 = 0.989, p = 0.320$ . This suggests that the null hypothesis that “foreign capital” is exogenous cannot be rejected, that is to say, there is no endogeneity in the OLS model.

China. I argue that due to specific incentives facing local Chinese Communist Party officials, those officials and their local court systems are more likely to adhere to the rule of law if they are more dependent upon foreign capital.

This chapter has several limitations. First of all, the subjective evaluations of judicial corruption are from respondents who had no court experiences. The generating process for the evaluations is unclear. They might overestimate or underestimate the degree of corruption in local courts due to perception bias. This concern is partly eased by using business survey data at the prefectural level. As shown, increase in foreign capital also enhances investors' confidence in courts. Secondly, data on the county level and prefectural level do not allow this research to disaggregate sources of foreign investments. What was found in the quantitative results might be the outcome of the weighted average of all foreign capital combined. This problem is solved by using provincial level data in the next chapter.

This chapter poses a new question: If government court spending reduces judicial corruption, what determines government's incentive to finance courts? As the theory implies, court spending is one mechanism that governments use to strengthen courts. We would expect that in places where there is a large share of foreign enterprises from outside the "China circle," governments should have a positive incentive to finance courts; in places where there is a large share of SOEs, domestic private enterprises, and ethnic Chinese investors, governments should have a negative incentive to finance courts. The next chapter tests this proposition empirically.

## CHAPTER V

# When Do Authoritarian Rulers Spend Money on Courts: Sub-National Evidence from China

### 5.1 Introduction

Why do some Chinese local governments spend more money on courts, while others spend less? This chapter addresses this question empirically. Financial resources largely determine the incentives and behaviors of courts in China. Courts with guaranteed and sufficient funding have more resources to achieve efficiency, implement reforms, hire professional judges, and have less incentives to engage in corrupt activities; courts with uncertain and insufficient funding are less likely to be independent of economic interests and are more likely to engage in corrupt activities. However, courts in China do not control their own “purses.” The power of budgeting lies in the hands of governments at various levels.

“[B]udgeting was the lifeblood of government” (Wildavsky and Caiden, 1997, xxiii). Since financial resources are limited, budget becomes a mechanism for making choices among alternative expenditures. The budgetary process always involves competing players with distinctive preferences and conflicting goals. The budget, therefore, resembles a contract which reflects how the government prioritizes alternatives and makes commitment to various clashing interests. Govern-

ment spending on courts indicates the priorities regional governments give to the judiciary. However, little is known about budgeting in authoritarian regimes (Ang, 2010a; Shih, Zhang, and Liu, 2010; Shih and Zhang, 2007); less is known about court budgeting. The lack of research is partly due to the opacity of the budgetary process in authoritarian regimes. Using newly released “internal” data on provincial budgets published by the Ministry of Finance of the People’s Republic of China<sup>1</sup>, I am able to systematically examine government spending on courts both across space and over time. This chapter seeks to explain the sub-national variation of government spending on courts among China’s 31 provinces during the period of 1995-2006.

I argue that Chinese local officials prioritize court spending only when courts can serve the purposes of those officials. And the “usefulness” of courts depends on the ownership structure of the local economy. In places where there is a large share of state-owned enterprises (SOEs) and private enterprises, governments are less likely to finance courts, because SOEs and private enterprises do not frequently rely on courts to enforce contracts. Instead, SOEs and private enterprises resort to the government for dispute resolution and contract enforcement. In places where there is a large share of foreign-invested enterprises (FIEs), governments have strong incentives to finance courts, because court is a useful tool for FIEs to enforce contracts and settle disputes. I also argue that foreign investors from within the “China circle” - Hong Kong, Macao, and Taiwan - resemble domestic investors in the sense that they rely on kinship connections and clientelistic ties to conduct business in mainland China, therefore, they do not exert a positive pressure on government spending on courts, despite being FIEs in the technical sense.

I rely on both qualitative data and quantitative data to test these hypotheses. The qualitative data includes more than a hundred interviews with judges, party

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<sup>1</sup>Please see Ministry of Finance of People’s Republic of China (1996). The reports are now available in Beijing’s National Library.

and government officials, investors, scholars, and ordinary citizens. On the quantitative side, I compiled an original time-series-cross-section data set on provincial government spending on courts across China's 31 provinces over the period of 1995-2006.

The rest of the chapter is organized as follows: the next section will frame the research question and provide a detailed description of institutions governing court finances; the subsequent section will discuss the empirical strategies and analytical results; the fourth section will test a possible phenomenon: provincial governments compete in court spending to prevent capital from moving; the last section will then conclude with a summary of major findings and broader significance.

## 5.2 Sub-National Court Spending in China

As discussed in Chapter III, Chinese local courts are financed by local governments at the same territorial level, for example, a county government is responsible for funding the county's basic people's court. Courts depend on local governments for basic necessities, including judges' salaries and bonuses, office supplies, vehicles, court buildings, etc. This fund - court spending - is listed as an independent category in the government budget as stipulated in a 1982 central Party document and later in the 1983 Categories of State Budget <sup>2</sup>. In 1998, a "dual-track" system (*shouzhi liangtiaoxian*) was applied to court revenues and expenditures. In this "dual-track" system, all court income, including mainly litigation fees and fines, should be turned in to the territorial government; and each year, the court prepares a budget to be submitted to the government, and the government makes the budget according to the need of the court and the financial situation of the government. The core principle of the "dual-track" system is that court's spending should

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<sup>2</sup>Please see "On Solving Financial Difficulties of People's Courts (*Guanyu jiejie renmin fayuan yewu jingfei kunnan wenti de tongzhi*)" issued by the Supreme People's Court and the Ministry of Finance on August 31, 1985.

be independent of its income, that is to say, how much money a local government allocates to the court in the budget should be unrelated to how much money the court turns in to the government<sup>3</sup>.

In 2007, a new regulation on litigation fees was adopted. This new regulation significantly decreases litigation fees in almost all categories of disputes<sup>4</sup>. As a consequence, fees collected by local courts significantly dropped in 2007, as did local governments' revenues. To compensate for the loss of revenues, especially to guarantee court funding, the Ministry of Finance allocated 3 billion RMB (approximately 380 million U.S. dollars) to finance courts at various levels, especially in western provinces where financial resources have long been scarce<sup>5</sup>. This is the first time that the central government paid for local court expenditures out of the central budget. Before this, court funding completely relied upon local budgets. The center is also considering centralizing the court fiscal system to make the central government pay for all local courts to make local courts less dependent on local governments<sup>6</sup>.

Since court finance is highly decentralized, court funding is to a large extent determined by the financial resources of the local government and, especially, the importance of the court in the eyes of the officials who are making the budget. A glance at the budget data shows several patterns of court spending in sub-national China (Figure 5.1). First of all, the share of court spending in provincial budgets manifests significant stability over time: the lines are smooth except spikes in certain years. Secondly, in most provinces the shares are increasing over time except Hainan and Qinghai. Thirdly, a spike of court spending occurred around 2002 in

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<sup>3</sup>For details about the "dual-track" system, please see "On Implementing the 'Dual-Track' Regulations (*Guanyu renzhen guanchede luoshi 'shouzhi liangtiaoxian' guiding de tongzhi*)" issued by the Supreme People's Court on June 9, 1998.

<sup>4</sup>Please see "Methods of Paying Litigation Fees (*Susong feiyong jiaona banfa*)"

<sup>5</sup>Please see a news report on this <http://politics.people.com.cn/GB/1026/6286758.html>

<sup>6</sup>Please see <http://news.21cn.com/domestic/yaowen/2008/12/05/5573183.shtml>

most provinces. Figure 5.2 shows the changes over time in Beijing and Jiangsu. Court spending as a share of provincial budget climbed to another level in 2002 in both provinces. One possible cause is China's joining the World Trade Organization (WTO) in 2001, which imposed international standards of trade and investment on China and attracted significantly more foreign investors. Lastly, court spending reveals significant variation both across space and over time. This begs the question: why do some local governments spend more money on courts while others spend less given that the institutions are identical across the country?

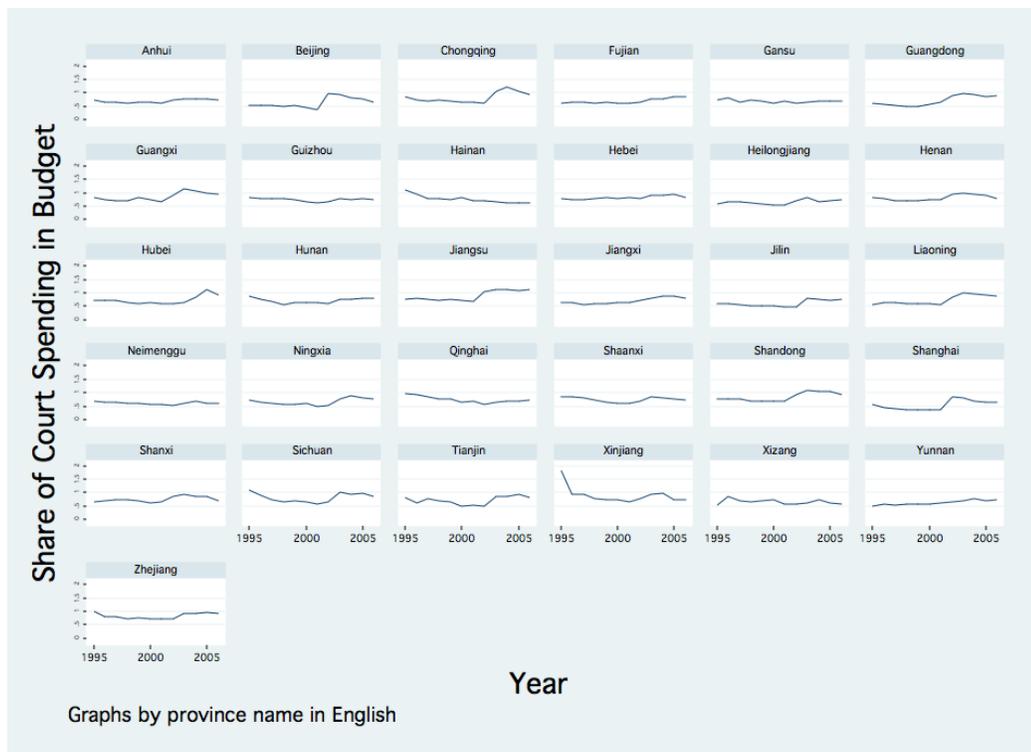


Figure 5.1: Court Spending in Provincial Budgets across 31 Provinces (1995-2006)

