

China's Evolving (Implicit) Economic Constitution¹

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1. Introduction

This paper addresses a puzzle that arises from China's thus far highly successful economic transformation. While not speaking directly to China's situation, in his observations concerning the importance of pre-commitment for economic efficiency, Elster (1995) captures the essence of the China puzzle.

I suggest that pre-commitment – to be credible and effective – needs democracy, that is, the possession and exercise of political rights....The promises of an executive are much more credible if there is a well-established procedure for throwing the executive out of office for failing to keep those promises....In summary, economic efficiency often requires pre-commitment, which – to be credible – requires that citizens be endowed with effective political rights. (p. 215).

How, in light of this widely held perspective, has China, governed by a communist party, achieved such a robust economic performance? With a constitution that prohibits “sabotage of the socialist system” and imposes minimal constraints on the power of the state, what accounts for China's burgeoning market economy and its ability to move repeatedly to the next level of economic prosperity?

This essay argues that China's operative legal and regulatory framework that governs economic decision-making is absorbing international law and enforcement procedures at unprecedented speed. Through the process of international economic treaty making, China has adopted a set of pre-commitment devices that is effectively meeting the rising standards of predictability and accountability required to attract new rounds of investment and technology. China's ability to incorporate an expanding body of international law and obligations into its legal fabric results in part from the ambiguous, ineffectual nature of its constitution. It is the “admixture of formal rules, informal norms, and enforcement characteristics” (North, 1994, p. 366), with, in this case, *international* characteristics, that increasingly guides the decision-making of China's political leadership, its administrative apparatus, its court system, and its tens of millions of commercial entities.

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2. Constitutional economics

What is a constitution? Why do constitutions matter for economic performance? Elster stresses the fluid nature of national constitutions. According to Elster, the rules that comprise a constitution may be written or unwritten, effective or ineffective. For Buchanan (1987), the essential task of constitutional economics is to understand “the working properties of alternative sets of legal-institutional-constitutional rules that constrain the choices and activities of economic and political agents, the rules that define the framework within which the ordinary choices of economic and political agents are made” (p. 585). In light of these broad conceptions of constitutions, this essay focuses its analysis on the working properties of “framework rules.”

Framework rules include both formal and informal rules. North (1994) argues that, in order to be effective, the formal constraints embodied in the set of rules must be consistent with informal constraints, such as norms of behavior, conventions, and self-imposed codes of conduct (p. 360). In the case of China, within the economic arena, we observe an increasing confluence of both formal and informal rules – the essential framework rules - with international norms.

Why does a constitution, or a set of framework rules, matter for economic performance? According to Elster, “...constitutions matter for economic performance to the extent that they promote the values of stability, accountability, and credibility” (p. 210). Elster emphasizes “the centrality of the idea that constitutions serve as pre-commitment devices” (p. 211). Pre-commitment devices serve to reduce transactions costs, defined by North as “the costs of specifying what is being exchanged and of enforcing the consequent agreements” (p. 361). From North’s perspective, a nation’s economic institutions that embody pre-commitment devices “... form the incentive structure of a society, and...are the underlying determinants of economic performance” (p. 359).

3. China’s constitution

What is particularly striking about China’s constitution are the seemingly contradictory provisions and resulting discretion for interpretation. The new Constitution adopted in 1982 simultaneously guarantees that “Citizens of the People’s Republic of China enjoy freedom of speech, of the press, of assembly, of association, of procession, and of demonstration” [Article 35], proclaiming that “The personal freedom of citizens of the People’s Republic of China is inviolable...” [Article 37]. Yet, the same document requires that “The exercise by citizens of the People’s Republic of China of their freedoms and rights may not infringe upon the interests of the state, of society, and of the collective, or upon the lawful freedoms and rights of other citizens” [Article 51]. In addition, “Citizens of the People’s Republic of China must...keep state secrets, protect public property, and observe labor discipline and public order and respect social ethics” [Article 53].

This ambiguity with respect to rules that govern civil rights extends to the realm of economic organization and individual economic rights. Although, according to an amendment of 1988, “The state protects the lawful rights and interests of the private sector of the economy” [Article 11], the Constitution also requires that “The socialist system is the basic system of the People’s Republic of China. Sabotage of the socialist system by any organization or individual is prohibited” [Article 1]. Furthermore, “The basis of the socialist economic system of the People’s Republic of China is socialist public ownership of the means of production...” [Article 6].

Conspicuously missing from China’s constitution are provisions regarding the right of individuals to enter into economic contracts and to secure private property against the power of the state. While the U.S. constitution makes clear limitations on the power of the state to expropriate private property,² the Chinese constitution does not. Contradictions and ambiguity within the Constitution at once opens the door to the abuse of private property, while, at the same time, opening the door to the creation of a capitalist system.

