

# **EDGS WORKING PAPER**

Number 1

“The China Problem Reconsidered:  
Property Rights and Economic Development in Northeast Asia”

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October 11, 2012

Presented as part of the “Property Rights, Power, and the Rule of Law” speaker series at the Equality Development and Globalization Studies (EDGS) program at Northwestern University, with generous support from the Rajawali Foundation.

**The “China Problem” Reconsidered:  
Property Rights and Economic Development in Northeast Asia**

Tom Ginsburg

This short essay concerns one of the great questions of contemporary economics and legal study: does the law have anything to do with why some countries are poor and others rich? This is, sadly, not merely an academic question, for poverty has remained a stubborn fact in the world today. The world’s richest countries, in per capita income, are Luxembourg and the United States, with per capita incomes of over \$50,000 and \$40,000, respectively. By contrast, the people of Sierra Leone survive on less than \$100 per year. Such stark disparities call out for analysis and action.

The idea that law might make a difference in economic outcomes goes back for millennia. For example, the classical Chinese philosophers seriously considered economic policy in their recommendations about how to order society. Confucius, who distrusted law as an instrument of social ordering, thought that the economy would thrive under a regime where law was little used. Without law, he argued, people would be motivated out of intrinsic desire to do right. In contrast, law would lead people to fear with consequent loss of productive capacity. Other philosophers, known today as the Legalist school, argued that people were lazy by nature, and required legal coercion and control to engage in productive activity.

Later thinkers also wondered whether law might make a difference in economic wellbeing. The great writer Charles Secondat de Montesquieu, considered to be the father of comparative law, was a proponent of commerce who thought that law could

facilitate wealth generation. Later, after the epochal changes brought about by the industrial revolution, classical social thinkers such as Marx and Weber speculated on the relationship between law and the economy. More recently, two waves of law and development activity in the late twentieth century have produced much new research into the question, yet there is relatively little consensus on the relationship between legal policy and economic development. Indeed, until the mid-1990s, the overarching emphasis in development policy was focused on issues such as capital transfers, macroeconomic stabilization and “getting the prices right” rather than institutions per se, despite overwhelming evidence that institutions (including legal institutions) make an enormous difference.

This essay focuses on a particular set of claims associated with the New Institutional Economics: that institutions that protect formal property rights and enforce formal contracts are essential for economic development. These claims have become the orthodoxy in the development community. Protections against opportunistic appropriation by others in the marketplace, and expropriation by state actors, facilitate the private investment decisions that underpin economic growth.

Some years ago, Professor Donald Clarke published an important article in the *American Journal of Comparative Law* in which he argued that the Chinese experience called into question the contract side of this equation. As he put it “whether contract rights are judicially enforced is less important than whether property rights are secure: the lack of an effective formal judicial system that enforces contract rights puts definitely out of reach only a relatively small number of growth-enhancing transactions, whereas the fear of confiscation of one's property by government makes a very large number of

growth-enhancing investments impossible.”<sup>1</sup> Clarke went on to argue that the literature had overemphasized formal institutions at the expense of informal ones, and provided numerous examples from the Chinese experience with state-led economic growth.

In this essay I argue that while Clarke was right, he did not go far enough in challenging the orthodoxy. The China experience forces us to refine our conceptions of property rights as well as contracting institutions. Notwithstanding great fanfare, China does a pretty poor job of protecting property rights as classically conceived: as bundles of entitlements that obtain to individuals or collectivities and are protected from outside interference. On the other hand, China has made an unmistakable commitment to a market economy, that is, to a property-respecting *regime*. Most people’s property is mostly respected most of the time, even in China. China thus illustrates a property-respecting regime without strong protection of individual property rights. Individuals who are not politically connected do have a form of security in property, but it results not from any certainty of formal or even informal enforcement so much as probabilities: the government cannot afford to expropriate everybody, and so most people need not fear for their property. The unlucky few whose property is in the way of development projects have no effective recourse. Such a regime can induce investments from individual entrepreneurs because it both allows certain development-oriented collective projects to proceed, while guaranteeing for the modal property holder an immunity from expropriation that is actuarial rather than legal: protection results from the low probability of being targeted.