Court funding has great implications for judicial efficiency and judicial fairness<sup>7</sup>. In a conversation with a court official in Guangdong who had traveled to lots of courts in China, I asked: “Why are some courts clean, efficient, and profes-

<sup>7</sup>A consensus is that insufficient funding is often correlated with inefficient and unfair court decisions, judicial corruption, and lack of professionalization. Please see He (2008), Wang (2010), Yang (2009), Jin (2008), Xue and Zhang (2001).

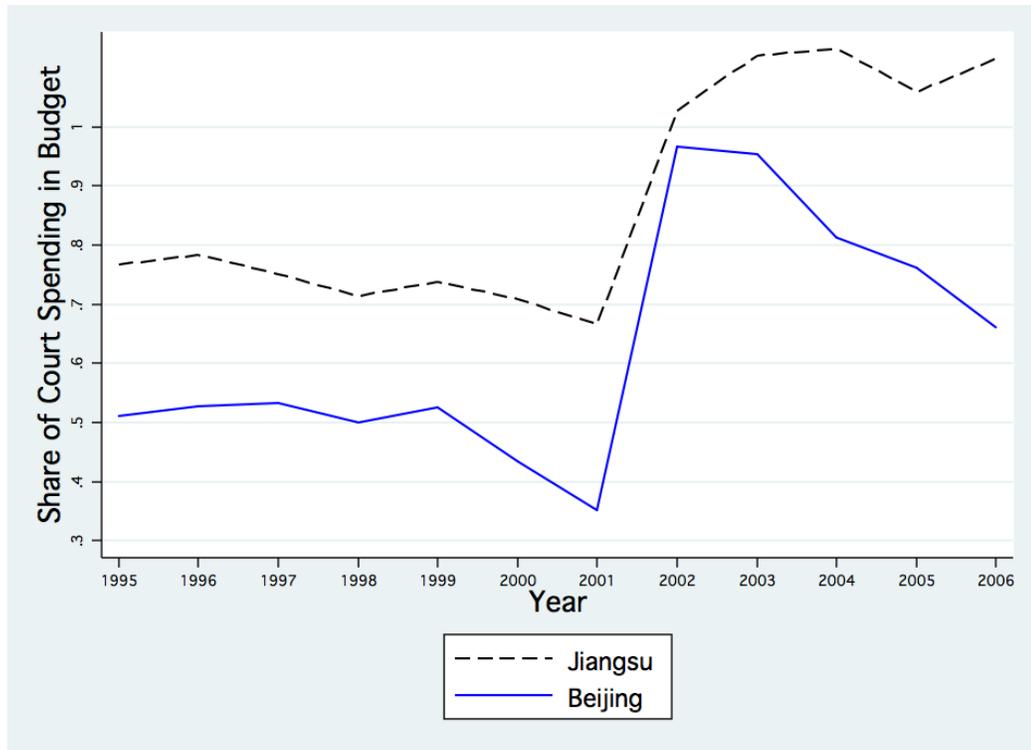


Figure 5.2: Court Spending in Beijing and Jiangsu (1995-2006)

sional while others corrupt, incompetent, and inept?” His answer was simple but illuminating: “It’s all about money!”<sup>8</sup> Whether a court can secure funding from the government to a large extent determines the “quality” of the court.

City D in Guangdong province is one of the richest cities in China. The story of city D’s development is a typical one. It is adjacent to one of the special economic zones (SEZs) opened in the early 1980s. Taking advantage of the “open door” policy and its regional location, city D attracted a large number of foreign investors from Hong Kong throughout the 1980s and 1990s. As a result, the city also drew in a lot of migrant workers. Now, more than half of the city population are migrants. Cheap labor, proximity to Hong Kong and ports, and favorable policies also drew many investors from the U.S., Japan, and Europe. The city soon became one of the manufacturing centers of China. In 2009, the GDP per capita of city D is around

<sup>8</sup>Subject #10, interview in Guangdong province, March 23, 2010.

\$8,800, well above the national average of \$6,800.

I visited a people's basic court in city D in March, 2010. The court is located in a town<sup>9</sup>. The court has 159 judges and staff members; of these, 131 have bachelor degrees and 13 went to graduate school. In 2009, the court received 31,728 cases and completed 30,518 cases (completion rate 96.19%). The average number of cases one judge completed is 402, 9 times the national average of 46 cases per judge. The court has a newly-built 9-floor building. A court official told me that the construction was completely taken care of by the town government, and it cost the government 70 million RMB (about 10 million U.S. dollars). The court did not pay a cent for the building<sup>10</sup>. The building is surely beautiful: marble floor in the lobby, 5 elevators, camera systems in every court room, large office space for judges, a library decorated by paintings by the judges, and a cafeteria for judges and staff to have breakfasts and lunches for free! And most notably, all the judges and staff are in uniforms! I had an interview with the president of the court in her deluxe office while she was brewing dragon well tea for me. She told me that the court completely relies on the city government for financial resources, and luckily for her court, the city government is economically better-off, so she "can focus on work rather than finding money for the court!" What her court needs to do is to prepare a budget at the beginning of each year to be submitted to the city government, and the government "always gives what we ask for!" The president also said that the "dual-track" regulation was strictly enforced, so the government decided on the budget only based on how much the courts needed rather than on how many fees the court collected and handed in to the government. The president then talked about the court fiscal reform. She said that:

"It is likely that, in the future, part of the court revenue will be allocated

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<sup>9</sup>City D is a prefecture level city. But D does not have districts or counties. So the basic courts (county level) are located in towns.

<sup>10</sup>Subject #10, interview in Guangdong province, March 23, 2010

from the central government. The intention of this reform is good, so courts are less dependent on local governments for revenues. But as a court in a wealthy area, this reform will reduce the funding of my court because the national government will try to balance different regions, so courts in developed areas will obtain less funding, whereas courts in underdeveloped areas will obtain more. The funding from the central government won't be comparable to what we are getting now from the city government.”<sup>11</sup>

I did not have to travel far to the west to find a court vastly different from the court in city D. In April, 2010, I arrived in city G in Jiangxi province which neighbors Guangdong province. City G was designated as an economic development zone (EDZ) in 1994. The EDZ status and rich natural resources made the development of city G very successful in the 1990s. A famous state-owned enterprise producing down clothes was established in early 1980s and became very profitable in the 80s and 90s because of the high quality feathers from ducks in the lakes surrounding city G. However, due to slack protection of intellectual property rights, many private firms pirated the techniques of the SOE. The city government, relying on taxes paid by those private firms, tolerated the rampant infringement. The pirated products soon ruined the reputation of the brand of the SOE. The city economy started to stagnate.

I visited the people's basic court in city G. The court has only 13 judges among whom 4 are officials who usually do not adjudicate cases. In 2009, the court completed about 600 cases, and each judge completed about 60 cases. I visited the court on an early afternoon to conduct an interview scheduled several days before. The court also has a new building. There was just one worker in the lobby sweeping the floor, and I heard bursts of laughter from several staff members playing poker

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<sup>11</sup>Subject #11, interview in Guangdong, March 23, 2010.

in the registration office. All the people I saw wore casual clothes. There was no elevator, so I climbed up the stairs to the third floor where the offices of major officials (such as president, deputy presidents, and chief of staff) are located. I talked to the chief of staff in her office. It was cold in her office because it was raining outside. She apologized for not having an air conditioner. She poured out a cup of hot water for me, and we started our conversation. She said that the court revenue came from two sources. One part was from the local government, the other from the central government transfer. Usually, the transfer from the central government was guaranteed, but local funds rarely arrived in time. She added that:

“The ‘dual-track’ regulation is never enforced here: the city government always returns 100% of what we turn in, and that’s it, they give us no more! But now the litigation fee is too low to run the court. For example, this new building costed 11 million RMB, the government only gave us 4 million, and we took a loan for 7 million. We are still in debt. We beg the government for money every year!”

As a consequence of the poor financial condition, the court had no money to investigate cases. The chief of staff said:

“We have to postpone cases. We don’t have many cars. Judges have to walk or ride a bike to investigate a case. Sometimes, if it is too far, we just don’t go. We don’t like people coming to our court to start a case. The fee is 5 yuan or 10 yuan for a case, but the cost is 500 yuan. We sometimes don’t let them register, or if they register, we just postpone it!”

The chief of staff also complained that most firms in city G were private firms, and those private firms did not need courts. They preferred to seek help from the government or the police rather than the court.<sup>12</sup>

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<sup>12</sup>Subject #29, interview in Jiangxi province, April 2, 2010.