4. The interaction of domestic and international law

At the international level, the International Monetary Fund (IMF), the World Bank, and the World Trade Organization (WTO) establish the legal framework for international monetary and financial matters as well as for trade. China’s resumption of its membership with the IMF and World Bank in 1980 marked a major step in reentering the international economy. Later, in 1988, China formally joined the Multilateral Investment Guarantee Agency (MIGA), pledging to embrace the principles and procedures of that international organization. China’s participation in MIGA illustrates the profound implications of the international treaty making process for China’s economy.

For the purpose of encouraging foreign investment to developing countries, MIGA extends guarantees to “alleviate concerns related to non-commercial risks” [Preamble].³ When a dispute arises between a foreign investor and a national government, both parties agree under MIGA procedures to submit to a dispute settlement mechanism. Subsequent to a negotiation and conciliation process, unresolved disputes are subject of an arbitration procedure. Under Article 57 of the MIGA Convention, a three-person tribunal is empowered to resolve the matter.

If MIGA finds that the host country is at fault and is liable for compensating the foreign investment entity, MIGA automatically honors its insurance contract with the firm and then turns to the national government for compensation. The existence of MIGA therefore (i) transforms a nation’s obligation not to expropriate from that to an individual firm to an international organization and (ii) thereby pre-commits the national government to fulfilling its treaty with the international organization.

² Of course, such restrictions were further clarified in subsequent court proceedings, notably the Dartmouth College Case of 1819 that limits the control a state government may have over a corporate charter.

³ www.miga.org/screens/about/convent/convent.htm (p. 3 of 29).

According to international law, host countries are entitled to regulate foreign investment.⁴ However, by accepting membership in MIGA, national governments accept limitations on their sovereignty. China’s civil code has been revised to accept explicitly this infringement on its national legal sovereignty.⁵ According to Article 142, of China Civil Code (1986):

If there is a conflict between civil laws of the People’s Republic of China (PRC) and international treaties contracted or joined by the PRC, international treaties will apply with exception of reservations made by the PRC while contracting or joining.”

Table 1: International Economic Agreements

Organization	Principle/commitment	Enforcement procedure
<i>International Monetary Fund</i> ⁶ (IMF); joined April 1980.	Article IV, Section 1 of the Articles of Agreement: each member shall (i) “endeavor to direct its economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability...;(ii) seek to promote stability by fostering orderly underlying economic and financial conditions...;(iii) avoid manipulating exchange rates...;and (iv) follow exchange policies compatible with...this section.”	Article IV, Section 3: “The Fund shall oversee the...compliance of each member with its obligations....Each member shall provide the Fund with the information necessary for such surveillance.... Article XXVI, Section 2: If a member fails to fulfill any of its obligations ...the Fund may declare the member ineligible to use the general resources of the Fund....If the member persists in its failure to fulfill any of its obligations under this Agreement, (it) may be required to withdraw from membership in the Fund....
<i>World Trade Organization</i> ⁷ (WTO); joined December, 2001.	The WTO oversees a wide range of multi-lateral agreements relating to trade in goods and services, intellectual property, dispute settlement, and trade policy reviews. The WTO agreements spell out the principles of liberalization and uniform national treatment for all domestic and foreign firms. Trade policy is required to be transparent. For China, key commitments include explicit schedules for lower customs tariffs and relaxed restrictions on FDI for financial services, insurance, and telecommunications.	The WTO’s Dispute Settlement system is based on clearly defined rules with timetables for completing a case. Initial rulings are made by a panel and endorsed (or rejected) by the WTOs full membership; appeals based on points of law are possible. All final rulings or decisions are made by the WTO’s full membership. No single country can block these.
<i>TRIPS (trade-related aspects of intellectual property rights)</i> ⁸ (apply to all WTO members). Sometimes characterize-ed as one of 3 “pillars” of the WTO, the others being trade in goods and trade in services.	TRIPS has detailed stipulations regarding the standards of acquisition, scope and use of intellectual property rights, which must be enforced by every member. All members must comply with obligations on national treatment (equal treatment for foreign and domestic individuals and companies) and most-favored nation treatment (non-discrimination among foreign individuals and companies).	China has committed to implement the agreement of TRIPS immediately upon accession to WTO – with no transition period. TRIPS has detailed provisions regarding the system of domestic legal remedies and on the principles of law enforcement. TRIPS also stipulates the powers of the judiciary in reviewing the decisions of administrative bodies...as well as circumstances in which the Customs may take custody of goods suspected of infringing intellectual property rights.

⁴ Charter of Economic Rights and Duties of States (UNGA Resolution 3281 of 1974) acknowledges each state’s right to regulate foreign investment.

⁵ For a more complete account of how China’s membership in MIGA has affected economic and legal reform in China, see Feng (undated).