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<sup>1</sup> Donald Clarke, *Economic Development and the Rights Hypothesis: The China Problem*, 51 *American Journal of Comparative Law* 89, 96 (2003).

The essay is organized as follows. The first part reviews the institutional economic arguments concerning law. Part II considers whether informal institutions can, in part, substitute for poor formal legal institutions. This has been a longstanding trope of literature on Asian capitalism. After considering the relative merits of informal and formal systems of enforcement, Part III reviews the literature on property rights and contract enforcement, arguing that, as classically conceived, neither has played a huge role in Chinese development. It then argues that China has a “property regime” without very strong protection of property rights. Part IV concludes.

## **I. Institutions and Growth**

The rules, actors and processes that make up the legal system are a subset of what are now known in the economics literature as institutions. The new institutional economics has argued persuasively that institutions, not factor endowments, provide the crucial variable in economic outcomes. To see why, consider Mancur Olson’s simple observation that there are at least two possible explanations for observed differences in wealth across countries.<sup>2</sup> First, national borders could mark differences in the scarcity of productive resources needed for development, so that poor countries are poor because they lack resources. Second, “national boundaries mark the borders of public policies and institutions that are not only different, but in some cases better and in other cases, worse....On this theory, the poorer countries do not have a structure of incentives that brings forth the productive cooperation that would [facilitate development], and the reason they don’t have it is that such structures do not emerge automatically as a

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<sup>2</sup> M. Olson, “Big Bills Left on the Sidewalk: Why Some Nations are Rich, and Others Poor,” 10 *J. Economic Perspectives* 3 (1996).

consequence of individual rationality. The structure of incentives depends not only on what economic policies are chosen in each period but also on the long run or institutional arrangements.”<sup>3</sup>

Olson then proceeds to show that “neither differences in endowments of any of the three classical aggregate factors of production [land, labor, and capital] nor differential access to technology explain much of the great variation in per capita incomes, we are left with the second of the two ... possibilities set out above: that much the most important explanation of the differences in income across countries is the difference in their economic policies and institutions.”<sup>4</sup> A final bit of information upon which Olson lays great stress is that, since World War II, there have been some countries that have been divided into two very different governance schemes—Taiwan, ROC and the People’s Republic of China, East and West Germany, North and South Korea. He uses this point to suggest that these divided countries share the same culture but they have very different economic growth experiences. So, it is something besides culture that explains the difference. What is the difference? Institutions.

A recent elaboration has been outlined by Daron Acemoglu, who contrasts the institutions of European colonization and suggests that they provides a “natural experiment” for drawing distinctions between geography and institutions. “The colonization experience transformed the institutions in many lands conquered or controlled by Europeans but, by and large, had no effect on their geographies. Therefore, if geography is the key factor determining the economic potential of an area or a country, the places that were rich before the arrival of the Europeans should have remained rich

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<sup>3</sup> *Id.*

<sup>4</sup> *Id.*

after the colonization experience and, in fact, should still be rich today. ... If, on the other hand, it is institutions that are central, then those places where good institutions were introduced or developed should be richer than those in which Europeans introduced or maintained extractive institutions to plunder resources or exploit the non-European population.” Briefly to elaborate this point, there were two very different kinds of European colonies. At one extreme, the Europeans went into a country simply to extract some resource from it, much as the Belgians did in the Congo or the other European nations did with regard to sugar in the Caribbean and minerals in Central and South America. At the other extreme, the Europeans set up colonies for the purpose of encouraging settlement by their own and other populations. Think of New Zealand, Australia, and the United States as examples.

Acemoglu’s point is that the institutions that the colonizers established in the two different kinds of colonies were very, very different. Where the Europeans sought only to extract resources, they set up institutions designed to further that end and only that end. They were not interested, for example, in setting up a general system of property rights or of impersonally effective contract rights and remedies. Their interest was to make the lives of the elites engaged in extraction as profitable as possible. In contrast, the colonizers designed institutions whose purpose was to make the lives of the settlers as much as possible like those that the Europeans had back in their parent countries. So, they established property rights systems, independent judiciaries, responsive governments and the like.