The court's fiscal system governs the incentive structure of judges. A general observation is that judges are more likely to be focused on the *quality* of cases if their courts have sufficient funding, whereas judges are more likely to be focused on the *quantity* of cases if their courts have insufficient funding. This corresponds to the pay structure of local judges. In wealthy courts, judges' salaries depend upon rank and performance. And the performance is assessed by an evaluation system based on indicators such as number of errors and completion rate, etc.<sup>13</sup> However, in places where courts cannot secure funding from the government, judicial pay is tied to how many cases the judge can seek for the court. And the cases have to involve high stakes, because the litigation fee is proportional to the stake involved. A government official who was the chief of staff in a court in Hunan province told me that:

"Judges have to make money on their own! For example, in the court that I was working for, we had a policy called 'return.' The way it works is that judges usually go to talk to people working in banks and ask them to transfer their debt disputes to the court. Those debt cases often involve large money, so the litigation fees would be high. Although there is this 'dual-track' system, but my court had a deal with the district government that part of the litigation fee would be returned to the court. And the court paid judges based on the number of cases they adjudicated. Their wages were fixed, but bonuses were very flexible. Some judges had very close connections with lawyers, and lawyers always gave cases to the judges with whom they are friends."<sup>14</sup>

A legal scholar told me another story of this type of judge-lawyer transactions<sup>15</sup>:

"In inland and western provinces, judges often need to treat lawyers

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<sup>13</sup>Subject #10, interview with a court official, Guangdong province, March 23, 2010.

<sup>14</sup>Subject #25, interview in Guangdong, March 30, 2010.

<sup>15</sup>This types of judge-lawyer transactions are illegal according to the PRC Judges Law.

to meals, especially famous lawyers. I myself witnessed one of these meals. Once, during a dinner in Hunan province, a judge said to a lawyer: ‘Lawyer Wang, please bring your cases to me!’<sup>16</sup>

In sum, government funding has significant impacts on courts and judges in a way that can potentially determine the efficiency and fairness of judicial judgments.

### 5.3 Empirical Strategies and Results

Based on the discussion in the theory chapter, four testable hypotheses are generated:

*Hypothesis 5.1: As the contribution of foreign direct investment from outside the “China circle” to the local GDP increases, local governments in China are more likely to provide financial support to courts, ceteris paribus*

*Hypothesis 5.2: The proportion of foreign direct investment from within the “China circle” in local GDP has a negative effect on local governments’ financial support to courts, ceteris paribus.*

*Hypothesis 5.3: As the share of state-owned enterprises in local economy increases, local governments’ financial support to courts decreases, ceteris paribus.*

*Hypothesis 5.4: As the share of private enterprises in local economy increases, local governments’ financial support to courts decreases, ceteris paribus.*

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<sup>16</sup>Subject #27, interview in Guangdong, March 31, 2010.

### 5.3.1 Data and Measurement

I will test the four hypotheses using an original time-series cross-section data set on court spending of 31 Chinese provinces in 1995-2006. I limit my data-collection efforts to these 12 years mainly because the core dependent variable - court spending as a proportion of government budget - is only available from *Statistical Reports on Local Finance (Difang caizheng tongji ziliao)* published by the Ministry of Finance of the PRC for these 12 years<sup>17</sup>. The credibility of this data source has been examined by scholars who have collected data from the same reports (Ang, 2010b; Landry, 2010a).

“Government’s spending on courts” (*court*) is measured by *the proportion of court spending in the overall government budget*. Financial support from territorial governments is a crucial way to keep courts running as discussed in the second section. If a local government has the inclination to empower the local court, a necessary method is to allocate a larger percentage in the overall budget to the court. A potential critic might say that court spending actually reflects the extent to which local governments financially control the courts. Therefore, court spending measures the lack of judicial independence rather than judicial strength. I argue that this is not the case. First of all, the extent of being controlled by the government should be measured by the proportion of funding from the government in the overall court spending. If a court has a large amount of self-raised funds, the court should enjoy fiscal autonomy from the local government. But here, I use the proportion of court spending in *the overall government budget*, which reflects the priority a local government gives to court. Secondly, assuming the criticism is accurate, some studies have shown that the dependence of courts on local governments is conducive to building a clean and professional legal system

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<sup>17</sup>Budget data of Chinese governments at various levels are usually confidential. I accessed these reports through public libraries in China, but on the first pages of each book, it still says these are “internal materials.”

in China; without checks and balance from the government, courts are more likely to be corrupt (Gao, 2008; Li, 2010).

FDI is measured in two ways. To distinguish FDI from within and outside the “China circle,” I collected the amount of FDI inflows from Hong Kong, Macao, and Taiwan (*China circle*) in 1995-2006 across China’s 31 provinces and provincial level cities. FDI from outside the “China circle” is measured using the amount of FDI inflows from all other countries (*foreign*). The sources of FDI data are provincial yearbooks of 31 provinces published in 1996-2007.

Share of state-owned enterprises in the local economy (*SOE*) is measured by the share of labor force employed in urban SOEs in the total urban labor. *SOE* is expected to have a negative impact on government spending on courts, because SOEs are backed by the government, and therefore, do not rely on courts to settle disputes and enforce contracts.

Share of private enterprises in the local economy (*private*) is measured by the percentage of labor force employed in the urban private sector (including private enterprise employees and self-employed workers) in the total urban labor. The effect of *private* is expected to be negative, because it is well-known that private entrepreneurs in China have strong patron-client ties with local governments (Wank, 1999), which will only undermine formal legal institutions.

Several controls are also included: *GDP per capita* (log-transformed), weight of the service sector in the overall GDP (*service*), GDP growth rate (*GDP growth*), share of rural population (*rural pop*), log transformed population (*population*), number of cases accepted by first instance courts (*cases*), number of law offices (*law offices*), and number of lawyers (*lawyers*).

### 5.3.2 Model Specification and Econometric issues

The data set is compiled by the author from various sources. An inevitable problem is missing data. Especially, provincial statistical yearbooks are published in a very decentralized manner in China. The central Bureau of Statistics requires local statistical yearbooks to report major statistics including GDP, employment, and investment, etc. Besides these, what other information to reveal is at the discretion of provincial bureaus of statistics. The following chart (Figure 5.3) shows the percentage of missing values for major variables used in the model. As is shown, while most variables are complete, some major independent variables have *non-ignorable* missing values, for example, *China circle*, *foreign*, *cases*, *law offices*, and *lawyers*.

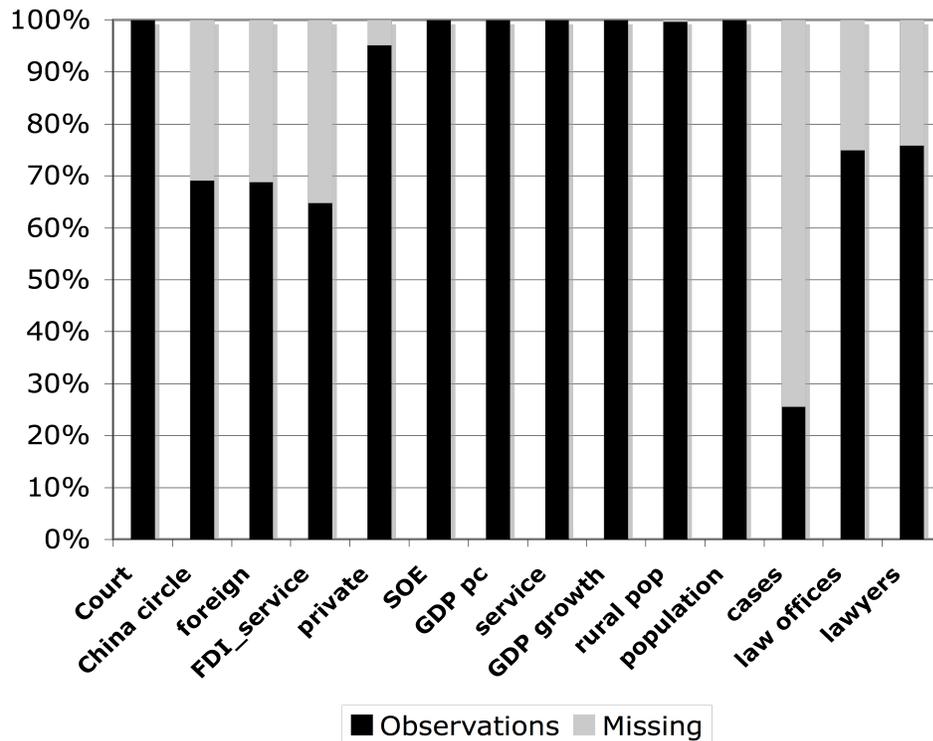


Figure 5.3: Pattern of Missing Values

A conventional way to deal with missing data is listwise deletion. But as King

et al. (2001, 51) argue, if the missing process is *nonignorable*, that is, if the probability that a cell is missing depends on the unobserved value of the missing response, listwise deletion can bias conclusions. The missing process is highly likely to be nonignorable in this case. For example, provinces with less FDI are less likely to report information on FDI. To create balanced matrices for time-series cross-section analyses, I employed multiple imputation technique to impute five multiple matrices with complete data on each variable<sup>18</sup>.