⁶ www.imf.org/external/pubs/ft/aa/as04.htm

⁷ www.wto.org/english/res_e/doload_e/tif.pdf

⁸ www.wto.org/english/tratop_e/trips_e/tripfq_e.htm

Through this mechanism, China's obligations to MIGA and commitment to respect the rights of private foreign direct investment override relevant provisions of the Constitution, including language relating to the primacy of the "socialist system." Respect for the rights of foreign capital, as specified by the convention establishing MIGA therefore become, in Buchanan's words, "working properties" of "sets of...rules" that "define the framework within which the ordinary choices of economic and political agents are made." Table 1 summarizes other examples of international economic agreements that are reshaping China's body of framework rules.

5. The motivation

What motivates China leadership to cede vast swaths of China's legal sovereignty to the international system? China's political leadership does not secure its legitimacy through an electoral process. As such, it enjoys relatively little procedural legitimacy. Rather, the leadership's legitimacy is largely based on performance legitimacy. Broadly speaking, the leadership's legitimacy stands on three performance standards. These are rising economic prosperity, social stability, and national territorial integrity. Arguably, the first of these – rising economic prosperity – is the most important due to its instrumental value in successfully securing the other two performance standards.

If China is to capture economic benefits from participation in the international system, it faces a kind of all or nothing choice with respect to its acceptance of international law and treaty. In the 21st century, international trade and foreign investment are increasingly large scale, fast speed, and high frequency transactions that require the stability, accountability, and credibility that can be guaranteed only through full participation in the international legal and regulatory system. In the absence of a consistent, transparent commitment to this framework, traders and investors will move their exchanges and transactions elsewhere.

But how have China's decision-makers come to understand the critical role of international law in framing China's domestic economic system? It is the outcome of a learning process. James Buchanan (1979) insists that "a market is not competitive by assumption or by construction," but "*becomes* competitive, and competitive rules *come to be* established as institutions emerge" to shape behavior (p. 29, author's emphasis).

North (1994) describes this process, including the critical role of competition in motivating learning and the evolution of institutions.

While idle curiosity will result in learning, the rate of learning will reflect the intensity of competition among organizations. Competition, reflecting ubiquitous scarcity, induces organizations to engage in learning to survive, the degree of competition can and does vary. The greater the degree of monopoly power, the lower is the incentive to learn (p. 362).

Jefferson and Rawski (1995) propose a model of China's industrial reform, which they see as a cumulative process that begins when partial relaxation of the institutional

constraints associated with socialist planning initiates competition in the markets for industrial products. Facilitated by decentralization, which strengthens local incentives for economic development, competition reduces profits, creating financial pressures that induce technical innovations, promote economizing behavior, and stimulate fresh rounds of market-leaning institutional change (p. 134).⁹

Jefferson and Rawski define a seven-stage process culminating in the “creation of a market-based system as an endogenous outcome of the partial reform process” (p. 149). Writing in 1994, they observe:

The rise of pro-market sentiments among the political and administrative elite represents the biggest feedback of all in China’s partial reform process. In the early 1990s these changes coalesced into a stunning reversal of deep-seated attitudes. Ideas that only ten years earlier stood far beyond the limits of permissible discussion now took center stage...

Emphasizing a virtuous circle of reform – reform, competition, learning, and shifts in attitudes in favor of further reform – Jefferson and Rawski conclude, “Although official documents rarely use terms like ‘ownership reform’ or ‘privatization’ to describe these changes, recent initiatives amount to a policy of endogenous or induced privatization” (p. 150).

6. Conclusions

This essay attempts to capture the essential changes – notably China’s adoption of international rules – that frame China’s emerging economic institutions and decision processes. These changes are, of course, not limited to China; China is part of a process of “globalization of law.” According to China-Laws-Online:

The current trend is that international norms and national norms are being combined and unified at the speed and in the scale that are unprecedented. It is predictable that in the not long distant future the line dividing the national laws and that governing the international community will become so thin that it will have no practical significance....This is referred to as globalization of law.¹⁰

Clearly, for China, the line between the rules that frame economic activity in China and best international practice remains of substantial practical significance. What is most remarkable is the extent to which that line has narrowed in the past 20 years. North emphasizes the importance of adaptive rather than allocative efficiency as the key to long-run growth (p. 367). Three factors have driven China’s capacity to adapt. These are its relatively unformed domestic legal system, its decentralized administrative structure, which has nurtured entry and competition and thus learning, and the Chinese leadership’s singular quest for continuing economic prosperity as an avenue to political legitimacy.

⁹ See Qian and Weingast (1997), who develop this argument within the context of “federalism as a commitment to preserving market incentives.”

¹⁰ China-Laws-Online.com, p. 1 of 4.

The answer to the puzzle raised by Elster at the beginning of this essay is that the enforcement of pre-commitment originates with two sources. One is China's growing entrepreneurial population, which is now afforded membership in China's communist party. The other is international organizations and enforcement procedures, which are increasingly defining the relevant framework rules that govern China's economy.

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