The new institutionalists emphasize two central roles for law and legal institutions: the protection of property rights and the enforcement of contracts. They

follow neo-classical economics in seeing individuals in the private sector as the primary source of innovation and ideas. Individuals, however, are threatened by expropriation from the state and appropriation from other persons with whom they contract.

Enforceable property rights and contract law, in this view, are central to economic functioning by enhancing predictability for entrepreneurs and reducing the costs of transacting. Law can play a crucial role in protecting entitlements and reducing transaction costs.

This comports well with the economic theory of regulation generally. In liberal theory, law exists to protect markets, but its regulatory role is limited to what are known as market failures. Market failures occur when the sum of behavior by individuals making rational decisions is not socially optimal. These come in several varieties: collective action problems; externalities; public goods; informational asymmetries; and strategic behavior. In these situations there should be some government or legal intervention to protect people from themselves. Systems that enforce property rights and enforce contracts are themselves public goods that reduce negative externalities.

## **II. Are Formal Institutions Necessary at All?**

One of the great virtues of the new institutional economics has been its emphasis on informal alternatives to formal institutions.<sup>5</sup> As early as 1963, Stewart Macauley

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<sup>5</sup> Douglass North, *Institutions, Institutional Change, and Economic Performance*, (New York: Cambridge University Press, 1993); Williamson "The Institutions and Governance of Economic Development and Reform," in M. Bruno and B. Pleskovic, eds., *Proceedings of the World Bank Annual Conference on Development Economics*. Washington, D.C.: World Bank. (1994:174) argues, "it is easy to assign too much weight to the institutional environment and too little to the institutions of governance. The exaggerated emphasis on court ordering (by the institutions of the state) over private ordering (by the immediate parties and affiliates to a transaction) is one illustration."



noted that formal law did not seem to be as important as had been suspected when he interviewed enterprise managers in the United States.<sup>6</sup> More recently, McMillan and Woodruff rely on interview data from Vietnam to find that entrepreneurs perceive little benefit from the formal legal system.<sup>7</sup> In these and many many other contexts, entrepreneurs are able to develop systems of private ordering that are able to overcome problems in formal contract enforcement. Informal alternatives to formal institutions include merger, arbitration, retaliation, altruism, and many others.<sup>8</sup>

One of the emphases in this literature is trust. Trust, as one of our colleagues has put it, “is a kind of social glue that allows people to interact at low transaction costs.”<sup>9</sup> Reducing transaction costs increases the resources available for production. Social psychologists have learned that different societies differ in their capacity to generate impersonal trust among their participants. In societies where people are likely to trust outsiders whom they don’t know, such as Japan and the United States, it is argued, that social cooperation is easier, and this has economic spillovers.<sup>10</sup> Fukuyama, for example, asserts that Japanese and American firms are larger than their equivalents in China and Taiwan because of the propensity of Japanese and Americans to trust others. This reduces problems of monitoring within the firm, a positive economic benefit. By analogy, networks of overseas traders or shared ethnic ties are able to rely on social bonds to

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<sup>6</sup> Stewart Macauley, “Non-Contractual Relations in Business: A Preliminary Study,” 28 *Am. Soc. Rev.* 55 (1963).

<sup>7</sup> McMillan, John, and Christopher Woodruff. 1999. "Interfirm Relationships and Informal Credit in Vietnam," 98 *Quarterly Journal of Economics* 1285-320.

<sup>8</sup> Richard A. Posner, *Creating a Legal Framework for Economic Development*, 13 World Bank Research Observer 1 (1998).

<sup>9</sup> Larry Ribstein, “Law vs. Trust”, 81 *B. U. L. Rev.* 553, 553 (2001).

<sup>10</sup> Francis Fukuyama, *Trust*, (New York: Free Press, 1995); See also Robert Putnam, *Making Democracy Work*, (Princeton University Press, 1993).

establish economic trust, giving them a comparative advantage in reducing transaction costs.

No doubt this type of network has an advantage in environments when legal protections are weak. The basic idea is that without law, one must limit exchange to those one knows and has social ties with. A key feature is the reputational enforcement mechanisms available to in-group members. A diamond merchant in Brooklyn who cheats another will suffer a severe sanction of being cast out of the group, losing potentially profitable future exchange possibilities.<sup>11</sup> The availability of these in-group enforcement mechanisms can make transacting within the group cheaper than transacting on the spot market.