A pooled time-series cross-section analysis will allow me to examine the variation of court spending both across space and over time. The unit of analysis is province/year. All the 31 provinces over the time period of 1995-2006 ( $N=31$ ,  $T=12$ ) are included in the following analysis. To test the four hypotheses, a dynamic model is specified as follows<sup>19</sup>:

$$\begin{aligned}
Court_{i,t} = & \alpha + \sum_{j=1}^p \phi_j Court_{i,t-j} \\
& + \sum_{k=1}^n \sum_{j=0}^q \delta_k Chinacircle_{i,t-j} + \sum_{k=1}^n \sum_{j=0}^q \theta_k foreign_{i,t-j} \\
& + \sum_{k=1}^n \sum_{j=0}^q \mu_k SOE_{i,t-j} + \sum_{k=1}^n \sum_{j=0}^q \omega_k private_{i,t-j} \\
& + \mathbf{X}\beta \\
& + \lambda_t + \gamma_i + \epsilon_{i,t}
\end{aligned} \tag{5.1}$$

In Equation (5.1),  $Court_{i,t}$  is the dependent variable which measures the proportion of court spending in the overall government budget in province  $i$  at time  $t$ .  $\alpha$  is the intercept.  $\phi_j$  is the marginal effect(s) of lagged dependent variable(s).

<sup>18</sup>For multiple imputation, I used *Amelia II* (Version 1.2-14, built: 2009-11-16) designed by James Honaker, Gary King and Matthew Blackwell. Please refer to <http://gking.harvard.edu/amelia/> for more information. For analyses of multiple imputed data sets, I used the *Stata miest* package contributed by Kenneth Scheve.

<sup>19</sup>To follow the suggestions of De Boef and Keele (2008), the model is specified in a general way which puts no restrictions on the dynamic components.

Lagged dependent variables are included to eliminate serial correlation of the errors (Beck and Katz 2009). Another rationale of including the lag is that the budgeting process is incremental: this year's budget is based on last year's (Wildavsky and Caiden, 1997).  $\delta_k$  is the marginal effect(s) of *China circle* which is measured by the weight of FDI from Hong Kong, Maucou, and Taiwan in the overall provincial GDP.  $\delta_k$  is expected to be negative because FDI from within the "China circle" should have a negative impact on court spending.  $\theta_k$  should be positive, since they are estimates of the marginal effects of FDI from outside the "China circle."  $\mu_k$  is the marginal effect(s) of *SOE* which is the weight of SOEs in the overall urban economy.  $\omega_k$  is the marginal effect(s) of private enterprises. Both  $\mu_k$  and  $\omega_k$  are expected to be negative.  $X$  is a vector of controls including *GDP per capita* (log transformed), *service*, *GDP growth*, *rural pop (log)*, *population (log)*, *cases (log)*, *law offices (log)*, and *lawyers (log)*.  $\lambda_t$  is the time "fixed effect" which includes dummy variables for each year. They capture the remaining serial variation not explained by the independent variables, such as national policy shift. And  $\gamma_i$  is the unit "fixed effect" which are province dummy variables. These dummies take into account unexplained regional heterogeneity, for example, historical factors.  $\epsilon$  is the error term.

Pooled Ordinary Least Squares (OLS) regressions with panel corrected standard errors (Beck and Katz, 1995) are used to estimate Equation (5.1). A Lagrange multiplier test recommended by Beck and Katz (2009) suggests that two levels of lag for the dependent variable should be included to eliminate serial correlation in  $\epsilon_{i,t}$ <sup>20</sup>. In the first four columns in Table 5.1, I set  $p = 2$  and  $q = 1$ . In the last four columns in Table 5.1, I set  $p = 1$  and  $q = 0$ . In addition to inclusion or exclusion of lags, columns in Table 5.1 also have different combinations of "unit fixed effects" and/or "time fixed effects."

<sup>20</sup>By excluding all lags,  $F = 27.40, p < .01$ . By including one lag,  $F = 26.28, p < .01$ . By including two lags,  $F = 0.31, p = .58$ .

### 5.3.3 Results

Table 5.1 shows the results of least squares dummy variables (LSDV) estimates of Model (5.1) and its variations. The first four columns include two-year lags of the dependent variable. This is a very stringent test, since inclusion of lagged dependent variables usually suppresses the significance of other independent variables (Achen, 2000). As shown in column 1-4 of Table 5.1, the point estimates of the marginal effect of “China circle” are all negative. In three of the four estimates, this effect is distinguishable from 0. Especially, the negative effect is significant in column 4 which includes both province dummies and year dummies. This indicates that after controlling for all sources of heterogeneity across space and over time, FDI from within the “China circle” still exerts a negative impact on government spending on courts.

Table 5.1: Determinants of Court Spending: Least Squares Dummy Variables Estimation

Variable	Coefficient (P.C.S.E)															
lag_court	0.698 (0.137)	***	0.560 (0.141)	***	0.626 (0.136)	***	0.465 (0.147)	***	0.548 (0.072)	***	0.442 (0.078)	***	0.542 (0.074)	***	0.396 (0.085)	***
lag2_court	-0.073 (0.108)		-0.097 (0.105)		0.066 (0.098)		0.020 (0.101)		-		-		-		-	
China circle	-0.017 (0.007)	**	-0.016 (0.008)	*	-0.009 (0.007)		-0.014 (0.006)	**	-0.015 (0.004)	***	-0.012 (0.007)	***	-0.011 (0.004)	***	-0.012 (0.006)	**
lag_China circle	0.002 (0.006)		-0.001 (0.007)		0.001 (0.006)		-0.004 (0.006)		-		-		-		-	
foreign	0.012 (0.005)	**	0.014 (0.006)	**	0.008 (0.005)		0.011 (0.006)	*	0.010 (0.003)	***	0.017 (0.005)	***	0.007 (0.003)	**	0.012 (0.005)	**
lag_foreign	-0.002 (0.005)		0.006 (0.006)		-0.002 (0.005)		0.002 (0.005)		-		-		-		-	
private	-0.001 (0.002)		-0.001 (0.002)		-0.002 (0.002)		-0.002 (0.002)		-0.001 (0.001)		-0.001 (0.001)		-0.001 (0.001)		-0.003 (0.001)	**
lag_private	0.001 (0.002)		0.001 (0.002)		0.001 (0.002)		-0.000 (0.002)		-		-		-		-	
soe	-0.004 (0.002)	**	-0.005 (0.002)	***	-0.002 (0.001)		-0.003 (0.001)	**	-0.002 (0.001)	***	-0.003 (0.001)	***	-0.001 (0.001)		-0.001 (0.001)	***
lag_soe	0.003 (0.002)		0.002 (0.002)		0.001 (0.002)		0.002 (0.001)		-		-		-		-	
gdp pc (logged)	0.001 (0.020)		-0.127 (0.059)	**	0.014 (0.019)		-0.227 (0.094)	**	-0.009 (0.024)		-0.087 (0.055)		-0.004 (0.022)		-0.168 (0.077)	
service	0.001 (0.001)		-0.001 (0.001)		-0.000 (0.001)		-0.001 (0.001)		0.000 (0.001)		0.002 (0.001)		-0.001 (0.001)		-0.002 (0.001)	
gdp growth	0.008 (0.004)	*	0.016 (0.006)	***	0.001 (0.003)		0.005 (0.004)		0.009 (0.004)	**	0.014 (0.005)	**	0.002 (0.003)		0.003 (0.004)	
rural pop	0.001 (0.001)		-0.001 (0.002)		0.001 (0.001)		0.001 (0.002)		0.001 (0.001)	***	0.000 (0.002)		0.001 (0.000)	***	0.001 (0.002)	
population (logged)	0.000 (0.020)		0.292 (0.300)		0.007 (0.026)		-0.440 (0.308)		-0.011 (0.024)		0.295 (0.266)		-0.011 (0.026)		-0.208 (0.286)	
cases (logged)	0.009 (0.011)		0.010 (0.050)		0.003 (0.013)		0.006 (0.046)		0.003 (0.003)		-0.000 (0.047)		0.001 (0.014)		-0.003 (0.044)	
law offices (logged)	0.022 (0.034)		0.084 (0.060)		-0.003 (0.035)		0.063 (0.058)		0.049 (0.036)		0.119 (0.060)		0.028 (0.033)		0.111 (0.057)	***
lawyers (logged)	-0.013 (0.021)		0.004 (0.040)		0.006 (0.021)		0.030 (0.041)		-0.021 (0.022)		0.008 (0.038)		0.002 (0.019)		0.024 (0.035)	
Province fixed effects	NO	YES	NO	NO	NO	YES	YES	NO	NO	NO	YES	YES	NO	NO	YES	YES
Year fixed effects	NO	NO	NO	YES	YES	YES	YES	NO	NO	NO	NO	NO	YES	YES	YES	YES
Intercept	-0.002 (0.191)		-1.117 (2.568)		-0.060 (0.208)		5.308 (2.987)	*	0.248 (0.235)		-1.563 (2.245)		0.261 (0.246)		3.018 (2.771)	
N	310		310		310		310		341		341		341		341	
R <sup>2</sup>	0.654		0.710		0.745		0.784		0.630		0.693		0.714		0.768	
χ <sup>2</sup>	600.129		4044.009		268130.378		5045.842		548.439		2027.976		26239.871		9083.444	

\*p < .1, \*\*p < .05, \*\*\*p < .01

On the other hand, the point estimates of the marginal effect of “foreign” are all positive. And in three of the four regressions, the effect is distinguishable from 0. In column 4, after controlling for province dummies and year dummies, “foreign” still has a significantly positive effect on court spending.

In addition, the point estimates of “private” and “SOE” are all negative. The effect of “SOE” is significant in three regressions, whereas the effect of “private” fails to show significance at any conventional levels.