A leading figure in this literature is Greif, who pursues historical and game theoretic lines of inquiry to explore the relative costs and benefits of the reliance on formal law versus informal mechanisms of market ordering.<sup>12</sup> Greif's original work was on long distance trade in the early modern world. He observed that traders were able to overcome problems of monitoring and enforcement of contracts with systems of private ordering, much as overseas Chinese traders continue to do today in Southeast Asian environments when formal protection of the legal system.<sup>13</sup>

In thinking about how informal institutions reduce transaction costs, Greif emphasizes enforcement more than information. Small groups may indeed be good

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<sup>11</sup> Lisa Bernstein, "Opting Out of the Legal System: Extra-contractual Relations in the Diamond Industry," 21 *J. Legal Stud.* 115 (1992).

<sup>12</sup> Avner Greif, "Contracting, Enforcement, and Efficiency: Economics Beyond the Law," in Annual World Bank Conference on Development Economics 1996 at 239-65.

<sup>13</sup> Doner, Richard, and Ben Ross Schneider. 2000. "Business Associations and Economic Development: Why Some Associations Contribute More Than Others," 2 *Business and Politics* 261-88.

vehicles for the transmission of information about a trader's reputation and reliability. But Greif points out that reputation matters in anonymous markets just as it does in networks. What truly distinguishes successful informal institutions from formal ones is the type of enforcement.<sup>14</sup>

Greif distinguishes collective and individualistic enforcement systems. Imagine that there are two groups in a society. Members can trade within the group or with members of the other group. Trades across groups are subject to general, impersonal legal regulation, so that defection will lead to a possible legal sanction, and will certainly lead to punishment by the cheated party. Within groups, however, collective enforcement mechanisms can operate. Any agent who defects in a transaction will be subject to collective punishment in the form of reduced opportunities for future trades.

The relative efficiency of the two different types of enforcement mechanisms cannot be deduced as a logical matter, but will greatly depend on technological factors, economies of scale, and other exogenous features. But certain parameters can be identified. For example, when economies of scale are not high, there may be an advantage for in-group, collectivized enforcement mechanisms which rely on personal knowledge and hence limit the number of potential exchange partners.

Studies of overseas Chinese firms illustrate both the strength and weakness of these kind of network features. On the one hand, informal enforcement has allowed the development of powerful networks in contexts where formal enforcement is weak. They have also allowed firms to weather difficult economic times—reports from the Asian

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<sup>14</sup> Greif, *supra* note 12.

economic crisis have suggested that socially connected firms were more easily to engage in “forgiving” behavior in difficult economic times.

On the other hand there are some weaknesses associated with collective enforcement mechanisms. One concerns scale. Overseas Chinese firms are famous for having the strengths and weaknesses of family business. One of the problems with family businesses is that they often have trouble delegating power to professional managers; another problem is the universal issue of succession of firm leadership. Family firms, too, have problems in that they often break up assets when succession occurs. If one comes from a culture of equal division of assets, multiple children of the founder will divide and dissipate the asset rather than keeping it together and this can limit scale. Large publicly traded firms have mechanisms that allow them to survive these kind of transitions by enforcing more or less objective measures of performance.

To be sure, size is not everything. The question of economies of scale will depend on the sector and product. Smaller firms, it has long been thought, have greater flexibility. In addition, they are the linchpin of a culture of entrepreneurship. The relative strengths of formal versus informal mechanisms will loosely track the advantages of small firms organized in networks as opposed to large integrated firms.

Still, one would be hard-pressed to celebrate informality as a general matter. De Soto, whose studies of the informal sector in Peru celebrated the energy and creativity of poor slum dwellers, explicitly calls for formalizing their institutions to the greatest extent possible. Remaining informal has costs, leaving the people subject to extortion from state actors, having to invest resources to avoid detection, minimizing investment in fixed

equipment, and keeping enterprises small. While these problems may not hinder the *legal* economy that relies only on informal enforcement, the problems are suggestive.