Since the two-year lag of the dependent variable and all the lags of the independent variables are not significant, column 5-8 show the results without these lags<sup>21</sup>. As shown, the point estimates of “China circle” remain negative, and the effect is distinguishable from 0 in three regressions. On the other hand, “foreign” shows a significantly positive effect in all the four regressions. In addition, both “private” and “SOE” show negative effects. The effect of “private” is significant in one regression, whereas that of “SOE” is significant in three regressions.

In terms of controls, some deserve special highlighting. First of all, the one-year lag of court spending shows consistent significance across all regressions. This is consistent with the well-know argument that the budgetary process is incremental. Secondly, the point estimates of GDP per capita are negative in six out of eight regressions, and two of them are significant. At the same time, GDP growth rate shows consistently positive effect on court spending, and in four regressions, the effect is significant. This casts doubts on classic modernization theory which would predict that level of economic development rather than speed will strengthen institutions. Lastly, neither “law offices” nor “lawyers” show significant results. This further implies the limitations of China’s civil society.

Generally speaking, the results shown in Table 5.1 are supportive of all the four

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<sup>21</sup>Excluding the two-year lag of the dependent variable is likely to cause serial correlation in the error term, which will potentially bias the estimates. But as shown in column 5-8, the point estimates are not significantly different from those in column 1-4. This indicates that serial correlation left in the error term after excluding the two-year lag is too weak to bias the results.

hypotheses. A detailed discussion of the meanings of these results will be offered in the discussion chapter.

## 5.4 Regional Competition and Court Spending

This section discusses and tests a question: whether a province's action to finance courts will induce another province to move in the same direction. If the answer is yes, we expect to see that a province's increase in court spending would induce a connected province's increase in court spending too, because provincial governments are competing for capital, and capital is mobile.

Regional competition has long been considered a key factor in incentivizing governments to provide public goods, promote economic growth, and discipline corruption. In the classic Tiebout model, municipalities within a region, which rely on tax revenues, compete on government services to attract and retain tax payers who can "vote by their feet" (Tiebout, 1956). In explaining China's economic growth, Montinola, Qian, and Weingast (1995) offer a theory which they term "market-preserving federalism." In this theory, they argue that because of administrative decentralization and fiscal decentralization, provincial governments in China are incentivized to protect properties of local firms which then causes economic growth. The causal chains between fiscal decentralization, regional competition, and economic growth are further tested and supported by the empirical studies of Lin and Liu (2000) and Zhang and Gong (2005). Cheung (2009) bluntly argues that competition among counties is the single most important factor that causes China's rapid economic growth in the last 30 years.

Cai and Treisman (2005) specify, in a theoretical model, the conditions under which competition to attract mobile capital disciplines governments. They derive that whether competition to attract mobile capital discipline governments depends on initial endowment: When endowment asymmetry is sufficiently large, govern-

ments in poorly endowed units invest less in infrastructure, attract less capital, and thus have lower total output under capital mobility than under immobility. By contrast, governments in well-endowed units invest more in infrastructure, attract more capital, and have higher output when capital can flow freely. When the gap is large, competition for capital does not discipline governments in the poorly endowed units, forcing them to improve their business environment. On the contrary, since they see little hope of winning, governments give up on competing for capital and focus instead on public consumption. They conclude that capital competition exacerbates initial inequalities, hindering economic development in the poorly endowed units, while stimulating it in their better-endowed rivals.

However, literature in the China field still lack systematic explanations on conditions under which competition for capital would produce a race-to-the-top rather than a race-to-the-bottom effect. While studies reviewed above have found a positive association between fiscal decentralization and economic growth, fragmented markets, local protectionism, real estate bubbles, environmental degradation, decreasing spending on welfare and education, and worsened labor standards are also consequences of regional competition. In addition, previous studies have found that regional competition exists in China, but few studies have shown *who* are in the competition. Are they neighboring locales or locales that are at the same level of economic development? The following analysis is a preliminary attempt to address these questions.

#### **5.4.1 Empirical Strategies**

Conventional econometric methods view spatial interdependence as a nuisance and use strategies to correct it, for example, panel-corrected standard errors. However, as Franzese and Hays (2007*b,a*) show, failure to model spatial interdependence is a serious misspecification risking sizable omitted variable bias. In the

following analysis, I add a spatial lag to equation (5.1) to test whether provinces in China are interdependent in terms of court spending and how the inclusion of a spatial lag influences the results.

Franzese and Hays (2006, 2007 $b,a$ , 2008) pioneer the empirical modeling of spatial interdependence in political science. As they define, “strategic interdependence arises whenever some unit(s)’s actions affect the marginal utilities of the alternative actions for some other(s)” (Franzese and Hays, 2007 $a$ , 745). They further distinguish two types of strategic interdependence. If actions by unit  $i$  induce unit  $j$  to move in the same direction, the actions of  $i$  and  $j$  are *strategic complements*. Examples of strategic complements include cuts in capital taxes or costly labor, environmental, or other regulatory standards as a result of competition for mobile capital. Conversely, if actions by unit  $i$  induce unit  $j$  move in the opposite direction, they are “strategic substitutes.” An example of “strategic substitute” is defense expenditures: an increase in defense expenditures in one country lowers the marginal security benefit from defense spending in its military allies, creating an incentive for them to free ride. Note that both race-to-the-bottom and race-to-the-top dynamics occur when policies are strategic complements (i.e., when policy changes in one unit create incentives for others to adopt similar changes).

As for court spending, I argue that that provincial governments’ financial supports to courts are “strategic complements.” The mechanism goes as follows: province  $i$  strengthens its legal system to keep foreign investors from moving. Observing this, province  $i$ ’s competitor  $j$  also increases its court spending, because the officials in province  $j$  believe that foreign investors in their jurisdiction are likely to pose a credible exit threat by leaving province  $j$  for province  $i$  because of better legal protection there. The following analysis will test this possibility.

A spatial-temporal lag model is specified as follows:

$$\mathbf{y} = \phi \mathbf{M}\mathbf{y} + \rho \mathbf{W}\mathbf{y} + \mathbf{X}\beta + \epsilon \quad (5.2)$$

where  $\mathbf{y}$  is court spending,  $\mathbf{M}\mathbf{y}$  is just the familiar (first-order) time-lagged dependent variable, with  $\phi$  its coefficient.  $\rho$  is the spatial autoregressive coefficient, and  $\mathbf{W}$  is an  $NT \times NT$  block-diagonal spatial-weighting matrix.  $\mathbf{W}\mathbf{y}$  is the spatial lag, which is a weighted sum of other units' court spending,  $y_{jt}$ , with weights  $w_{ij}$  reflecting relative connectivity from  $j$  to  $i$ . The matrix  $\mathbf{X}$  contains all the independent variables in Table 5.1.

Due to missing data, 9 provinces<sup>22</sup> and 5 years<sup>23</sup> are dropped in the following analysis<sup>24</sup>. Now the data set has  $N=21$  and  $T=7$ .

The key question then is how to specify the spatial-weighting matrix  $\mathbf{W}$ . Since this research is completely exploratory, I will firstly try with a specification where neighboring provinces are assumed to be competing with each other. I calculate the spatial lag,  $\mathbf{W}\mathbf{1}$ , using a standardized binary contiguity-weights matrix, which begins by coding  $w_{ij} = 1$  for provinces  $i$  and  $j$  that share a border and  $w_{ij} = 0$  for provinces that do not border. I then row-standardize the resulting matrix by dividing each element by its row's sum, making  $\mathbf{W}\mathbf{y}$  the simple average of *Court* in  $i$ 's "neighbors." Table 5.2 shows sample provinces and their neighbors.

## 5.4.2 Results

As Franzese and Hays (2007*b,a*) show, spatial-maximum likelihood (S-ML) produces consistent estimation that is weakly dominant compared to other estimators such as spatial-2SLS and spatial-OLS. Table 5.3 shows the results of S-ML estima-

<sup>22</sup>The dropped provinces are Shanxi, Neimenggu, Jilin, Heilongjiang, Hubei, Hainan, Guizhou, Tibet, and Ningxia

<sup>23</sup>The dropped years are 1995-1999.

<sup>24</sup>Statistical techniques for analyzing multiple imputed data have not been developed.

Table 5.2: Sample Provinces and Their Neighbors

Province	Neighbors				
<b>Beijing</b>	Tianjin	Hebei			
<b>Tianjin</b>	Beijing	Hebei			
<b>Hebei</b>	Beijing	Tianjin	Liaoning	Shandong	Henan
<b>Liaoning</b>	Hebei				
<b>Shanghai</b>	Jiangsu	Zhejiang	Anhui		
<b>Jiangsu</b>	Shanghai	Anhui	Shandong	Zhejiang	
<b>Zhejiang</b>	Shanghai	Jiangsu	Anhui	Fujian	
<b>Anhui</b>	Shanghai	Jiangsu	Zhejiang	Shandong	Henan
<b>Fujian</b>	Zhejiang	Guangdong			
<b>Shandong</b>	Hebei	Henan	Jiangsu	Anhui	
<b>Henan</b>	Hebei	Anhui	Shandong	Shaanxi	
<b>Hunan</b>	Guangdong	Guangxi	Chongqing		
<b>Guangdong</b>	Fujian	Hunan	Guangxi		
<b>Guangxi</b>	Guangdong	Hunan	Yunnan		
<b>Chongqing</b>	Hunan	Sichuan	Shaanxi		
<b>Sichuan</b>	Chongqing	Yunnan	Shaanxi	Gansu	Qinghai
<b>Yunnan</b>	Sichuan	Guangxi			
<b>Shaanxi</b>	Henan	Chongqing	Sichuan	Gansu	
<b>Gansu</b>	Shaanxi	Sichuan	Qinghai	Xinjiang	
<b>Qinghai</b>	Sichuan	Gansu	Xinjiang		
<b>Xinjiang</b>	Gansu	Qinghai			

tion of model (5.2)<sup>25</sup>.