Collective mechanisms, once established, can crowd out potentially profitable inter-group exchanges. A member of one group who *seeks* to exchange with the other group might be giving a signal that he has been sanctioned by his own group. This would lead to intra-group transactions remaining the norm, even when inter-group transactions would be good.

What does this suggest for development policy? The policy implications are to take advantage of informality when it exists and reduce total reliance on formal institutions. For example, policymakers might promote information-sharing intermediate associations to help groups coordinate on expectations for what is to be punished and share information. Under certain economic circumstances, informal institutions of contract enforcement can function perfectly well.

But these are not all economic circumstances. Where a large number of exchange partners are desirable; where economies of scale suggest that larger enterprises will be more efficient; and possibly, where technological complexity requires some sophisticated assignment of entitlements and property rights, formal institutions will be preferable, and impersonal exchange enforcement should dominate.

In promoting formal legal institutions, policymakers must be careful not to crowd out informal enforcement.<sup>15</sup> Informal institutions can function even when formal institutions are available, and vice versa. But Ribstein argues that imposing mandatory

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<sup>15</sup> Larry Ribstein, "Law v. Trust," 81 *B.U. L. Rev.* 553 (2001).

rules onto parties can actually undermine informal trust mechanisms. A good legal policy will provide a set of formal institutions as to promote intergroup exchange.

To summarize, the informal institutions identified by scholars that apparently have played such an important role in economic development in Asia and elsewhere should be considered complements to formal legal development. Notwithstanding the power and scope of informal institutions, development policy should focus on the formal side.

### **III. The China Problem Redux: An Actuarial Theory of Property Rights Protection**

We are now in a position to say something about the China problem. If informal institutions can substitute for formal ones, then formal institutions are hardly necessary for economic development. We have many examples of informal contract institutions, many under the rubric of so-called relational contracting. What, however, about property rights? As laid out in the introduction, Professor Clarke's main claim was that contract had been overemphasized in the literature. The implication was that the minimal job for the watchman state that wishes to facilitate development is to protect property rights. After all, there are certainly limits to private substitutes for a property rights regime, given that the chief threat is expropriation by the state itself. How can informal institutions constrain the mighty formal powers of the executive?

One answer is provided in current Chinese practice, in which political institutions substitute for legal ones. Unable to rely on courts to protect their property rights, Chinese entrepreneurs seek alternative mechanisms to enhance security, mainly through providing a stake to local government, individual officials, or relatives of politically connected a

stake of some sort in. No doubt this is a pragmatic move in an environment with weak law, though it also implies distortion in investment allocation decisions.

It remains an open question, however, as to whether it really makes sense to speak of “rights” in Chinese property today. Since 2004, the Constitution has provided for private property, socialist property and property rights in land, all “in accordance with law”. The Constitution allows expropriation in the public interest and in accordance with the provisions of law, and requires compensation, though there is no provision as to whether the compensation should be full, fair, adequate or anything else. The constitutional requirement is thus met so long as any minimal compensation is offered, and by all accounts it is not always. In any case, the constitution is non-justiciable and so there is no mechanism for formal enforcement of these rights.

It would be wrong, however, to suggest that the constitution does not matter simply because of lack of justiciability. Indeed, if it was irrelevant, why would the Chinese Communist Party amend the document four times since 1982 (in 1988, 1993, 1999 and 2004)?<sup>16</sup> The constitution plays an important role as an authoritative ideological statement and communicative act.<sup>17</sup> The Chinese Communist Party uses constitutional amendments to signal new directions in policy. Elevation of a particular policy into the

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<sup>16</sup> The Constitution has been revised four times, reflecting China’s economic reforms. In 1988, the Constitution was revised to make reference to a private sector to complement the “socialist public economy.” Art. 11. It also provided for transfer of land use rights, even though land remained owned exclusively by the state or collectives. 1993 amendments added the phrase “socialism with Chinese characteristics” to the preamble and introduced the “socialist market economy,” incorporating Deng Xiaoping’s formula for a market-friendly economy. In 1999, a reference to the recently deceased Deng was incorporated into the preamble. In 2004, the Constitution was amended to guarantee private property and provide for compensation for expropriated land, an important signal for both foreign investors and China’s own market sector.