First of all, the key independent variables that have significant effects in Table 5.1 are still mostly significant and in right directions in Table 5.3. The only exception is that all the four major independent variables become insignificant in the fourth column where both province fixed effects and year fixed effects are included. This might be due to the small degree of freedom caused by list-deletion of observations<sup>26</sup>.

Interestingly,  $\rho$ , coefficient of the spatial lag, is significantly positive in column 1 and 2 when year fixed effects are excluded. This implies race-to-the-top dynamics among the neighboring provinces: an increase of court spending in province  $i$  will induce  $i$ 's neighboring province  $j$  to increase its court spending. However, after including the year fixed effects,  $\rho$  becomes negative and insignificant.

There are two possibilities for the insignificance of the spatial lag. First of all, recall the graph at the beginning of this chapter which shows that court spending is growing over the years. This implies that changes in court spending across provinces are due to some "common exposure" rather than "spillover" from neighboring provinces. The *Wald* test shows that the year fixed effects are jointly significant ( $\chi^2=59.97$  and  $p = 0.000$  in column 3;  $\chi^2=66.02$  and  $p = 0.000$  in column 4). This suggests that the "common exposure" might be related to China's increasing involvement in globalization and FDI inflow over time.

The second possible cause is that the spatial-weighting matrix  $W$  is inaccurately specified. It might be the case that neighboring provinces do not compete for capital. Consider, Guangdong province and Guangxi province share borders, but due to the large gap of prosperity between the two provinces<sup>27</sup>, it is not likely for a firm to leave Guangdong for Guangxi. So Guangxi government's increase in court

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<sup>25</sup>ML estimation of spatial-interdependence models is made possible in Stata by MacMillan, Franzese, and Hays (N.d.)

<sup>26</sup>The model now has only  $NT = 147$  observations but 37 variables.

<sup>27</sup>Guangdong's per capita GDP in 2006 is 28,332 yuan, whereas Guangxi's is only 10,296.

Table 5.3: Determinants of Court Spending: MLE of Spatial Interdependence Models I

Variable	Coefficient (S.E)		Coefficient (S.E)		Coefficient (S.E)		Coefficient (S.E)	
lag_court	0.488 (0.102)	***	0.312 (0.118)	***	0.528 (0.076)	***	0.322 (0.094)	***
Spatial lag	0.135 (0.044)	***	0.183 (0.051)	***	-0.058 (0.050)		-0.036 (0.049)	
China circle	-0.015 (0.006)	**	-0.015 (0.012)		-0.012 (0.006)	*	-0.015 (0.010)	
foreign	0.014 (0.008)	*	0.019 (0.009)	**	0.005 (0.008)		0.005 (0.009)	
private	0.000 (0.001)		0.000 (0.002)		-0.000 (0.001)		-0.001 (0.002)	
soe	-0.001 (0.001)	*	-0.005 (0.002)	***	-0.001 (0.001)	*	-0.002 (0.001)	
gdp pc (logged)	-0.075 (0.064)		-0.226 (0.171)		0.043 (0.068)		0.174 (0.385)	**
service	0.001 (0.002)		0.002 (0.001)		-0.001 (0.001)		0.000 (0.001)	
gdp growth	0.017 (0.007)	**	0.026 (0.008)	***	0.010 (0.007)		0.002 (0.009)	
rural pop	-0.000 (0.001)		-0.000 (0.002)		0.001 (0.001)		0.001 (0.002)	
population (logged)	0.065 (0.024)	***	-1.333 (2.133)		0.069 (0.026)	***	-2.562 (1.808)	
Province fixed effects	NO		YES		NO		YES	
Year fixed effects	NO		NO		YES		YES	
Intercept	0.231 (0.272)		5.353 (6.446)		-0.117 (0.298)		7.783 (5.971)	
N	146		146		146		146	
Wald $\chi^2$	350.35		664.05		657.45		1106.39	

\* $p < .1$ , \*\* $p < .05$ , \*\*\* $p < .01$

spending will not induce Guangdong to move in the same direction.

### 5.4.3 Space is More Than Geography

As Beck, Gleditsch, and Beardsley (2006) argue: “Space is more than geography.” I specify another spatial-weighting matrix  $W$  which only connects prosperous provinces. This is consistent with Cai and Treisman (2005)’s argument that only well-endowed units discipline governments to compete for capital whereas poorly-endowed units give up. This insight is also consistent with my qualitative interviews. A court official in Dongguan City, Guangdong province, mentioned that his court only competes with courts located at a similar level of economic development, such as Guangzhou City and Shenzhen City.<sup>28</sup>

I calculate a new spatial lag,  $W2$ , again using a standardized binary contiguity-weights matrix, which begins by coding  $w_{ij} = 1$  for provinces  $i$  and  $j$  that (1) are located along China’s east coast, and (2) share borders, or (3) are provincial-level cities, and  $w_{ij} = 0$  otherwise. Because of Guangdong’s heavy weight in the national economy, it is considered one of the provincial-level cities along with Beijing, Shanghai, and Tianjin. Chongqing, though a provincial-level city, is not considered a member in this “club,” because of its low level of development.<sup>29</sup> I then row-standardize the resulting matrix by dividing each element by its row’s sum, making  $Wy$  the simple average of *Court* in  $i$ ’s “competitors.” Table 5.4 shows sample provinces and their competitors.

Table 5.5 shows the results of S-ML estimation of model (5.2) using the new spatial-lag.

As shown, the effects of key independent variables are in right directions. However, the coefficients on “foreign” that the nonspatial model found substantively

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<sup>28</sup>Subject # 10, interview with a court official, Dongguan City, Guangdong province, March 23, 2010.

<sup>29</sup>Chongqing became a provincial-level city in 1997 and still falls behind in terms of economic development. Chongqing’s per capita GDP in 2006 is 12,475 yuan, only 1/5 of Beijing’s.

Table 5.4: Sample Provinces and Their Competitors

<b>Province</b>	<b>Competitors</b>				
<b>Beijing</b>	Tianjin	Shanghai	Guangdong		
<b>Tianjin</b>	Beijing	Shanghai	Shandong	Guangdong	
<b>Hebei</b>					
<b>Liaoning</b>					
<b>Shanghai</b>	Beijing	Tianjin	Jiangsu	Zhejiang	Guangdong
<b>Jiangsu</b>	Shanghai	Shandong	Zhejiang		
<b>Zhejiang</b>	Shanghai	Jiangsu	Fujian		
<b>Anhui</b>					
<b>Fujian</b>	Zhejiang	Guangdong			
<b>Shandong</b>	Tianjin	Jiangsu			
<b>Henan</b>					
<b>Hunan</b>					
<b>Guangdong</b>	Beijing	Shanghai	Tianjin	Fujian	
<b>Guangxi</b>					
<b>Chongqing</b>					
<b>Sichuan</b>					
<b>Yunnan</b>					
<b>Shaanxi</b>					
<b>Gansu</b>					
<b>Qinghai</b>					
<b>Xinjiang</b>					

Table 5.5: Determinants of Court Spending: MLE of Spatial Interdependence Models II

Variable	Coefficient (S.E)	Coefficient (S.E)	Coefficient (S.E)	Coefficient (S.E)
lag_court	0.487 *** (0.104)	0.276 ** (0.119)	0.539 *** (0.074)	0.287 *** (0.096)
Spatial lag	0.009 (0.044)	0.349 *** (0.096)	-0.053 (0.034)	0.155 * (0.093)
China circle	-0.017 *** (0.006)	-0.011 (0.013)	-0.012 ** (0.006)	-0.013 (0.012)
foreign	0.014 (0.009)	0.016 * (0.009)	0.006 (0.007)	0.004 (0.008)
private	0.000 (0.001)	0.001 (0.002)	-0.000 (0.001)	-0.001 (0.002)
soe	-0.001 * (0.001)	-0.005 ** (0.002)	-0.002 ** (0.001)	-0.002 (0.002)
gdp pc (logged)	-0.069 (0.078)	-0.178 (0.175)	0.104 (0.085)	0.033 (0.381)
service	0.000 (0.002)	0.001 (0.001)	-0.001 (0.001)	0.000 (0.001)
gdp growth	0.021 *** (0.007)	0.027 *** (0.008)	0.012 * (0.007)	0.002 (0.008)
rural pop	-0.000 (0.001)	0.002 (0.002)	0.001 (0.001)	0.001 (0.002)
population (logged)	0.074 *** (0.025)	-2.060 (1.941)	0.062 ** (0.025)	-2.605 (1.676)
Province fixed effects	NO	YES	NO	YES
Year fixed effects	NO	NO	YES	YES
Intercept	0.204 (0.329)	7.273 (5.864)	-0.382 (0.349)	8.421 (5.606)
N	146	146	146	146
Wald $\chi^2$	301.98	744.94	705.97	1121.17

\* $p < .1$ , \*\* $p < .05$ , \*\*\* $p < .01$

and statistically significant are smaller in the spatio-temporal model. This suggests that nonspatial analysis of provincial court spending understated interdependence strength and overestimated foreign capital's roles.