<sup>17</sup> Nathan 1988; Cao 2004: 122-40

constitutional text marks it as a legitimate basis for governance, and usually follows, rather than precedes, implementation. The constitution thus serves as a coordination device for internal discourse within the authoritarian regime. And it is a signal of political intention, raising the costs for violation.

It is not surprising that many of the aggrieved property owners whose assets have been sacrificed to the developmental imperative have invoked the constitution in protest. Their claims are not based in law, but in politics. The Party has made a public political commitment to property, and thus incurred the associated political costs from violations that have become rampant. Whether these commitments are best thought of in terms of *rights*, of course, depends on one's conception of what a right entails. In the broader view that rights consist of any justified claim, the Chinese regime meets the basic conception.<sup>18</sup> On the legal view that there can be no right without a remedy, in accordance with the Roman maxim *ubi jus ibi remedium*, the situation is doubtful.

In short, China presents a regime with phenomenal economic development and dubious protection of property rights. Does this pose a further “China Problem” to institutional economics literature, beyond the sketchy contract enforcement regime emphasized by Clarke?

I want to raise the distinction between a property-respecting regime and individual property rights. In the classic liberal conception the regime is the sum of individual entitlements. We speak of a property regime that aggregates the property rights of individuals into some higher order.

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<sup>18</sup> Eric Feldman, *THE RITUAL OF RIGHTS IN JAPAN* (2000).



The Chinese property regime is one of mostly credible political commitments to limits on expropriation, at the same time that any given individual has no secure entitlements. Surely most people's property is mostly respected most of the time. But if a local government decides to take one's land for a development project, there is very little that can be done about.

Let me elaborate on what I will call an *actuarial* theory of property protection. This theory is limited to what are known as developmental states.<sup>19</sup> Developmental states are those regimes that make a credible bargain with their citizens to pursue state-centered policies that will enhance economic development, and thus overall welfare. They are to be distinguished from liberal democracies, in which the state is to have only a minimal "watchman" role in the economy, and from parasitic authoritarian regimes, in which the ruling elite seeks only to maximize its own welfare and is not interested in providing public goods. North Korea or Zimbabwe might be an example of the latter. History's best examples of developmental states are found in China's neighbors, Japan, Korea and Taiwan, in the postwar period. The model was effectively introduced into the region during the Meiji era of Japanese development, surely the best historical analogue for contemporary Chinese experience.

In the developmental context, there is an implicit bargain between citizens and the state.<sup>20</sup> The citizens will forego rights and democracy, but the state will produce public goods. In the classic period of East Asian development, the state provided health care, housing, and good jobs to the citizens, who accepted a lack of political participation as the price to be paid. This does not mean the state was unconstrained. Should the

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<sup>19</sup> Chalmers Johnson, *MITI AND THE JAPANESE MIRACLE* (1982).

<sup>20</sup> Hilton Root.

government have failed to provide certain levels of public goods, its legitimacy would have been eroded. It is difficult to specify the precise mechanism whereby discipline would be imposed. In Singapore and pre-war Japan (postwar Japan fits the model uneasily because it was a democracy), constrained electoral competition provided information to the rulers. In Korea and Taiwan, the mechanisms were more subtle.

Specifically focusing on property for the moment, it is clear that property rights were generally protected during the high growth period for most people in Japan, Korea and Taiwan. But the exercise of formal property rights was conditioned through the exercise of administrative “guidance” by state bureaucrats who were ostensibly concerned with overall welfare. Occasionally ones formal rights were set aside, without “full” compensation.<sup>21</sup> This occurred in the pre-war period, for example when landlord-tenant disputes were shifted into a government sponsored mediation forum precisely so that they would not be adjudicated by relatively good quality courts. It also occurred in the context of large infrastructure projects, in which the overall developmental imperative was clear.

One component of the developmental state system was relatively weak courts. I’ve written elsewhere of what I call the Northeast Asian legal complex, which has its origins in Japan’s peculiar adoption of modern Western law in the 19<sup>th</sup> century, and its subsequent transfer of western-style legal institutions to its colonies in Korea and Taiwan.<sup>22</sup> The Northeast Asian legal complex had three main elements: a professional,

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<sup>21</sup> Frank K. Upham, “The Man Who Would Import: A Cautionary Tale about Bucking the System in Japan,” *Journal of Japanese Studies*, vol. 17, no. 2 (Summer 1991), pp. 323–43.