Interestingly,  $\rho$ , coefficient of the new spatial lag, is significantly positive in column 4 now even when both province fixed effects and year fixed effects are included. This suggests that governments' financial supports to courts are "strategic complements" among prosperous provinces in China. One province's action will induce its competitor to move in the same direction. This finding lends support to Cai and Treisman (2005)'s insight that only well-endowed units compete for capital while poorly-endowed units are not in the race.

Whether there are race-to-the-top dynamics or race-to-the-bottom dynamics depends on what kinds of capital provinces are competing for. There are race-to-the-top dynamics among the competing provinces for foreign capital: an increase of foreign capital in province  $i$  will *increase* court spending in  $i$ , which will then induce  $i$ 's competitor  $j$  to *increase* its court spending. By contrast, there exist race-to-the-bottom dynamics among the competing provinces for investors from within the "China circle" and SOEs: an increase of "China circle" and SOEs in province  $i$  will *decrease* court spending in  $i$ , which will then induce  $i$ 's competitor  $j$  to *decrease* its court spending.

In sum, this section finds preliminary evidence of spatial-interdependence among China's most prosperous provinces. And empirical analyses suggest race-to-the-top dynamics among coastal provinces competing for foreign capital from outside the "China circle," and race-to-the-bottom dynamics among coastal provinces competing for SOEs and capital from within the "China circle."

## 5.5 Discussion

The empirical evidence from provincial government spending on courts in 1995-2006 is consistent with the theoretical argument. While foreign capital from outside the “China circle” push Chinese local governments to strengthen courts by providing more financial support, state-owned enterprises, private enterprises, and foreign capital from within the “China circle” discourage local governments from spending money on courts.

What this finding implies partly contradicts the new institutional economics which argues that property holders will demand a limited government under which the ruler and asset holders share power (North and Weingast, 1989). What has been found in China is that domestic investors and investors from within the “China circle” are blocking legal reforms. A strong legal system is conducive not only to the protection of domestic capital but also to the protection of foreign capital. Facing competition from the foreign side, domestic investors have no interests in pushing for legal reforms. Instead, domestic investors have a strong incentive to obstruct legal reforms to consolidate their comparative advantages in conducting business in China. Domestic firms and firms run by ethnic Chinese who have political connections with Chinese government have hindered China’s progress towards rule of law.

The findings also contradict the classic modernization theory which argues that the level of economic development will explain the emergence of democracy and rule of law (Rostow, 1960, 1971; Organski, 1965). The assumption on which classic modernization theory depends is that as the economy develops, the middle class will emerge, and the middle class will demand democracy and rule of law. As Moore (1966, 430) succinctly summaries, “No bourgeois, no democracy.” However, classic modernization theory fails to examine the heterogeneity of the middle class. As this research shows, asset holders have different preferences for the rule of law.

And the preference is a function of asset holders' existing or potential connection with the ruler. Politically connected asset holders have no interests to push for rule of law which benefits politically unconnected asset holders.

The empirical results show that the speed of economic development (GDP growth rate) has a positive sign. This finding is consistent with my earlier research on people's preference for courts in China. In Shen and Wang (2009), we showed that people in faster growing counties are more likely to go to court when having disputes. This is because a growing economy ruins the traditional social network that people have been relying on to settle disputes, which therefore makes going to court an attractive option. In a transition from a traditional economy to a market economy, the conventional way of dispute settlement, such as mediation, lost its strength as economic activities are more complicated and economic actors are more mobile. The state, as a third party force, gradually substitutes social networks as the major contract enforcer.

The findings also show the limitations of China's civil society. Though China's legal profession flourishes, and lawyers becomes more professional, their influence on the political arena is still inadequate. This is due to the strict control of the state. All law firms in China need to register at the local legal bureau (*sifaju*), which is part of the government. On their daily operation, law firms are expected to follow the Party's guiding principles and government policies. When these principles and policies contradict laws, lawyers are supposed to stick to the former rather than the latter. Especially in politically sensitive cases, such as cases involving dissidents, lawyers' work is to defend the state rather than defend the plaintiff or the defendant. Another way the state controls law firms is that party branches are encouraged to be established in every law firm that has more than three party members. Lawyers with party membership have higher political status than non party members. Lawyers in China also act as "fire alarms" to monitor possible

social unrest. A lawyer told me that, as of 2009, a new policy states that if more than 10 people are involved in a labor dispute, the lawyer should report the case to the local legal bureau<sup>30</sup>. Given these constraints, lawyers' political power is very limited.

## 5.6 Concluding Remarks

This chapter has argued that Chinese provincial government's inclination to finance courts is related to the ownership structure of the local economy. In places where there is a large share of FIEs from outside the "China circle" in the local economy, provincial governments are likely to allocate a bigger percentage of the fiscal budget to courts; whereas in places where there is a large share of SOEs, private enterprises, and FIEs from within the "China circle" in the local economy, governments are less likely to finance courts. Drawing on qualitative elite interviews and quantitative analysis of an original time-series cross-section data set of provincial government spending on courts in 1995-2006, this chapter has empirically tested this theory.

In addition, utilizing the techniques of spatial econometrics, this chapter shows preliminary evidence that provinces in China compete in court spending to prevent capital in their jurisdictions from moving. But competition only exists among prosperous provinces; among mid-income and poorly endowed provinces, the competition effect disappears.

This research illuminates two puzzling facts in Chinese politics. One concerns how China has achieved rapid economic growth with a weak legal system (Montinola, Qian, and Weingast, 1995). Unlike existing literature, which focuses on government protection of property (Oi, 1992; Montinola, Qian, and Weingast, 1995; Whiting, 2000; Clarke, Murrell, and Whiting, 2008), this research shows that the

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<sup>30</sup>Subject #22, interview in Guangdong, March 29, 2010.

Chinese government has also relied on the formal legal institutions to make a credible commitment to foreign investors who do not have political connections in China. By strengthening local courts, Chinese local governments have been able to provide a more fair and efficient legal environment for foreign investors to do business and prevent them from moving. The “myth” of China’s growth lies not only in the bureaucracy but also in the legal institutions.

The second puzzling fact concerns why Chinese authoritarianism is so resilient despite a fast growing economy (Nathan, 2003). As this research implies, the Chinese governments have been using different institutions to co-opt asset holders who might push for democracy. Through the cadre evaluation system, the Chinese state incentivizes local agents to protect properties of asset holders. The local state agents utilize patron-client ties to protect domestic capital on one hand and the formal legal institutions to protect foreign investors on the other hand. Investors from both home and abroad have become “allies of the state” (Chen and Dickson, 2010), who cooperate with the Chinese state to delay democracy in China (Gallagher, 2002).

## CHAPTER VI

### Conclusion

This dissertation tracks the development of China's formal legal institutions across space and over time, arguing that the variation of the rule of law at the sub-national level in China is caused by the diversification of ownership structure in the local economy. In places where there is a large share of foreign invested enterprises (FIEs) from outside the "China circle," local governments are more likely to finance courts, and courts are less likely to be corrupt; in places where there is a large share of state-owned enterprises, domestic private enterprises, and foreign enterprises from within the "China circle," local governments are less likely to finance courts, and courts are more likely to be corrupt.

Foreign investors from outside the "China circle" have a stronger preference for judicial impartiality than domestic and ethnic Chinese investors. The reasons are twofold. Firstly, when foreign investors arrived in China, the market in coastal areas was already occupied by domestic and ethnic Chinese investors who had a language advantage and had already built strong connections with the Chinese government. To have a fair competing environment, foreign investors were more likely to demand that local governments act according to the law. In addition, foreign investors are subject to stricter internal auditing rules and anti-corruption rules imposed by their countries of origin. Conversely, domestic investors and

ethnic Chinese investors prefer administrative channels in enforcing contracts and settling disputes. The lack of fiscal constraints enables domestic and ethnic Chinese firms to build clientelistic ties with local governments through which properties are protected in a more efficient and effective way than going to court.

This dissertation also argues that Chinese governments at various levels only seek to improve judicial impartiality and judicial efficiency in the commercial realm. Through the *nomenclatura* system and the financial system, the CCP and the Chinese government still hold strong sway over the judiciary to limit ordinary citizens' opportunities to challenge the state in the political and civil realms. As a consequence, the incentive to provide credible commitment to foreign investors from outside the "China circle" contributes to the rise of a limited form of the rule of law where commercial disputes are settled in an increasingly fair fashion whereas judicial unfairness is still prevalent in cases involving ordinary citizens.

This dissertation proposes a rational choice explanation rather than a cultural explanation of the rise of limited rule of law in China. Foreign investors exert a positive influence on China's legal reforms not because foreign investors are noble. Foreign investors, like domestic investors, come to China to conduct business to earn profits, not to promote the rule of law. It is an unintended consequence for foreign investors to push the building of the rule of law in China, because foreign investors can maximize their profits in a more efficient way under a fair legal environment than a biased legal environment. This dissertation does not imply that foreign investors will always exert a positive effect in the future. As foreign investors have gotten used to China's business environment and learned to conduct business in a Chinese way, the positive influence of foreign capital on rule of law is likely to be diluted. As the theory predicts, new businesses (domestic or foreign) who do not have strong political connection but have strong bargaining power will continue to push for the rule of law.