<sup>22</sup> *Law and the Liberal Transformation of the Northeast Asian Legal Complex in Korea and Taiwan*, in *FIGHTING FOR POLITICAL FREEDOM: COMPARATIVE STUDIES OF THE LEGAL COMPLEX AND POLITICAL LIBERALISM* 43- 63 (Terrence Halliday, Lucien Karpik and Malcolm Feeley, eds., Hart Publishing, 2007).

hierarchically organized, somewhat competent court system working in a small zone; a small, cartelized private legal profession without much independent political influence; and administrative law regimes that insulated bureaucratic discretion exercised by developmental regimes. These institutions interacted in a particular way that was internally consistent and stable, and understanding them provides insight into what was most important about law's role in the political economy of the high-growth era. Clearly this system does not perfectly translate into the Chinese context, where large numbers of legal professionals are being trained. But the core elements of limited courts and administrative flexibility seem to describe the situation well.

The regime's overall commitment to development means that there are practical and political limits on policy. Credibility is not established through legal or constitutional entrenchment, as in the classical liberal model, but through the predictable reaction of markets and citizens to policies that do not further the developmental imperative. Riots and the cost of capital are the mechanisms of discipline. Together they do limit the extent to which the regime can interfere with property rights. To illustrate, it is virtually unimaginable that China could engage in mass expropriations today along the lines of those that occurred in the early 1950s. The regime has no incentive to do so. But it surely can interfere with the rights of thousands, or even hundreds of thousands, of geographically concentrated citizens whose land stands in the way of a dam, highway or train line. There is no security in individual property, even as there is an overall commitment to property.

This paradox makes sense if one focuses attention on the overall constraint rather than the individual risk. Suppose there are 100 units of property in the economy, with an

implicit understanding that the government can expropriate up to 10 units for developmental purposes. Each expropriation after 10 will result in a large reputational penalty, regardless of its effect on overall welfare. Suppose further that compensation  $c$  for property of value 1 is a result of a probabilistic determination such that  $c$  is always less than 1. The typical model assumes that each expropriation with compensation  $c < 1$  will reduce incentives to invest because it will create a sense of insecurity among all other property holders in the system. But if the overall constraint is credible, each expropriation would have the opposite effect on investors. After the first expropriation, the odds of being expropriated have fallen from .10 to .09 (from 10/100 to 9/99). After the second, they have fallen further to .08, and so on, so that before the last expropriation, each investor has only a .01 chance of being the target. To be sure, the odds are still greater than a hypothetical regime in which property rights are perfectly protected. But overall welfare in developmental regimes may suffer from over-protection of property rights as much from under-protection, particularly if welfare-enhancing projects are limited by holdout problems.

I call this an actuarial model for obvious reasons. While no one has truly safe property rights, the overall constraint means that there are probabilistic limits on the ability of the state to expropriate, and this can induce investment with some confidence. The property-respecting regime can expropriate when needed for overall welfare, and individuals can operate with some security.

The key to the whole model is to set a credible and relatively transparent overall constraint on expropriation. In the context of the Northeast Asian developmental state, this may have been provided in part through Cold War geopolitics (though in Japan I

believe conventional constitutional and legal mechanisms were sufficient). Because the authoritarian regimes of Korea and Taiwan were dependent on the United States for overall security, and because both faced Leninist adversaries who projected an alternative vision of the nation, the claim to protect free markets was essential to their legitimacy. (Who can avoid laughing at the label “Free China” applied to Chiang Kai-shek’s regime on Taiwan?) Mass expropriations would not be feasible in such circumstances. With the odds of governmental interference being low, investors could be confident that property was actuarially secure, even if there was not necessarily protection for individual property holders.<sup>23</sup>

In China, the sources of constraint are less clear. I have argued above that they are provided through a combination of riot and market discipline, rather than the courts. The Party has staked its claim to legitimacy on continued economic growth, and so mass expropriations must be limited to welfare-enhancing infrastructure investments. Individual expropriations are of less concern, so long as they are isolated and do not surpass the overall constraint level.

### **Conclusion: The East Asian Challenge**

We still know surprisingly little about how individual legal reforms, available to policymakers in developing countries, produce positive economic outcomes. Causal relationships and specific explanatory trajectories are tricky to isolate. Perhaps the best

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<sup>23</sup> See Kuche Case, Korean Constitutional Court, 1992.

position can be summarized as saying that appropriate law is a necessary, but not sufficient condition for sustainable growth. Bad law hurts, but good law does not necessarily help without the presence of strong legal institutions. Still, sustained growth without the basic structures of a modern legal system is nearly impossible to contemplate in the current international environment.

The legal aspects of the East Asian development model have received relatively little attention to date.<sup>24</sup> Nevertheless, certain core features of legal institutions can be identified. First, the most successful East Asian countries, Japan, Korea and Taiwan, all shared the version of modern law associated with Japan's borrowing from Europe in the 19<sup>th</sup> century. This involved the adoption of core legal categories like the corporate form, as well as modern systems of property and contract law. Another important feature was institutional. All three countries had distinctive judicial branches which had absorbed, at least formally, the ideal of judicial autonomy. These branches were staffed by elites, so chosen by passing an extremely difficult exam, that in some sense reflected the legacy of Chinese imperial examinations. Thus, the basic structure of a modern legal system was in place and was staffed by high quality people with high status. These aspects of the Northeast Asian model seem to conform with the basic idea that law matters.

However, two elements of the East Asian experience differed. First was the limitation on the legal profession. The liberal model of law protecting private property and enforcing private contracts implicitly assumes some capacity in the legal system to

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<sup>24</sup> See Tom Ginsburg, "Does Law Matter for Economic Development? Evidence from East Asia," 34 *Law & Soc'y Rev.* 829 (2000); Katharina Pistor and Phillip Wellons, *The Role of Law and Legal Institutions in Asian Economic Development* (Asian Development Bank, 1997).

deal with these disputes. When lawyer availability is artificially constrained, as in East Asia, this represented at least a slight deviation from the model. A second point, more controversial, is the role of the state. Compared with the United States, administrative law was relatively undeveloped in East Asia. Judges tended to insulate the administration. This enabled the bureaucracies to act with some discretion and flexibility that certainly would not have been available to them had the public and interest groups been able to use administrative law to complicate policymaking. In short, the Northeast Asian model represented a different relation of state, law and economy, posing some challenge to conventional theories.

Observers of Chinese legal development have argued that it poses further challenges to the mainstream theories of the necessity of a well-functioning legal system as a precursor to economic development.<sup>25</sup> Broadly speaking, the challenge is that China has enjoyed rapid growth with a legal system that is even more marginal than that found in the capitalist economies of Northeast Asia at the outset of their rapid development experience. While the Northeast Asian countries had a functionally differentiated judiciary at the outset of their development period, China's judiciary has been staffed for much of the rapid growth period by ex-military officers. This lack of institutional autonomy and differentiation from the political system has been thought to be a constraint on economic development since the time of Max Weber. Clarke notes that "it is by no means clear that contracts are better enforced in China today than in China in the Qing dynasty or as far back as the Han two millennia ago, yet growth rates are surely very different."

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<sup>25</sup> Donald Clarke, *Economic Development and the Rights Hypothesis: The China Problem*, 51 Am. J. Comp. L. 89, 93 (2003).

I have argued that property institutions in China also force us to revise the conventional model in the new institutional economics. The key element for the Chinese regime, particularly in a context of rapid, state-led economic development, is not to provide universal protection against expropriation, but to transmit an effective overall constraint on the amount of expropriation that is tolerable. So long as the overall constraint is effective and credible, individual expropriations will actuarially *enhance* security of investment for those remaining within the system. If it is the overall property-respecting regime that is important, rather than individual property rights, then the institutional consequences are quite different. We need be much less concerned with legal security protected through autonomous, quality courts, so much as overall political constraints. Riot and market discipline, it seems, may be effective substitutes for law for the overall constraint of the regime, whereas they are clearly insufficient for individual cases.