Methodologically, this dissertation combines both qualitative and quantitative research. On the qualitative side, the researcher conducted over a hundred interviews with Party and government officials, judges, investors, scholars, litigants, and ordinary citizens in Beijing, Liaoning, Jiangsu, Shanghai, Jiangxi, Guangdong, and Hainan provinces during the summer of 2007 and spring and summer of 2010. On the quantitative side, the researcher compiled and analyzed three original data sets. The first data set includes survey data of ordinary citizens across mainland China's 102 counties in 2003 matched by yearbook statistics on the local political economy. The second combines business survey data in mainland China's 120 cities in 2005 and yearbook statistics of local economy. The third is comprised of variables on provincial government budgets and other demographic and economic aspects of mainland China's 31 provinces over the time period of 1995-2006.

## 6.1 Limitations

This dissertation falls short of uncovering the causal mechanisms that link investors, government actions, and court quality. Although empirical evidence has supported that there are causal links between investors and government action (Chapter V), investors and court quality (Chapter IV), and government action and court quality (Chapter IV), this research has not been able to test this causal chain in a unified econometric model. This is partly due to data availability: measures of the three variables - investors, government actions, and court quality - do not exist simultaneously at the same level. While data on investors exist on provincial, prefectural, and county levels, measure of court spending only exists at the provincial level<sup>1</sup>, and measures of court quality only exist at the prefectural level.

With improvement in data availability and taking advantage of the recent de-

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<sup>1</sup>The "finances" variable in Chapter IV is an aggregate measure of spending on the police, the procuratorate, courts, and legal bureaus.

velopment in econometric techniques in identifying and testing causal mediation effects (Imai, Keele, and Yamamoto, 2010; Imai, Keele, and Tingley, 2010; Imai et al., 2010), future research is possible to uncover this causal chain more thoroughly.

This problem also requires more qualitative research to investigate how investors influence government actions and how governments reform courts accordingly. Several possible channels for business lobbying exist in China. Formal channels include local people's congresses, local people's political consultative conferences, business associations, non-governmental organizations, and lobbying through a foreign government; informal channels include personal contacts, tax evasion, work stoppage, and protests and demonstrations. Government actions include reforming institutions (e.g. centralizing the court fiscal system and raising the bar of judge qualifications), staffing professional judges, providing more financial support, and implementing stricter anti-corruption campaigns, etc. More thorough field research is needed to examine these mechanisms.

## **6.2 Major Contributions**

This dissertation makes a contribution to four strands of literature in comparative politics. Firstly, this research offers a tentative explanation for why authoritarian rulers, equipped with guns and tanks, rule according to law. As this thesis argues, Chinese local officials tie their hands to seek cooperation of asset holders who rely on formal legal institutions for contract enforcement and dispute settlement. By using a mixture of governmental apparatus and legal apparatus, Chinese local governments have designed ways to suit investors from both home and abroad who help local officials fulfill their goals. By creating new constituents from asset holders whose interests are tied to the ruler's survival, the Chinese authoritarianism has been resilient despite rapid social and economic changes.

As Moustafa and Ginsburg (2008, 4-11) summarize, there are five primary func-

tions of courts in authoritarian states. Courts are used to

1. (social control) establish social control and sideline political opponents,
2. (legitimation) bolster a regime's claim to "legal" legitimacy,
3. (monitoring agents) strengthen administrative compliance within the state's own bureaucratic machinery and solve coordination problems among competing factions within the regime,
4. (credible commitment) facilitate trade and investment, and
5. (blame shifting) implement controversial policies so as to allow political distance from core elements of the regime.

As this research suggests, the "legitimation" function and the "credible commitment" function are interrelated in China. The Chinese Communist Party strengthened the court system to provide credible commitment to foreign investors who contribute to economic growth which further help legitimize the Party's rule. As Chapter III shows, courts in China perform the function of controlling the society and maintaining social stability. And as some of the recent cases (e.g. Liu Xiaobo's trial in court) suggest, legal institutions are used by the regime to sideline political opponents. But this research does not find strong evidence that social control is a major driving force for legal reforms. As empirical findings in Chapter V show, the number of cases accepted by courts does not affect provincial governments' financial support to courts. This implies that settling disputes is not a major concern in legal reforms, for most disputes in China are settled through alternative dispute resolution (ADR) mechanisms, such as arbitration and mediation. Sidelineing political dissidents is not salient enough to drive legal reforms, because, first of all, dissidents are small in number; secondly, sidelining political opponents has been a task for the Chinese government since the 1950s (counter-revolutionaries,

landlords, capitalists, rightists, etc.), it alone cannot explain why legal reforms only started in the 1990s. “Monitoring agents” might be a rationale for strengthening local courts; but as Chapter III argues, local courts have not served as effective tools for the center to monitor its local agents, because local courts are controlled by local governments and information about local injustice are often covered by repression. Lastly, “blame shifting” is not likely to work in China. Because of lack of judicial independence, ordinary citizens rarely separate courts from other Party and government organizations.

This research echoes more with the “credible commitment” argument. The findings in this dissertation are consistent with the theoretical insights found in North and Weingast (1989), North (1990), Weingast (1997), Root and May (2008). The courts-FDI dynamics found in this dissertation are also consistent with Gallagher (2002)’s argument that FDI has contributed to the delay of democracy in China. Whether the findings in China are generalizable to other authoritarian regimes is in question. As Ahlquist and Prakash (2008, 320) argue, “While there is a substantial literature to explain how host country institutions influence the location, amount, entry mode, and timing of FDI, the literature on how FDI might affect host country political institutions remains relatively underdeveloped.” Among the few studies in this line of thinking, Ahlquist and Prakash (2008) argue that higher levels of FDI inflows are associated with greater confidence in commercial contracts and, by extension, the protection of property rights in developing countries. Larrain and Tavares (2004) find that FDI as a share of GDP is significantly associated with lower corruption levels analyzing a broad cross section of countries over the period of 1970-1994. Fukumi and Nishijima (2009) through a panel analysis of 19 countries in Latin America and the Caribbean find that FDI could improve the quality of institutions. Kwok and Tadesse (2006) through analyzing a large sample of countries over the last 30 years find that multinational corpora-

tions reduce the level of corruption in the host countries. However, very few studies have been done in a sample of authoritarian regimes. This is partly due to the lack of reliable data in authoritarian regimes. More thorough and cross-national research needs to be conducted in this field.

Secondly, this dissertation makes a contribution to the empirical study of FDI. While most studies have been focused on how FDI *as a whole* changes the host country's governance and policies, for example, Prakash and Potoski (2006)'s study on environmental practices, Ahlquist and Prakash (2008)'s study on contracting confidence, Larrain and Tavares (2004)'s study on corruption, Neumayer and De Soysa (2005)'s study on child labor, and Figlio and Blonigen (2000)'s study on local government budgets, few studies have differentiated FDI by their sources. As this research shows, foreign investors have different incentives shaped by the investment environments *and* their countries of origin. Especially, the regulatory regimes in the countries of origin have a non-ignorable influence on how investors conduct business in a foreign country. Further research will benefit from a larger variation in FDI's influences by disaggregating foreign investors by their countries of origin.

Thirdly, this dissertation is one of a few empirical attempts to investigate how one government's action of strengthening its court system affects a connected government's action. It is well documented that competition for capital will induce governments to engage in "race-to-the-bottom" or "race-to-the-top" dynamics. The "race-to-the-bottom" school argues that the fear of capital outflows weakens governments' incentive of providing welfare services, environmental regulations, and nonproductive public goods that citizens value (Oates, 1972; Zodrow and Mieszkowski, 1986; Keen and Marchand, 1996; Cumberland, 1981; Rom, Peterson, and Scheve, 1998; Rodrik, 1997; Schulze and Ursprung, 1999). By contrast, "race-to-the-top" scholars argue that the competition for capital motivates governments to reduce their corruption, waste, and inefficiency, and to provide more growth-promoting

infrastructure (Qian and Roland, 1998; Montinola, Qian, and Weingast, 1995; Obstfeld, 1998; Stiglitz, 2000). Although the two sides disagree about whether such competition is desirable, they agree that it exists. However, as Cai and Treisman (2005) show, in a theoretical model, that whether competition for capital disciplines government depends on factor endowment of the localities. They argue that the discipline effect only exists among well endowed units but disappears in poorly endowed units because poorly endowed units are not in the race.

Empirical evidence is still lacking in supporting Cai and Treisman (2005).<sup>2</sup> Previous studies have also not defined conditions under which “race-to-the-top” or “race-to-the-bottom” dynamics emerge. This dissertation research shows preliminary evidence that only prosperous provinces in China engage in competition in court spending for preventing the outflow of foreign investors; this competition, however, does not exist among mid-income and poor provinces. In addition, this dissertation argues that whether there are “race-to-the-top” or “race-to-the-bottom” dynamics *depends* on what types of capital governments are competing for. If governments are competing for foreign capital from outside the “China circle,” there are “race-to-the-top” dynamics in court spending; if governments are competing for SOEs, domestic private enterprises, and ethnic Chinese investors, there are “race-to-the-bottom” dynamics in court spending.

Lastly, this research adds a new dimension to existing answers to a puzzle: how can China achieve fast economic growth with a weak legal system? Unlike previous explanations which focus on administrative decentralization, fiscal decentralization, and the cadre management system (Oi, 1992; Montinola, Qian, and Weingast, 1995; Whiting, 2000), this thesis argues that China’s legal system is adapting quickly to the changing political and economic environments. A marketized and diversified economy has nurtured an increasingly fair, efficient, and

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<sup>2</sup>A search through Google Scholar did not show one empirical research that tests this theory.

effective judicial system that reciprocally supports an increasingly complex and rights-conscious economy.

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